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Dear Sam,

Low Carbon Networks Fund: two-year review

I am writing to you on behalf of Northern Powergrid Holdings Company and its wholly owned electricity distribution licensees Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc. This letter provides our response to Ofgem's recent consultation on the two-year review of the Low Carbon Networks (LCN) Fund.

In summary, we remain supportive of the LCN Fund and consider that experience-to-date over the past two years has demonstrated that it is broadly fit for purpose. We consider that our thoughts on the relative strengths and weaknesses of the existing LCN Fund governance are largely in line with Ofgem's own published view. The one exception is the relative merits of the discretionary reward scheme. We continue to believe that the discretionary reward provides a meaningful incentive for companies to deliver the best learning from projects. In the transition to the Network Innovation Competition (NIC) we consider it important that there is the potential for network companies to earn a return on innovation projects. This incentivises the most highly innovative ideas and the best project delivery. Ultimately this will advantage customers.

Separately to this consultation, we believe that the RIIO innovation framework should continue to be developed in a format that largely mirrors the LCN Fund. We will provide further comments in support of this view in the parallel consultation on the NIC.

Responses to all the questions raised in the consultation are provided below.

1. Do respondents consider that the evaluation criteria have driven certain types of projects at the expense of other learning outcomes? If so, what are these learning outcomes and do they need to be specifically stimulated?

No. We do not believe that the evaluation criteria have driven particular types of project at the expense of others. The relatively broad scope of the projects to date indicates that the criteria are fit for purpose.

2. Do the evaluation criteria ensure that the LCN Fund is compatible with future developments in smart grids?

Yes. The evaluation criteria appear compatible with what are perceived to be the current requirements for future smart grid developments.

The projects funded appear in line with what industry believes will be the requirements of future smart grids. We are unable to identify any potential projects which we would like to undertake to support smart grid development but which are incompatible with the evaluation criteria.

3. We welcome your views and experiences on how we can enhance the requirements on learning dissemination for LCN Fund projects to ensure that industry gets the best value from them.

There already exist a wide range of incentives to achieve maximum value from the LCN Fund projects. Commitments for knowledge sharing are included ex ante at the bid stage in second tier projects and may be linked to attainment of the ex post successful delivery reward. The first and second tier awards (also part of the discretionary reward framework) provide an incentive for companies delivering first and second tier projects to deliver high quality learning and share this with the industry. Further, the RIIO cost assessment and business planning processes incentivise adoption of this learning by companies in their business plans. Finally, there is an existing requirement on companies to hold an annual conference, gain input from non-network companies and disseminate learning. DNOs have responded positively to this range of incentives. There are a series of workshops, websites and knowledge-sharing activities already taking place and the inaugural Energy Networks Association LCN Fund conference was deemed to be a successful landmark in sharing knowledge across projects.

Identifying and making the fullest use of learning is always potentially difficult. Much of the benefit is likely to lie in the experiential learning involved in executing the projects. This is notoriously difficult to share, even within organisations, let alone across industries. The best way to facilitate this type of learning is to encourage a deep and on-going dialogue between the LCN Fund participants and other interested parties. The range of incentives provided by the existing framework mean that further incentives or obligations are unnecessary.

4. We welcome respondents. views on the level of duplication across first and second tier LCN Fund projects and what changes, if any, we should make to the LCN Fund governance to address this duplication.

Experience to date suggests that the degree of duplication to date is not inappropriate. An element of duplication is a positive feature in order to reinforce learning and check that trial results are consistent across tests.

5. We welcome views on whether there is merit in each DNO undertaking its own monitoring or whether this could be avoided if all monitoring data was held in a single place and accessible to all DNOs.

With regards to duplication of monitoring there is conceptually value in capturing monitoring data centrally however there are issues in assuming that this will reduce or prevent duplication. Monitoring data is a likely key output measure for any smart grid/ low carbon project and most projects are likely to produce such data. This data is key to determining project learning and there may therefore be a need for some trials to duplicate data obtained by previous trials in order for appropriate and well characterized baselines to be assessed.

Notwithstanding that, there is clearly value in making such data available centrally. For such data to be properly understood, and to make any central repository useful, full context needs to be known and the capture of this must be addressed alongside any raw data. It may be useful for the industry to develop a basic standard for such data gathering that ensures some set of core variables are assessed by all trials in the same way so that comparisons can be made whilst allowing any enhancement as required by individual projects.

6. Given their wider scope, how can we best gain greater up front clarity in submissions on the learning outcomes of the larger, more complex projects?

Clarity on learning outcomes can be gathered from ensuring that project proposals are clear about what questions the trial aims to answer. These should be relatively straightforward to formulate and state. It is important that these questions, whilst well formed, should not lead to excessive constraints on the projects once running. Some of the LCN Fund projects are by their very nature complex and complicated. Such projects lead to emergent learning and it is often this learning that is the most valuable as it was unexpected. An overly prescriptive approach to defining the learning outcomes or outputs at the project outset, especially if these are tightly coupled with the various reward criteria, may lead to less, not more, value for the money spent as the emergent aspects are given less attention than might otherwise be the case.

7. We would be interested to hear your views on your experiences of this website and other means of facilitating collaboration.

The industry has several mechanisms and points of entry for potential collaborators in both LCN Fund and Innovation Funding Incentive (IFI) projects. These have worked well to date and we are not aware of good ideas for projects being overlooked by DNOs. The website provides one such entry point to the LCN Fund and is particularly useful for those parties that do not have pre-existing networks of contacts across the industry.

8. How should we design the form and content of guidance on carbon benefits so that they are comparable across projects?

There are clearly a large number of approaches that can be taken to the assessment of carbon benefits and it is not necessarily obvious which is the best or if indeed there is one best approach at all. It is unlikely that there will be consistency across projects without a common mandated process to make such an assessment. Ofgem needs to determine if this objective is sufficiently important to justify the creation of a common benefits evaluation process. Is it really necessary and does the assessment of carbon benefits add significant value in determining the best projects? A qualitative explanation of carbon benefits may be more appropriate.

In considering this question, it should perhaps be evaluated in the context of the policy on the NIC in the first instance since the LCN Fund now has a limited time left to operate. This may not change the evaluation greatly but it would be a more appropriate direction from which to approach the question.

If it is determined that a common process is required, we have the advantage that several options for quantifying carbon benefit have already been trialled through operation of the process in the initial round of LCN fund project bids.

9. How can we improve the LCN Fund first and second tier processes?

With the exception of suggestions included in this consultation response, we consider that both the first and second tier processes are fit for purpose.

10. How could we implement an additional stage to allow DNOs to amend submissions in response to comments from the Expert Panel or technical consultants without undermining the competitive nature of the process?

For the second tier process, the ability to modify projects in the light of the expert panel's or consultants' comments, as per the 2012 submission, should be retained. Having been through two cycles of the submission process we support the option to lengthen the overall process and allow a reasonable and timetabled revision stage following the expert panel's assessment. This can be likened to the approach taken with academic papers submitted for publication following referees' comments.

Such a revision period could be relatively short, a month say, and given that the expert panel would only need to consider any revisions and not the whole proposal, would not greatly add to the burden of assessment. There would be the added advantage that the proposals would then be of improved quality and provide better value for money.

Given the increasing maturity of the overall process this change in procedure could be accommodated by bringing forward the submission timetable from 2013 (a month's advance in 2012 may provide inadequate notice of the change and prevent some worthwhile projects from being ready for the next round).

11. We welcome your views on the suggested timings and whether or not the delay between project submissions and potential discretionary funding dampens the incentive.

We disagree with the view that the discretionary reward fails to incentivise companies to deliver high quality projects. We also contend that it is appropriate for companies delivering the best outputs to be given the opportunity to earn an explicit and clearly identifiable return on investment in addition to cost recovery. This feature of the LCN Fund is entirely consistent with the RIIO framework. Therefore we consider that the network innovation competition should retain this feature.

Returning to the LCN Fund, we recognise that the ex post nature of the first tier portfolio reward and the second tier discretionary reward means that any such funding is unlikely prior to 2014 and that this is a realistic and appropriate outlook given the nature of the projects which have been funded to date. In addition, the timing of the second tier successful delivery reward, which will naturally be linked to successful project completion, is likely to be similar. Despite the long elapsed time between bid submission and project completion, the discretionary funding does incentivise the delivery of valuable learning and will be particularly useful in ensuring properly documented and disseminated outcomes are produced at or before project closedown.

12. We would appreciate views on the easiest way to ensure a smooth transition from the LCN Fund to the new price control, whilst fulfilling the commitments we made on the LCN Fund in DPCR5 Final Proposals.

The LCN Fund governance is well developed and it is positive that the network innovation competition is likely to duplicate much of its content. The fact that the two schemes share so much in common means that the transition is less of an issue to manage than could otherwise be the case. It would be useful to set out and agree what will be the objectives of the transition to appropriately fulfil the final proposals commitments as well as what pitfalls are to be avoided. By setting out the issue we can be sure that the transition is then appropriately defined and managed.

Most importantly, we consider that the primary aim of the transition from operation of the LCN Fund in the DPCR5 period to the ED1 period should not cause either a hiatus or an absence of projects by virtue of the changing jurisdiction. The best projects should be brought forward and obtain funding in order for the low-carbon goals of both the LCN Fund and the network innovation allowance (NIA) and NIC to be realised. Furthermore, as stated by Ofgem, for existing projects, all commitments made through the LCN Fund in DPCR5 should be honoured through the transition.

Some first tier projects may start in the final year of the DPCR5 period and be completed within the ED1 period. The LCN Fund allows for funding to go up to three years from project commencement. Projects which are extant on the 31 March 2015 should be allowed to continue into the ED1 period, in this case funded from the NIA rather than NIC. If the NIA and NIC operate in the same manner as the LCN Fund, this arrangement should be satisfactory.

For second tier projects this is less of an issue as the funding for any individual project is drawn down through distribution use of system charges (DUoS) through a financial direction in the first year of the project. However if the submission competition remains as it currently is, that is with the competition cycle running late within the regulatory year, there may be a problem with DUoS recovery for an individual project running into the ED1 period. Three ways are available to avoid this:

1. the competition cycle could be progressively brought forward;
2. LCN Fund governance could be revised to transfer LCN Fund second tier commitments into the NIC at the start of ED1; and/or
3. the LCN Fund aspects of DPCR5 are extended into ED1 and LCN Fund second tier DUoS recovery arrangements and the NIC run in parallel for a period of up to one year.

We prefer options two or three above since in option one, by compressing project rounds, this is unlikely to lead to the highest quality projects.

Whilst the project funding aspects of the transition could be satisfied relatively simply, with relatively small accommodations, the issue of discretionary rewards could be more problematic. For projects starting late in the DPCR5 period these rewards are unlikely to be considered until some years after their commencement and therefore some considerable time into the ED1 period. However, with appropriate timely forecasting this issue is not insurmountable.

I hope you find these comments useful. If you have any questions arising from this response please do not hesitate to make contact.

Yours sincerely

Jim Cardwell
Head of Regulation & Strategy