



Promoting choice and value

for all gas and electricity customers

Decisions on the Network Innovation Competition and the timing and next steps on implementing the Innovation Stimulus

Final decision

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Overview:

As part of the RIIO (Revenue = Incentives + Innovation + Outputs) model for price controls, we outlined our intention to introduce a package of time limited measures, focused on supporting network innovation, called the Innovation Stimulus. The Innovation Stimulus consists of the Network Innovation Competition (NIC), the Network Innovation Allowance (NIA) and the Innovation Roll-out Mechanism (IRM). Over the last year we have been developing and consulting on aspects of the Innovation Stimulus in parallel to the RIIO-GD1 and T1 price controls that will be introduced in April 2013. We expect that much of the same policy elements could be adopted as part of the RIIO-ED1 price control.

This document sets out our decisions following two recent consultations on the high level policy aspects of the NIC, outlines the next steps for implementing the Innovation Stimulus over the coming year. It also highlights an issue that we believe will delay the implementation of the Gas NIC, which we are working to resolve at the earliest opportunity.

Context

Innovation is a key element of the new RIIO (Revenue = Incentives + Innovation + Outputs) model for price controls. The RIIO model will be applied to gas distribution companies (RIIO-GD1) and electricity and gas transmission companies (RIIO-T1) from 1 April 2013. It will be applied to electricity distribution companies (RIIO-ED1) from 1 April 2015.

During the price control and beyond network companies will need to address issues such as connecting increasing volumes of intermittent generation and renewable gas sources. They will need to do this without unnecessary network investment, for example, by using more flexible equipment or operating practices, or encouraging customers to manage their demand. To do this network companies will need to innovate. Therefore as part of RIIO, we proposed an Innovation Stimulus consisting of three measures: a Network Innovation Allowance (NIA); a Network Innovation Competition (NIC); and an Innovation Roll-out Mechanism (IRM).

The NIA replaces the Innovation Funding Incentive (IFI), which formed part of previous price control arrangements and the NIA and NIC mimic the structure of the Low Carbon Network Fund which consists of a First Tier allowance and a Second Tier annual competition for funding.

This decision document follows on from two previous consultations on the high level policy aspects of the NIC and will inform our development of the detailed proposals for the governance and workings of the NIC which we will publish in late 2012, in time for the first competitions in 2013.

Associated documents

- Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives (ref. 46/11) <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decisionbusplan.pdf>
- Open letter consultation on non-network company access to innovation stimulus (ref. 07/11) <http://www.ofgem.gov.uk/Networks/nic/Documents1/Open%20letter%20consultation%20on%20non-network%20company%20access%20to%20innovation%20stimulus.pdf>
- Decision and further consultation on the design of the Network Innovation Competition (ref.113/11) <http://www.ofgem.gov.uk/Networks/nic/Documents1/NIC%20Consultation.pdf>
- Update and further consultation on design features of the Network Innovation Competition (ref. 02/12) <http://www.ofgem.gov.uk/Networks/nic/Documents1/NIC%20con%20letter%20012.pdf>

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Executive Summary

Since the launch of the first RIIO (Revenue = Incentives + Innovation + Outputs) price control reviews in late 2010 we have been developing and consulting on the arrangements for the Innovation Stimulus.

A key component of the Innovation Stimulus is the introduction of two annual Network Innovation Competitions (NICs), one for electricity and one for gas. The NICs will follow the principles of the Second Tier of the Low Carbon Network Fund (LCN Fund), introduced in 2010 to incentivise low carbon innovation in electricity distribution networks. Network licensees¹ will be able to lead bids to compete for funding for innovative projects which could deliver low carbon and environmental benefits for consumers. They are encouraged to collaborate with a range of partners (such as suppliers, academics and local authorities) to develop high quality innovative proposals that deliver value for money for consumers. Our intention is for the first competitions to start in 2013, and run annually for the duration of the transmission and gas distribution price controls.

We expect that the majority of innovation policy, that has been developed as part of RIIO-GD1 and RIIO-T1, to be applied consistently as part of RIIO-ED1. Our expectation is that electricity distribution companies will join the electricity NIC from 2015. We will consult on this transition as part of the strategy for RIIO-ED1.

In chapter 1 we set out our decisions following two recent consultations on the high level policy aspects of the NIC. Combined, these consultations sought views on the following topics:

- 1) **The Competitive Framework** – the scope of network licensee involvement the competition, the competitive process, the high level evaluation criteria and the measures that will be adopted to facilitate collaboration in the competition.
- 2) **Project Funding** – the mechanism for raising project funding and funding of bid submission costs
- 3) **Risks and Rewards** - the specific incentives attached to the development and delivery of the project.
- 4) **Project Learning** – arrangements for ensuring knowledge dissemination and intellectual property requirements across industry

In chapter 2 we set out the next steps for implementing the whole package of measures known as the Innovation Stimulus (Network Innovation Allowance, Innovation Roll out Mechanism and NICs). Specifically we outline:

¹ Gas distribution, Electricity Transmission, Gas Transmission, Offshore Transmission Owners and Independent Network operators from 2013. Electricity Distributors and Independent Electricity Network Operators from 2015.



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- 1) **A potential delay to the Gas NIC** - we are working to resolve this issue as soon as possible.
- 2) **Next steps for implementing the NIC** – including our approach to developing the governance arrangements.
- 3) **Next steps for implementing the NIA** – we intend to consult in May on the eligibility and registration requirements for the NIA

Following the decisions outlined in this document, we will now begin drafting the detailed governance arrangements and licence conditions to enable Ofgem to run the competitions. These arrangements will be developed in consultation with stakeholders through the Innovation Working Group (IWG) and through formal consultation. For more information about this meeting or any future meetings please contact networks.innovation@ofgem.gov.uk.

1. Decisions on the NIC

Chapter Summary

In September 2011 and January 2012 we consulted on various high level policy aspects of the NIC to inform our development of the detailed governance arrangements for the competition. This section sets out those issues, and our decisions on these matters, in light of stakeholder feedback and further analysis.

Introduction

1.1. In September 2011 (the September consultation) we consulted on a number of key policy elements for the NIC. These were:

- Competitive process and high level evaluation criteria;
- Facilitating collaboration;
- Funding arrangements;
- Risk and reward; and
- Intellectual property rights arrangements.

1.2. Following the September consultation, we consulted further on a limited number of issues during January 2012 (the January consultation). These were:

- Breadth of network licensee involvement in the competition; and
- Funding of bid submission costs through the Network Innovation Allowance (NIA)².

1.3. We welcome the responses we received to both consultations³ and these are available on our website⁴. A short summary of these responses can be found in Appendix 1 (September 2011) and Appendix 2 (January 2012) of this document.

1.4. This chapter now sets out our decisions on these issues. The issues are categorised as follows:

² The NIA is a set allowance that each of the RIIO network licensees will receive to fund small-scale innovative projects as part of their price control settlement

³ 11 responses to the September consultation and 10 to the January consultation.

⁴ <http://www.ofgem.gov.uk/Networks/nic/Pages/nic.aspx>

- 1) **The Competition** – this section explains the scope of licensee involvement in the competition, the competitive process, the high level evaluation criteria and the measures that will be adopted to facilitate collaboration in the competition.
- 2) **Project Funding** – this section goes on to set out the mechanism for raising project funding, and notes we will further consider the issue of funding bid submission costs.
- 3) **Risks and Rewards** – this section explains the specific incentives attached to the development and delivery of the projects awarded funding through the NIC.
- 4) **Project Learning** – this section explains knowledge dissemination and intellectual property requirements which the winning projects will be required to adhere to.

1.5. As previously mentioned, our intention is for the NIC to follow the process of the Low Carbon Network (LCN) Fund⁵ introduced as part of the fifth electricity distribution price control (DPCR5). We consider that the LCN Fund has worked well to date and stakeholder responses to our recent two-year review of the Fund supported this view⁶. Therefore we consider the NIC should adopt the principles of the LCN Fund unless there is a good reason to diverge from a particular principle.

The Competition

Licensee involvement in the competition

1.6. In January 2012 we consulted on the inclusion of non-RIIO network licensees in the NIC. This meant the inclusion of Offshore Transmission Owners (OFTOs)⁷, in the electricity NIC⁸ and Independent Gas Transporters (IGTs)⁹ in the Gas NIC. (For the purposes of the consultation we categorised these companies as “non-RIIO network licensees”). The consultation asked stakeholders for their views on six specific considerations: appetite for entry; potential benefits; potential barriers; meeting the evaluation criteria; funding bid submission costs and halting projects.

1.7. We received 10 responses to the consultation and most of the respondents considered it appropriate to keep the competition open to non-RIIO network

⁵ The LCN Fund allows up to £500m to support projects sponsored by the distribution network operators (DNOs) to try out new technology, operating and commercial arrangements. The objective of the projects is to help all DNOs understand what they need to do to provide security of supply at value for money as Great Britain (GB) moves to a low carbon economy.

⁶ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=115&refer=Networks/ElecDist/cnf>

⁷ An OFTO is a holder of an offshore transmission licence granted by Ofgem.

⁸ and Independent Distribution Network Operators (IDNOs)⁸ from 2015 (alongside DNOs)

⁹ An IGT holds a gas transporter licence and can develop, operate and maintain local gas transportation networks

licensees. Those respondents felt having a greater number of licensees participating would increase competition and the overall levels and diversity of innovation. However, respondents also identified a range of barriers to entry for non-RIIO network licensees. These included difficulty in establishing separate governance arrangements, inability of non-RIIO network licensees to meet the evaluation criteria and the limited resources available to these licensees to spend on submissions to the competition.

1.8. We acknowledge that the inclusion of non-RIIO network licensees will result in some additional complexity. However currently we do not consider this is disproportionate to the potential benefits of including these participants in the competitions. Therefore we will keep the competition open for non-RIIO network licensees, providing that equivalent licence and governance arrangements can be implemented into their licences. Non-RIIO network licensees will need to be subject to the same arrangements as the RIIO network licensees, including claw back arrangements¹⁰ and the requirement to fund at least 10 percent of the total project costs.

1.9. Over the coming months we will work to establish the detailed licence conditions to allow non-RIIO network licensees to enter the NIC. Their participation will be conditional on accepting these equivalent arrangements. We intend to develop these arrangements in parallel to the timetable for RIIO network licensees, such that non-RIIO network licensees would be able to participate in the first NIC competitions.

1.10. We would encourage any non-RIIO network licensee interested in participating in the NIC to signal this interest to Ofgem (network.innovation@ofgem.gov.uk) and attend the Innovation Working Group (IWG)¹¹ that has been established to discuss the development and implementation of the Innovation Stimulus. Further details of the next meeting and timings for licence development are discussed in Chapter 3.

Competitive process

1.11. The LCN Fund competition follows a two stage process, comprising an Initial Screening Process (ISP) and a Full Submission stage. At Full Submission an independent Expert Panel assesses the Distribution Network Operators (DNOs)¹² comprehensive proposals and makes recommendations to the Authority, who decides which projects should be funded, taking into account the Expert Panel's recommendation. We proposed in our September consultation to introduce the same two stage process for assessing submissions to the NIC as this has worked well for the LCN Fund. Most respondents to the consultation agreed with this proposal,

¹⁰ If a project is halted or funding is not spent in accordance with the governance arrangements for the competition

¹¹ The IWG is working group brings together members of Industry, Government and stakeholder bodies to discuss the development and implementation of the Innovation Stimulus. Further details of the Innovation Working Group can be found on our website at the following address: <http://www.ofgem.gov.uk/Networks/nic/iwg/Pages/iwg.aspx>

¹² A DNO is as defined for distribution service providers in the Electricity Distribution Licence

although at the January IWG meeting some participants raised concerns that the current design of two stage process may not be appropriate for the NIC. They suggested there may be a large increase in the number of bids compared to the LCN Fund due to the increased number of eligible licensees. They were therefore concerned this would result in excessive resources being incurred by Ofgem and bidders on submissions that are unlikely to succeed.

1.12. We recognise the concern regarding the two stage process. However we do not currently consider there is sufficient evidence to suggest there will be an unmanageable increase in the volume of bids under the NIC compared to the LCN Fund. Therefore we will proceed with the current design of the two stage competitive process for the NIC. In the future, if experience from running the competition indicates that the volume of submissions is hampering the effectiveness of the competitive process, we will review these arrangements, as necessary, at that time.

1.13. As with the LCN Fund, entries to the competition will be per group and not per single licensee. This means that any licensees who shares the same ultimate controller and operate in the same sector will be counted as one group.

1.14. Additionally, we will need to consider whether it is more appropriate to have a separate Expert Panel for each NIC or whether it should be the same panel judging both competitions each year. We intend to assess the merits of both approaches over the coming months as we develop and finalise the detailed competitive process for each competition.

High level evaluation criteria

1.15. In our September consultation we set out our proposals for the high level evaluation criteria for the NIC. We proposed that NIC submissions should:

- accelerate the development of a low-carbon energy sector and/or deliver other wider environmental benefits;
- have the potential to deliver net financial benefits to existing and/or future network customers;
- have a direct impact on the operation of a network operators' licensed network;
- create knowledge that can be shared across energy networks in Great Britain (GB) or create opportunities for roll out for a significant proportion of GB networks; and
- are innovative (i.e. not business as usual) and have an unproven business case where the innovation risk warrants a limited trial research, development or demonstration project to demonstrate its effectiveness. Network companies will need to demonstrate that the incentives within the price control period are not sufficient to justify the project.

1.16. At Full Submission the expert panel and Ofgem will also use additional criteria. These criteria will measure the extent to which projects:



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- are relevant to current network requirements;
- demonstrate a robust methodology and readiness for implementation; and
- involve other partners and external funding.

1.17. These criteria were largely based on the criteria used for the LCN Fund. The key difference is that the NIC will provide funding for projects which deliver low carbon and/or other wider environmental benefits.

1.18. We also proposed to weight the criterion referring to the involvement of other partners and external funding. This was to encourage partnerships with Small and Medium Enterprises (SMEs) and non-network companies and new entrants following concerns raised by stakeholders that network companies could limit their collaboration to a small number of established, "incumbent", partners.

1.19. On the whole respondents agreed with the high level evaluation criteria we set out. Some concerns were expressed regarding giving extra weight to those project submissions who partner with small and medium sized enterprises, "non-standard" non-network companies and new entrants. We recognise these concerns and have decided not to weight the criterion referring to external partners in favour of any type of partner. We agree that this would risk distorting the competitive process.

1.20. Three respondents questioned the requirement for eligible projects to be relevant to current network requirements and the need to demonstrate a robust methodology that is ready to implement. The purpose of these requirements is to give us the ability to differentiate between projects which address issues more likely to happen earlier in the price control period and those projects which could wait. The need to demonstrate a robust methodology is so we can be confident that the licensee can be reasonably expected to deliver the project if awarded funding.

1.21. Following strong support from stakeholders we intend to keep the evaluation criteria as proposed in the September consultation with two exceptions. These alterations reflect two changes made to the LCN Fund evaluation criteria following the LCN Fund two year review¹³. We stated in our January consultation that we would adopt any changes that arise from the LCN Fund two year review if applicable to the NIC.

1.22. The first change involves merging the first two of the criteria outlined on the previous page above into one criterion: "accelerates the developments of a low carbon energy sector and/or delivers environmental benefits and has the potential to deliver net financial benefits" as these two criteria are interlinked and as separate criterion can lead to duplication in responses.

¹³ LCN Fund two year review decision letter:
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=115&refer=Networks/ElecDist/cnf>

1.23. The second change is to alter “has a direct impact on the operation of a network operators’ licensed network” to “provides value for money for network electricity/gas network customers¹⁴”. This criterion still requires the project to focus on learning that is applicable to the network licensee’s network but also requires the network licensee to demonstrate that the delivery of the project¹⁵ represents the best value for money to their network customers.

Facilitating collaboration

1.24. A key objective of both the LCN Fund and the NIC is to facilitate collaboration between parties. In our September consultation we proposed to require network companies to establish a collaboration platform/website to facilitate collaboration and non-network company participation in the NIC. The majority of respondents supported our proposal to introduce an online collaboration website in principle, but many said that further details about its operation were required.

1.25. A collaboration webpage on the ENA website is already in place for LCN Fund and we consider there are clear benefits for expanding the scope of this website to the Innovation Stimulus as well. We will require all network licensees applying for and receiving innovation funding (either through the LCN Fund, NIC and potentially the NIA) to maintain and update this website instead of creating a new separate portal for the NIC. We will expect all licensees to work collaboratively to maintain and update the website and to provide information for current and potential project collaborators. We agree with stakeholders that more detail surrounding the working arrangements for the website needs to be established and we intend to use IWG meetings to discuss the specific arrangements which will then be set out in the NIC governance documents.

1.26. Collaboration is an important feature of the competition and a number of non-network companies have expressed concerns that they may find it difficult to get network licensees to support their potential project’s proposal. Therefore in addition to the website and, in line with the LCN Fund two year review, we will introduce an additional requirement at the ISP stage that will require licensees to demonstrate in their project submission they have effective systems and processes in place for identifying project ideas and partners.

¹⁴ For the avoidance of doubt, for the electricity NIC the criteria will say “provides value for money for electricity network customers”, for the gas NIC “gas network customers”.

¹⁵ ie each of the individual project components represents value for money

Project Funding

Raising NIC Funds

1.27. In our September consultation we stated that successful NIC projects will be funded by network users, as successful innovation can be adopted across the whole network, bringing benefits to all network users. We therefore proposed that the funding for winning projects should be raised through relevant transmission charges and transferred to the company implementing the winning project. All respondents agreed with our proposal to use transmission charges to raise NIC funds. This will mean collecting funds through transmission use of system (TNUoS) charges in electricity and national transmission system (NTS) transportation charges in gas so the collection of funds is socialised across all parties.

1.28. Two respondents suggested that the System Operator (SO) is the most appropriate party to collect these funds on behalf of the transmission companies in Electricity as the NETSO¹⁶ is the entity responsible for collecting aggregated allowed revenues for all the transmission companies through TNUoS charges. We consider there is merit in this approach as it could simplify the collection mechanism.

1.29. Our decision is that funds will be raised through transmission charges and will be borne by users based on their use of the network, in line with the respective transmission charging methodology. We are consulting with the relevant transmission companies to effect this decision and we are reviewing whether it is appropriate for the SO to facilitate this as suggested by two stakeholders. The SO would then be required to collect the funds in the relevant sector and transfer funding to the company implementing the winning project. Once finalised this mechanism will be set out in the NIC governance document and company specific licence conditions.

Bid submission costs

1.30. In our September consultation, we asked whether it would be appropriate for a proportion of the NIA to be used to fund NIC bid submission costs. In our January consultation we subsequently set out a sliding cap mechanism which proposed a cap of between 5 and 10 per cent of the NIA allowance to be available to fund bid submission and set up costs. We also asked if we should fund reasonably incurred bid costs for non-RIIO network licensees.

1.31. Responses to our January proposal were mixed. Those who supported the sliding cap suggested that it would help ensure an equivalent proportion of allowed revenue would be available for spending by each licensee. However, other respondents did not support the sliding cap. They argued that it would not be

¹⁶ National Electricity Transmission System Operator

effective in delivering a level playing field across licensees. One respondent also suggested an alternative mechanism to ensure a level playing field.

1.32. Responses were also mixed with respect to funding non-RIIO network licensee bid costs. Those respondents who were against funding bid costs felt the non-RIIO network licensees would lack the right incentives to spend this money efficiently. Those respondents who supported funding bid costs considered non-RIIO network licensees would be discouraged from entering the competition without funding for bid costs, and that it would create a “level-playing field” for all licensees.

1.33. We take these concerns raised by stakeholders seriously. In light of these concerns, we intend to take some additional time to explore the issue of funding bid costs for both RIIO and non-RIIO network companies. We intend to publish our decision on this issue in the coming months.

Risks and Rewards

1.34. We sought views on three separate issues relating to risks and rewards in our September consultation.

i) Successful delivery rewards and cost over-runs

1.35. As exists in the LCN Fund, we proposed to introduce a successful delivery reward of 10 per cent to incentivise the efficient delivery of NIC projects. We also proposed that this would be offset by a protection mechanism for cost-overruns or unrealised direct benefits¹⁷ of up to 5 per cent (ie if an application for cost-overruns is made that licensee is unable to apply for a successful delivery reward for the project once completed). We stated this risk reward mechanism would be funded from the total project funding available therefore leaving £27m available for Electricity and £18m available for Gas projects each year.

1.36. The majority of respondents agreed with our proposals for the successful delivery reward and cost over-runs. Therefore we will implement these arrangements for the NIC.

ii) Ex-post discretionary reward

1.37. Participants in the LCN Fund can also apply for an ex-post discretionary reward, awarded to projects that provide exceptional learning once completed¹⁸. We

¹⁷ Direct benefits refers to expenditure already allowed for under the price control that will be avoided or replaced through the project

¹⁸ A total of £100 million of LCN Funding has been set aside for the following: shortfalls in direct benefits; cost overruns; rewards under the successful delivery reward; First Tier portfolio reward and second Tier discretionary reward.

proposed not to include an ex-post discretionary reward in the NIC as previous feedback from working groups suggested this reward does not influence the behaviour of the DNOs since it is uncertain and not linked to specific deliverables or objectives. The majority of the respondents to the consultation agreed with this view.

1.38. Therefore we will not introduce an ex-post discretionary reward for the NIC. However, if we consider at a later date an ex-post discretionary reward is appropriate to further incentivise network companies to outperform against expected learning outcomes, we will consult on such proposals at that time.

iii) Specific reward for commercial innovation

1.39. In the RIIO handbook¹⁹ we outlined our intention to offer specific rewards for commercial innovation. Evidence from the LCN Fund shows that multiple projects have included some element of commercial innovation and we consider this is likely to be the same for future NIC projects. We therefore proposed not to introduce a specific reward for commercial innovation and most respondents agreed with this proposal. Given this, we will not introduce a specific reward for commercial innovation, as we consider project submissions with an element of commercial innovation will exist without introducing a specific reward. To ensure this, the detailed eligibility and evaluation criteria for the NIC will be designed in a manner that accommodates projects involving commercial innovation on an equal basis with technical innovation projects.

Project learning

1.40. Knowledge transfer is a key aim of both the LCN Fund and the NIC and we will expect all companies to apply the appropriate learning arising from NIC funded projects. We expect full learning dissemination across industry to take place to ensure all network users benefit from innovation they have funded.

1.41. As with the LCN Fund, to ensure project learning is disseminated across industry, licensees will be required, at a minimum:

- To hold annual conferences to present project progress and learning;
- Produce regular reports on the progress of NIC funded project; and
- Produce a close down report at the end of a project that should be accessible to industry.

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<http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RIIO%20handbook.pdf>

1.42. Additionally we consulted on the use of default Intellectual Property arrangements in the September Consultation and below we have set out our decision on this topic.

Intellectual Property Rights (IPR) arrangements

1.43. The protection and dissemination of IPR generated through projects funded by consumers is an important element of the Innovation Stimulus. For the LCN Fund we created a default condition that all IPR which is material to the dissemination of learning for a given project should be shared between other DNOs free of charge. Companies can as part of their project submission propose alternative arrangements for IPR should these be deemed more appropriate on a project specific basis. In our September consultation we proposed to introduce the same default IPR for the NIC. We also stated that any royalties gained by network licensees from IPR funded by the NIC must be shared with customers, as they have funded up to 90 per cent of the creation of these royalties so should receive an equivalent share.

1.44. Most respondents supported our proposal regarding IPR and royalties. However, three respondents commented that the proposed arrangements may act as a disincentive to small businesses becoming involved in the NIC. We understand these concerns. However, we note that under the current arrangements we consider it feasible for a non-network company to ring-fence their IPR by providing specific funding for project elements that may generate IPR relevant to their work. We also consider that the arrangements have worked well to date for the LCN Fund, and note no LCN Fund Second Tier submissions have proposed alternative IPR arrangements.

1.45. For these reasons, we do not think these IPR arrangements will have a material impact on smaller enterprises who wish to partner with network licensees on a NIC project. Therefore, we will implement the same default IPR and royalties arrangements for the NIC as those which exist for the LCN Fund. These arrangements will be set out in the NIC governance documents.

2. Implementing the Innovation Stimulus and next steps

Chapter Summary

Below we outline a potential delay to the start of the Gas NIC. We have also set out the next steps for implementing the Innovation Stimulus work over the course of 2012.

Introduction

2.1. This chapter provides an update on key aspects of the implementation of the Innovation Stimulus, which are summarised below:

- A potential delay to the Gas NIC;
- Implementing the NICs;
- Implementing the NIA; and
- The timetable for developing the licence conditions and governance arrangements.

Potential delay to the Gas NIC

Overview of issue

2.2. In our March strategy document²⁰, we announced our decision to introduce a Network Innovation Competition (NIC) as part of a time limited Innovation Stimulus. We set out that there would be two NICs – one for electricity network companies and one for gas network companies.

2.3. We have been considering the options for implementing the NIC in both the gas and electricity sectors. A key implementation issue is the arrangements to enable the funding of successful projects. We have previously set out that successful NIC projects will be funded by all network customers. The funding for winning projects would be raised by network operators through use of system charges, and transferred to the company implementing the project. This mechanism is currently

²⁰ <http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionbusplan.pdf>

being used to fund projects under the Low Carbon Networks (LCN) Fund²¹ introduced under the fifth electricity distribution price control review (DPCR5).

2.4. Having reviewed the regulatory framework, we believe that we have identified a barrier to delivering this proposed funding approach in Gas sector. Moreover, we believe that this issue will delay the implementation of the Gas NIC by a year.

2.5. The Gas Act 1989 allows the Authority to insert provisions into the Gas Transporter licence that require a Gas Transporter to increase its charges to raise such amounts as may be determined and then pay those amounts to gas suppliers and gas shippers. However, the Gas Act does not allow the Authority to insert provisions into the licence for the raising and paying of amounts to other Gas Transporters. This differs from the framework in the Electricity Act 1989 which allows for the raising and paying of amounts to all electricity licence holders.

2.6. Our view is that, as drafted, the Gas Act does not allow us to implement the NIC in the Gas Sector using the mechanism used in the LCN Fund (i.e. establish the competition for Gas Transporters).

Finding a solution

2.7. We will work with Government to seek a long term solution to this problem. We believe that amendment to primary legislation is necessary in order for the Gas NIC to be implemented.

2.8. We have raised this issue with DECC and, together, we are seeking to find a solution at the earliest opportunity. DECC are actively considering the options for proposing an amendment to primary legislation and they believe that the necessary changes could be provided by April 2014. However, currently it appears unlikely that a legislative amendment could be provided in time for the start of the first Gas NIC, which is due to commence in April 2013.

2.9. We are continuing to consider the implications of this issue in the context of the overall RIIO-T1 and RIIO-GD1 innovation policy proposals.

Development of governance arrangements

2.10. We will continue our work to develop a set of governance arrangements which can be applied consistently in running both the Gas and Electricity NICs. We expect

²¹ More information on the LCN Fund can be found on our website here: <http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Pages/lcnf.aspx>

that these governance arrangements would be applied to Gas Transporters once primary legislation allows for the policy to be implemented.

2.11. As such, we strongly encourage Gas Transporters to continue to play their part in the process for developing governance arrangements for the NIC. The section below sets out the next steps for the NIC

Implementing the Network Innovation Competitions

2.12. The Electricity NIC will be introduced as part of the RIIO-T1 control which commence on 1 April 2013. The Gas NIC will be introduced following the resolution of the issue highlighted above. DECC currently believe that the necessary changes could be provided by April 2014.

2.13. We expect that the majority of innovation policy, that has been developed as part of RIIO-GD1 and RIIO-T1 to be applied consistently as part of RIIO-ED1. As such over the next year we will continue our work to develop a set of governance arrangements which can be applied consistently in running both the Gas and Electricity NICs. Therefore we would strongly encourage gas distribution and transmission companies and electricity distribution companies to continue to engage in the process for developing the governance arrangements.

2.14. In preparation for the first competitions we will complete the following work over the course of 2012:

- 1) Resolve key implementation issues for the innovation stimulus such as the possible inclusion of cross sector projects in the NIC;
- 2) Draft and implement licence conditions which will allow licensees to raise funding and set the legal framework for the Governance arrangements;
- 3) Consult on a Governance document for each sector which sets out the detailed criteria for the competition, guidance on the obligations and requirements on participants of the NIC.

Cross sector projects

2.15. Increasingly, as we move towards a low carbon economy there is an emphasis on integrated energy network solutions. Given this, it is possible to envisage that a gas and electricity network company may want to collaborate on a joint project which is eligible for funding from both NICs. Solutions for the decarbonisation of heat or providing integrated energy solutions for off-grid communities could be examples of such projects.

2.16. We believe the NIC could provide a platform for trialling cross sector projects that benefit both electricity and gas consumers. For this reason we are currently

investigating the legal and implementation options for including cross sector projects in the NIC. From a practical point of view we are also considering how we could develop the NIC governance documents to facilitate such projects in the competitive process for example how the submission and evaluation process will assess cross sector projects and their potential benefits to both sectors. We will continue to explore this issue with members of the IWG and other interested parties over the coming months.

2.17. Additionally, if we consider there's a strong case to encourage the submission of integrated cross sector projects through the NIC we may also consider additional incentives to facilitate their entry in the competition. However, we note in the short term, the submission of cross sector projects will only be possible once the implementation issues for the Gas NIC are resolved.

Implementing the Network Innovation Allowance

2.18. Alongside developing the NIC Governance we are also developing the governance arrangements for the NIA. The NIA is a set allowance that each of the RIIO network licensees will receive to fund small-scale innovative projects as part of their price control settlement. Our intention is for the NIA to function in a similar way to First Tier of the LCN Fund. The NIA also replaces the Innovation Funding Incentive (IFI), which has been included in previous price control settlements. In the coming months, we plan to consult on the detailed eligibility criteria and key regulatory requirements which will be attached to the use of NIA. We will also discuss these issues at the next IWG meeting on 22 March.

Licence conditions and governance documents

2.19. The licence conditions for the RIIO network licensees are currently being drafted in conjunction with an industry working group (the Licence Drafting Working Group) as part of the RIIO-T1 and RIIO-GD1 price control projects. The licence conditions relevant to the innovation stimulus will be consulted on through this process. We intend to issue consultations on all the price control licence conditions during the coming year. The table below sets out an indicative timetable for these consultations. We intend to develop the equivalent licence conditions for the non-RIIO network licensees on a similar timeframe.

2.20. Over the coming months we will be drafting governance document in conjunction with the IWG. There will be a separate document for gas and electricity which sets out the detailed criteria for the competition, guidance on the obligations and requirements on participants of the NIC.

Decisions on the Network Innovation Competition and the timing and next steps on implementing the Innovation Stimulus

2.21. The timetable for consulting on these documents is set out below.

| Consultation | Indicative Date |
|---|-----------------|
| NIA consultation | May 2012 |
| First consultation on RIIO licence conditions including innovation specific conditions | July 2012 |
| Second consultation on licence conditions including innovation specific conditions. The consultation will include the NIC and NIA governance documents. | October 2012 |
| Statutory consultation on licence conditions including innovation specific conditions. The consultation will include the NIC and NIA governance documents. | December 2012 |
| Licence changes takes affect | 1 April 2013 |

Further information and contact details

2.22. The next Innovation Working Group (IWG) meeting will be held on Thursday 22 March 2012. Following this meeting we expect to hold the IWG every 4-6 weeks over the next few months. If you would like to attend any future meeting please contact networks.innovation@ofgem.gov.uk.

2.23. If you wish to discuss any of the issues raised in this document further, please feel free to contact Nicola Meheran at Nicola.Meheran@ofgem.gov.uk or on 020 7901 0515.

Appendices

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Appendix 1 – Summary of responses to the September 2011 consultation

Overview of respondents

1.2. We received 11 responses, two of which were from non-network companies. The network company responses were on behalf of: electricity distribution network operators (DNOs), gas distribution networks (GDNs), the operator of the gas national transmission system (NTS), and electricity transmission owners (TOs). One of the non-network company responses was from a technology company and the other was from an energy supplier.

Do you agree with the proposed two stage evaluation process and evaluation criteria?

1.3. Most respondents agreed with the two stage evaluation process proposed by Ofgem. One respondent felt there may be considerable resource implications for Ofgem running the gas and electricity NICs at the same time and questioned if an alternative approach could be considered. A number of responses noted that to date no submissions to the Low Carbon Networks (LCN) Fund have failed the initial screening process (ISP) element of the evaluation process. These respondents felt that this hurdle could be made higher. It was also pointed out that the ISP stage gave Ofgem and the other applicants visibility of which other projects were likely to go on to full submission allowing them to fine tune their own projects before full submission.

1.4. On the whole respondents agreed with the high level evaluation criteria we set out. Some expressed concern over giving extra weight to those project submissions which partner with small and medium sized enterprises, “non-standard” non-network companies and new entrants. A number of respondents were concerned that projects of high quality might lose out to less robust projects that had “non-standard” partners. Two respondents questioned the requirement for eligible projects to be relevant to current network requirements as this may limit the incentive for innovative, forward looking thinking. One respondent sought clarity on the requirement for projects to have a robust methodology and be ready for implementation as innovative projects by their nature may require further work before they are ready.

Do you agree with our proposals for facilitating non network company preparation for the NIC?

1.5. The majority of respondents supported our proposal to introduce an online collaboration forum in principle but felt further details were required. The DNOs with experience of the LCN Fund pointed out that a range of projects already involved

working with partners. One respondent felt no obligations should be placed on licensed companies to respond to every enquiry received through any collaboration platform. Another respondent questioned what action Ofgem would take if a licensed network company continued to submit projects involving the normal partners.

Do you agree that the transmission companies should raise the funding for the NIC, and that it should be borne by customers according to their network usage?

1.6. None of the respondents disagreed with our proposal that the funding for the NIC should be raised through transmission charges paid by customers according to their network usage. Two TOs believed that the funding for the NIC should be raised by the system operator (SO) as they could be the sole point of contact for the distribution of funds and then transfer funds to the relevant licensee. One stated that this was their preference for how the NIA should be raised.

Should network companies be funded to cover some or all of the preparation costs for submissions to the NIC? If so, is the Network Innovation Allowance (NIA) the best way to achieve this?

1.7. Most respondents supported allowing licensees to use part of their NIA to cover some or all of the preparation costs for submissions to the NIC. One respondent felt that companies should be funded to develop projects but that the NIA was not the place to do this. This respondent suggested setting aside part of the NIC amount to fund the preparation of projects. One non-network respondent felt that all collaborating parties should have access to the same preparation cost funding and that the NIA was the correct funding source.

1.8. A number of respondents suggested a cap on the amount of the total NIA. These ranged from 10-20 per cent of the NIA. Some respondents argued that only those projects which were successful at the ISP and full submission stage should have their preparation costs funded through the NIA. One respondent argued that those submissions which were successful at full submission should have their setup expenditure paid as part of the project costs allowing them to retain their NIA for projects.

Do you agree with our approach to learning and intellectual property (IP) generated by the NIC? If not, please indicate how these arrangements could be improved.

1.9. Most respondents supported our proposal regarding intellectual property. However, three respondents commented that the proposed arrangements may act as a disincentive to small businesses becoming involved in the NIC.

1.10. Another respondent pointed out that there are costs associated with the dissemination of knowledge. This respondent felt that knowledge dissemination should be factored into the costs of successful projects. One respondent felt that it

was overly burdensome to require licensees to implement all learning resulting from the NIC. This respondent felt that companies should only have to implement all relevant learning.

Do you agree with our proposals to offer a successful delivery reward and protection against cost overruns?

1.11. A small number of respondents provided the same response for both question 6 and 7 or combined their response to both questions.

1.12. None of the respondents disagreed with our proposed way forward regarding the successful delivery reward and protection cost overruns.

1.13. One respondent felt that Ofgem should monitor which licensees require cost overrun protection. They felt where a single licensee asks for protection on a number of occasions then they should be excluded from the NIC for a certain amount of time.

1.14. One respondent disagreed that any return above 100 per cent of the cost of a project was unnecessary. They commented that a project that is delivered to a particularly high quality and delivers high quality learning should allow the licensee to recover more than their at-risk project costs. Another respondent argued that Ofgem should take into account factors beyond the licensee's control that might affect the deliverability of a project.

Do you agree with our proposal not to have an ex-post delivery reward or specific reward for commercial innovation?

1.15. The majority of the responses did not disagree with our proposal to not have an ex-post delivery reward. However three responses from network companies felt that an ex-post reward for commercial innovation should be retained.

Appendix 2 – Summary of responses to January 2012 consultation

Overview of respondents

1.1. We received 10 responses in total to the consultation. 1 from a non-RIIO network licensee (an OFTO), 4 from DNOs, 4 from TOs and GDNs and 1 from a trade organisation (including representation from GDNs and IGTs).

How should we treat non-network licensees in the NIC?

1.2. Most of those who responded to the consultation felt that non-RIIO network licensees should have the opportunity to enter the NIC independently. Some of these noted that collaboration may still be preferable for some applicants, whilst another suggested that it would be important to allow non-RIIO network licensees to enter independently as RIIO licensees would not always have an incentive to collaborate, eg with OFTOs. Two respondents felt that non-RIIO network licensees should only be able to enter on a collaborative basis with RIIO licensees, suggesting that would be the most efficient and productive mechanism.

Appetite for entry

1.3. Two respondents felt able to comment on the appetite for entry among non-RIIO licensees into the NIC. One respondent felt that there was insufficient appetite to warrant developing arrangements to allow them to participate in their own right. A non-RIIO network licensee felt that OFTOs in particular have a strong appetite for NIC funding, in view of the unique technical features of their offshore installations which make them unlikely to benefit from the R&D activities of onshore utilities.

Potential benefits

1.4. The majority of respondents identified benefits with allowing non-RIIO licensees to benefit from NIC funding in some form, whether directly or through collaboration with a RIIO licensee. A number of respondents highlighted that having a greater number of licensees participating would increase competition and the overall levels of innovation, whilst the diversity of types of licensee would increase the innovative range. In particular, it was observed that non-RIIO licensees could play a distinct role in developing innovative technology in areas such as offshore networks and emerging low carbon heat networks. It was noted that newly built networks may provide ideal opportunities to test new technologies and new approaches to distribution networks.

Potential barriers

1.5. Three respondents commented explicitly on the potential of non-RIIO licensees to meet the evaluation criteria independently of collaboration with RIIO licensees. Two felt that non-RIIO licensees would not be well placed to meet the criteria due to prohibitive resource and financial implications, and the technical and operational cooperation necessary from RIIO licensees. A small number of respondents also reiterated support for the evaluation criteria, and confirmed that non-RIIO licensees should be subject to the same evaluation criteria as non-RIIO licensees.

Meeting the Evaluation criteria

1.6. Five respondents identified a range of potential barriers. Difficulties in establishing governance arrangements to accommodate non-RIIO network licensees were felt to be one barrier. One respondent felt that non-RIIO licensees would have insufficient incentives to enter the competition, given that any technology that might allow them to gain a competitive advantage would be shared across industry. Another felt that since non-RIIO licensees have no access to NIA funding for smaller projects, they may be put off by the perception that the NIC is only for large-scale projects. A number of respondents described the limited resources available to non-RIIO licensees as a barrier to successfully completing bids and projects. This included concerns that non-RIIO licensees may lack some of the knowledge and experience necessary, and it was noted that they may also lack working relationships with larger suppliers and public bodies.

1.7. Of those who suggested solutions, the majority felt collaboration with RIIO licensees to be the most appropriate means of overcoming the barriers identified. Two described the value of the LCN second tier arrangements, for instance in providing an opportunity for organisations to earn a premium return as the result of the outcome of projects. It was suggested that a discretionary reward or similar mechanism should be extended to all participants in the NIC. Among other things, one respondent emphasised the value to be gained in simplifying the bid process and reserving part of the NIC for smaller projects.

Funding bid submission costs

1.8. There were mixed opinions from respondents on introducing a separate mechanism to provide non-RIIO network licensees with funding for reasonably incurred bid submission costs. Those in favour felt this funding to be fair and necessary. These respondents were unconcerned about the anticipated absence of incentives for non-RIIO licensees to spend such funding efficiently. Rather it was suggested that they would have similar incentives to RIIO licensees and that cost efficient bid preparation would be necessary to enable applicants to get project funding. Further comments were made around the design. These included the need to avoid double counting of bid costs when different parties collaborate in a bid, a fixed/minimum level of bid cost allowance for non-RIIO licensees due to their lower annual revenues, and increased NIC funds for gas distribution.

1.9. Those against the funding approach proposed were concerned about the complexity of creating funding arrangements, and an absence of incentives for non-RIIO network licensees to spend funds efficiently. A range of alternatives were suggested instead. Two felt that the non-RIIO licensees should collaborate on projects with RIIO licensees. The remaining suggestions included allowing reasonable bid costs to be recovered through NIC funding and the requirement to reach a particular level of scoring in the bid assessment process to achieve cost recovery, regardless of whether the project is successfully funded in the competition.

Halting projects

1.10. Six respondents answered this question. All agreed with ensuring that all bidders are subject to the clawback requirement. Two respondents felt that this would be brought about most efficiently through non-RIIO licensees collaborating on projects with RIIO licensees. Others felt there should be clawback arrangements for non-RIIO licensees in the same way as for RIIO licensees.

Do you agree with a sliding cap of between 5 and 10 per cent of the NIA to fund bid submission costs for RIIO network licensees?

1.11. Respondents offered mixed opinions over the value of a sliding cap. Those who supported the sliding cap suggested that it would help ensure an equivalent proportion of allowed revenue would be available for spending by each DNO. Those who did not support it suggested that it would add an extra layer of complexity, and argued that it would not be effective in delivering a level playing field thanks to a range of other factors. One suggested alternative was to increase the NIC funding to cover bid submission costs, funding for successful bids and successful delivery awards, and to set aside a fixed proportion of NIC funding for bid submission costs. Another proposal was to have a fixed allocation to each RIIO network company per annum to be recovered from NIA in a way that incentivises all companies to bid in an efficient way.

1.12. Whether or not the sliding cap mechanism was supported, the majority of respondents had concerns over the level of the cap. It was observed that the levels of the cap proposed would mean less funding than under DPCR5, and it was argued that the level of funding provided would not be sufficient. One respondent felt that the funding would be sufficient, and another felt that the level of the cap should be reviewed after the second year.

Appendix 3 - Glossary

A

[Authority/Ofgem/GEMA](#)

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

B

C

D

[Distribution Network Operators \(DNOs\)](#)

Holders of electricity distribution licences. Licences are granted for specified geographical areas. Currently in Great Britain there are six corporate groups owning the fourteen licensed distribution areas.

[DPCR5](#)

Distribution Price Control Review. This price control runs from 1 April 2010 until 31 March 2015.

E

[Electricity transmission system](#)

The system of high voltage electric lines providing for the bulk transfer of electricity across GB.

F

G

[Gas Distribution Networks \(GDNs\)](#)

Holders of gas transporters licences owning distribution system networks. Currently in Great Britain there are four corporate groups owning eight licensed distribution areas.

[Gas and Electricity Markets Authority \(GEMA\)](#)

(See the Authority/Ofgem/GEMA)

[Gas Distribution System](#)

The distribution system is a network of pipelines operating at pressures below seven bar, transporting gas from the local transmission system (LTS) and delivering it to domestic, commercial and industrial gas consumers.



Decisions on the Network Innovation Competition and the timing and next steps on implementing the Innovation Stimulus

H

I

Innovation Stimulus

Package of three time limited measures to incentivise innovation under the new RIIO framework

IRM

Innovation Rollout Mechanism. Enables companies to apply for additional funding within the price control period for the rollout of initiatives with demonstratable and cost effective low carbon and environmental benefits.

Innovation Working Group (IWG)

Working group that brings together members of Industry, Government and stakeholder bodies to discuss the development and implementation of the Innovation Stimulus.

J

K

L

Licence conditions (obligations)

An obligation placed on the network companies to meet certain standards of performance. The Authority (GEMA) has the power to take appropriate enforcement action in the case of a failure to meet these obligations.

Low carbon economy

An economy which has a minimal output of greenhouse gas emissions.

Low Carbon Networks Fund (LCN Fund)

A mechanism introduced under DPCR5 to encourage the DNOs to use the price control period to prepare for the role they will have to play as GB moves to a low carbon economy. The fund makes £500m made available for DNOs and partners to innovate and trial new technologies, commercial arrangements and ways of operating their networks.

M

N

[Network licensees](#)

Holder of a network licence issued by Ofgem.

O

[Ofgem](#)

(See the Authority/Ofgem/GEMA)

P

Q

R

[RIIO \(Revenue = Incentives + Innovation + Outputs\)](#)

Ofgem's new regulatory framework, stemming from the conclusions of the RPI-X@20 project, to be implemented in forthcoming price controls. It builds on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network at value for money to existing and future consumers.

[RIIO-GD1](#)

The price control review to be applied to the gas distribution network operators, following GDPCR1. This price control would be expected to run from 1 April 2013 and will be the first transmission price control review to reflect the new regulatory framework, RIIO, resulting from the RPI-X@20 review.

[RIIO-T1](#)

The price control review to be applied to the electricity and gas transmission network operators, following the TPCR4 rollover. This price control would be expected to run from 1 April 2013 and will be the first transmission price control review to reflect the new regulatory framework, RIIO, resulting from the RPI-X@20 review.

S

[Stakeholder](#)

Stakeholders are those parties that are affected by, or represent those affected by, decisions made by network companies and Ofgem. As well as consumers, this would for example include Government and environmental groups.

Sustainable energy sector



Decisions on the Network Innovation Competition and the timing and next steps on implementing the Innovation Stimulus

A sustainable energy sector is one which promotes security of supply over time; delivers a low carbon economy and associated environmental targets; and delivers related social objectives (eg fuel poverty targets).

T

Transmission Owners (TO)

Companies which hold transmission owner licenses. Currently there are three electricity TOs; NGET, SPTL and SHETL. NGG NTS is the gas TO.

U

V

W

X

Y

Z

Appendix 4 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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