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Dear Dora

Further consultation on design features of the Network Innovation Competition

I welcome the opportunity to contribute to the development of the Network Innovation Competition. Electricity North West has a good track-record of using the current innovation stimuli, namely the Innovation Funding Incentive (IFI) and the Low Carbon Networks Fund (LCN Fund), for the benefit of our stakeholders. Our view is that the LCN Fund has had a very positive impact on detailing the challenges for distribution network operators in the transition to a low carbon economy, understanding how the challenges will manifest into network problems and considering the potential solutions. Similarly, the Innovation Funding Incentive has been successful in bringing forward many developments that have improved quality of supply for customers. We hope the new Network Innovation Competition will have the same positive impact as its predecessor schemes, and are keen to be involved in its development.

We agree that RIIO and non-RIIO licensees should be eligible to participate in the Network Innovation Competition and all licensees should receive the Network Innovation Allowance and we see the governance arrangements and Ofgem's powers being extended to encompass all network licensees. The scope of Network Innovation Competition and the Network Innovation Allowance currently appears too narrow and we expect to see the governance documents detail the scope of eligible projects under the low carbon and environmental benefits criteria. We would be concerned if, for example, innovative projects focussed on customer service or quality of supply were not eligible for funding.

We have a concern that the competitive nature of the current Tier 2 process is actually stifling collaboration in some areas where collaboration will be essential for the efficient development of standards. We do not believe that this has caused any problems to date, but we believe the design of the future scheme needs to be mindful of the need for appropriate collaboration versus the innovative power of competition

We are concerned that the suggested percentage of the allowance that can be used to develop proposals is smaller than the current First Tier of the LCN Fund. We suggest that the value should not be defined within the governance arrangements but instead is submitted with and agreed as part of the acceptance of each company's Innovation Strategy. The current restriction on the percentage of project costs consumed internally within IFI should not be carried forward into the Network Innovation Allowance as there is a need for the companies to develop and apply specialist legal and commercial skills in their innovation plans.

We are sceptical as to whether the proposal to apply the current Second Tier LCN Fund evaluation process to the Network Innovation Competition will work as there are likely to be significantly more funding applications.

I have also made specific comments on the questions raised in the consultation letter in the attached Appendix.

Please do not hesitate to contact me if you have questions regarding my comments.

Yours sincerely,

A handwritten signature in cursive script that reads "Sarah Walls". The signature is written in black ink on a light-colored background.

Sarah Walls
Head of Economic Regulation

Appendix 1 – Consultation Questions

Below are specific responses to the questions raised in the consultation:

- i.* **Appetite for entry:** Electricity North West will be a RIIO licensee in the future and so is unable to comment on non-RIIO licensees' appetite, but we believe that non-RIIO licensees should be eligible to enter the Network Innovation Competition (NIC) and should be encouraged to be involved by allowing reasonable bid development costs to be recovered as per RIIO licensees. The success of the LCN Fund is in part attributable to the competitive process which drives innovation and the generation of viable 'value for money' business cases. We believe that non-RIIO licensees' participation will drive further the competitive nature of this element of the innovation stimuli.
- ii.* **Potential benefits:** It is important that we recognise that the aim of the competition is to develop future network models and/ or solutions and therefore involving all network licensees is essential to ensure the viability of potential solutions and that the learning outcomes are disseminated widely.
- iii.* **Meeting the evaluation criteria:** The evaluation criteria described in the September 2011 consultation appear appropriately balanced providing a wide set of criteria fulfilling the objectives whilst not placing any licensee in an advantageous position. The test of the opportunity for roll-out across GB is an important one and we would expect to see a wide range of projects with differing applicability rate. As long as this criterion is not given too much prominence over the other criteria then we see no reason why it should be removed or changed.
- iv.* **Potential barriers:** We have a concern that the competitive nature of the current Tier 2 process is actually stifling collaboration in some areas where collaboration will be essential for the efficient development of standards. We do not believe that this has caused any problems to date, but we believe the design of the future scheme needs to be mindful of the need for appropriate collaboration versus the innovative power of competition.

The governance process for the Network Innovation Competition may be put under a considerable strain if the volume of gas and electricity bids appears in the same volumes experienced by the LCN Fund. In its first year, the LCN Fund evaluated a project submitted by ~75% of all eligible licensees. Whilst the submission rate dropped in the second year to ~45% of licensees submitting one project, could the Network Innovation Competition's evaluation process handle at least 30 bids (ie ~75% of network licensees submitting a project proposal) of varying different sizes and complexity?

We urge Ofgem to examine the current LCN Fund process, mindful of the maximum numbers of bids the NIC process (both Initial Screening and Full Submission stages, especially as at the Initial Screening stage licensees may submit multiple outline bids) must manage and a realistic volume of bids it will likely manage, to decide whether it is a viable approach for the Network Innovation Competition. In addition, Ofgem should consider whether a single approach is appropriate for the range, size and complexity of likely projects.

- v.* **Funding bid submission:** We support the proposal to allow non-RIIO licensees to recover reasonable bid development costs as it will encourage non-RIIO licensees to participate in the Network Innovation Competition. But Ofgem must ensure that it has the appropriate powers to grant the recovery of costs and to gain reports from the non-RIIO licensee. We note that the recovery of bid development costs is not straight forward due to the relative price control arrangements of Independent Distribution Network Operators (IDNOs) and independent Gas Transporters (IGTs). For example, the bid development costs of a distribution network operator (DNO) are included in its allowed revenue and hence will be included in its use of system charges. So an IDNO operating a distribution

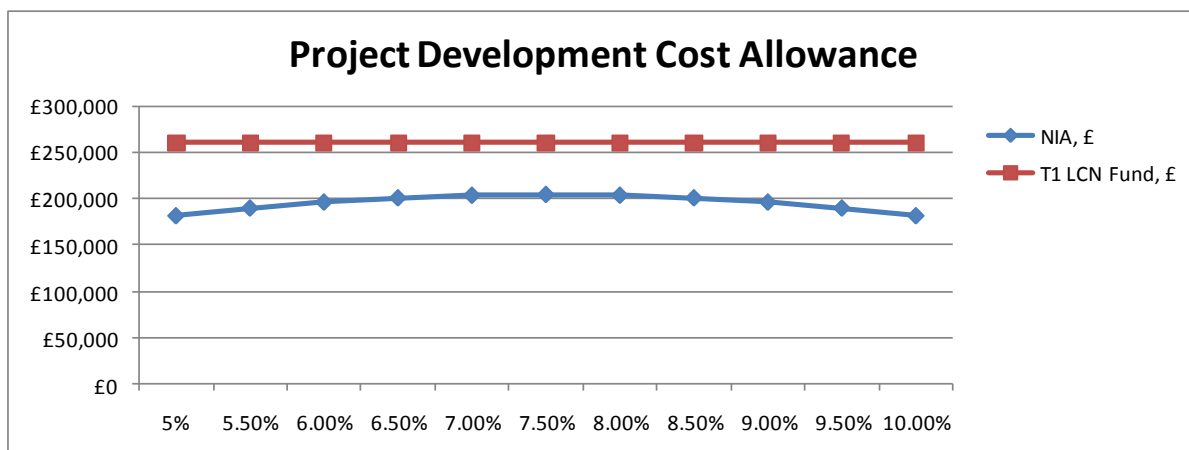
system with connected customers in that DNO's area will recover the proportion of the DNO's bid development costs from its customers due to the relative price control arrangements. This is unlikely to provide sufficient funds to finance the development of bids for an IDNO. But it is not appropriate to break the relative price control arrangements and allow an IDNO or IGT to recover reasonable bid development costs directly from its customers. However the bid submission costs are recovered, the value recovered from its customers relating to a host DNO's bid submission costs should be recorded, reported and disallowed from an IDNO's or IGT's bid development allowance to avoid double counting.

- vi. **Halting projects:** We agree that Ofgem should have the same powers across RIIO and non-RIIO licensees to halt projects and recover misspent and/ or unused funds.

Funding RIIO licensees

As a single licensee we believe that Electricity North West is disadvantaged, in comparison with multiple licensee organisations, to develop eligible projects under the LCN Fund framework. In our response to the LCN Fund: Two Year Review consultation we illustrated that Electricity North West has used the low carbon networks fund framework extensively to develop and deliver future network projects. We also highlighted that Electricity North West has incurred development expenditure in addition to the allowable set-up allowance (currently set at 20%) within the First Tier to develop innovative projects. We therefore suggested that Ofgem should reduce the Discretionary Fund element and increase the First Tier allowance and correspondingly the allowable set up percentage to promote the development of innovation projects. Currently Electricity North West's First Tier allowance is fixed at £1.3 million per annum, of which £260,000 is made available for development of projects.

The current percentage proposals for the Network Innovation Allowance would result in an allowance similar in size to the combined current T1 LCN Fund and IFI allowances, but perversely the current percentage proposals for the development of projects results in a smaller allowance than is currently available to Electricity North West. The chart below shows the comparison between the development costs allowed under the T1 LCN Fund and the proposed NIA (assuming a 1% NIA and 2011-12 allowed revenue).



This will have a detrimental impact on the development of innovative proposals for the Network Innovation Competition and will penalise Electricity North West more than other multiple licensee organisations.

The inclusion of all RIIO and non-RIIO licensees in the Network Innovation Competition results in a wide range of regulated companies, from small independent network operators to large transmission organisations. As the NIA allowance and hence the development costs allowance is linked to the licensee's allowed revenue those larger licensees and organisations with multiple licensees will have significantly more financial resources available than smaller licensees to

develop and promote innovative projects, yet we are all in competition together to seek funds from the Network Innovation Competition.

Innovation Roll-out Mechanism(IRM)

We fully support the need for this type of mechanism as part of the innovation stimuli portfolio. There is recognition across the industry that throughout the RIIO price control timeframes the challenges will be two-fold: 1) to develop and implement new innovation projects using NIC and NIA funds; and 2) to integrate into business as usual the learning outcomes from the innovation projects launched within DPCR5 (using IFI and LCN Funds) and those projects launched early within RIIO. Greater emphasis will be placed on realising the value generated from innovation projects completed to date through the development and implementation of new business processes and plans and we see the IRM supporting this activity.