To transmission companies, distribution companies, generators, suppliers, shippers, offshore transmission owners, customer groups and other interested parties.

Promoting choice and value for all gas and electricity customers

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Date: 29 May 2012

Consultation on funding the cost of preparing submissions for the Network Innovation Competition and the Governance of the Network Innovation Allowance

Purpose

Innovation is a key element of the new RIIO (Revenue = Incentives + Innovation + Outputs) model for price controls. As part of RIIO, we proposed an Innovation Stimulus which consists of three measures:

- a Network Innovation Allowance (NIA);
- a Network Innovation Competition (NIC); and
- an Innovation Roll-out Mechanism (IRM).

The NIA and NIC broadly replicate the structure of the Low Carbon Network (LCN) Fund[1] which consists of a First Tier allowance and a Second Tier annual competition for funding. The purpose of this letter is to consult on aspects of the NIC and NIA.

The NIC will comprise of two competitions - one for gas[2] and one for electricity. We consulted on the NIC in September 2011 and January 2012. This letter consults further on funding the cost of preparing submissions for the NIC.

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. The size of the NIA is between 0.5 and 1 per cent of the licensee's annual allowed revenue, dependent on the quality of the Innovation Strategy submitted by each licensee. This letter also consults on the detailed governance of the NIA. In particular, we are seeking stakeholders' views on:

- high level project eligibility criteria;
- the project registration process;
- eligible expenditure;
- reporting and audit requirements for NIA projects; and
- knowledge transfer including the treatment of intellectual property.

We welcome responses regarding any of the issues raised in this document by **28 June 2012**. Please send responses to networks.innovation@ofgem.gov.uk.

[1] More information is available here.
[2] In March 2012 we announced a potential delay to the commencement of the Gas competitions.

Consultation on funding the cost of preparing submissions for the NIC

March Decision Document

In our March 2012 decision document[3] we noted that a number of stakeholders had concerns with aspects of our proposals for providing bid preparation costs for the NIC. Given these concerns, we explained that we would take additional time to consider the issue further. In the same document, we also outlined our intention to keep the NIC competition open for non-RIIO network licensees[4], providing we could put in place equivalent licence and governance arrangements for those licensees.

Summary of responses to January Consultation

Responses to our January 2012 proposal for funding bid preparation costs contained mixed views. Those who supported the sliding cap mechanism[5] suggested that it would help ensure an equivalent proportion of allowed revenue would be available for spending by each network licensee. However, other respondents did not support the sliding cap. They argued that it would not be effective in delivering a level playing field across all network licensees competing in the NICs. To deal with this, one respondent suggested introducing an annual fixed allowance for each licensee.

In January, we also asked whether we should fund reasonably incurred bid costs for non-RIIO network licensees. Responses to this question were also mixed. Those respondents who were against, considered that the non-RIIO network licensees would lack the right incentives to spend the money efficiently. Those respondents who were in favour, considered that non-RIIO network licensees would be discouraged from entering the competition without funding for bid costs, and that providing bid costs would create a "level-playing field" for all licensees.

Revised Proposal

We continue to consider it appropriate for bid costs to be funded to encourage high quality submissions and effective competition. However, we also want to ensure that any funding is spent efficiently and provides value for money for consumers. We also want to ensure that the competition is fair for all licensees.

Therefore, we consider there is merit in providing an annual fixed allowance for bid costs for all licensees (as suggested by one stakeholder). In determining the cap, it is important to set it at a level that ensures high quality bids can be submitted, but which also incentivises cost efficiency in the bidding process. We consider that a reasonable proportion of total bid costs is around 5 per cent of the funding available (the annual funding is £30m for electricity and £20m for gas). On this basis we propose to set an annual cap of up to £175k to be spent on NIC bid preparation costs[6] or up to 5 per cent of annual NIC funding requested by a bidding group, whichever amount is smaller.

For RIIO network licensees[7] the bid preparation costs will be recovered through their NIA. However, non-RIIO network licensees do not receive any NIA funding as this is part of the RIIO price control settlement. We welcome views from stakeholders on whether the funding of bid preparation costs for non-RIIO network licensees should be funded from the existing

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[3] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=346&refer=Networks/nic
[4] Network licensees that are not regulated through the RIIO price control framework i.e. OFTOs and independent network operators.
[5] We outlined a sliding cap mechanism where the level of the funding cap varied between 5 and 10% depending on the value of the RIIO network licensees NIA (which could vary between 0.5-1% of their allowed revenue).
[6] Assuming 14 RIIO network groups (6 DNOs, 4 TOs, 4 GDNs) involved in the competition and maximum availability of funding of £50m per year.
[7] Network licensees that are regulated through the RIIO price control framework i.e. GDNs and TOs from 2013 and DNOs from 2015

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funding set aside for funding the NIC, or should alternative funding be raised in addition to the annual allowance.

In addition, we want to introduce strong incentives to encourage the cost efficient use of bid preparation costs. Some respondents to the September consultation suggested that we introduce a requirement whereby only those licensees who submit projects that pass the Initial Screening Process ("ISP"), should be eligible to recover bid costs. Respondents felt that this would reduce the risk of consumers funding poorly prepared submissions that failed to meet the eligibility criteria for the competition. We consider that there is merit to this suggestion. Therefore we intend to introduce this arrangement into the relevant governance documents. This approach will be applicable to both RIIO and non-RIIO network licensees requesting bid costs.

- **Question 1: Do you agree with a fixed annual allowance for bid costs for all licensees and an annual cap per bidding group of £175k or 5% of annual NIC funding request, whichever amount is the smaller? If not please provide evidence to justify an alternative level of cap.**

- **Question 2: We welcome views from stakeholders on whether the funding for bid preparation costs should be funded from the existing funding set aside for funding the NIC, or alternatively, should it be raised in addition to the annual NIC allowance?**

Consultation on the Network Innovation Allowance

Principles

In our Decision on Strategy[8] for the RIIO: T1 and GD1 price controls we decided that the NIA would be available to fund smaller scale research, development, trials and demonstration projects which undertake commercial, technological and operational innovation. Since then we have been developing our proposals for aspects of the detailed governance of the NIA which we have tested with the Innovation Working Group ("IWG")[9]. In developing the proposals set out in this letter, we have sought to incorporate aspects of three core principles. We have developed these principles in consultation with stakeholders through the IWG. We are looking to ensure the NIA will fund projects to:

- deliver innovative solutions that are relevant to the challenges faced by network licensees (as identified in their innovation strategies);
- generate new knowledge that can be shared amongst licensees; and
- have the potential to deliver value for money for consumers.

In the following discussion we will explain how each proposal that we are consulting on delivers against the principles listed above. In developing these proposals, we have considered the effectiveness of similar arrangements which have been included in previous price controls, namely the Innovation Funding Incentive ("IFI") and the First Tier of the Low Carbon Networks Fund ("LCN Fund"). We have sought to utilise the best aspects of both sets of arrangements.

NIA Project Eligibility Criteria

We want to ensure that the NIA is used to deliver the policy intent set out in the Decision on Strategy for the RIIO: T1[10] and GD1[11] price controls while meeting the principles set out

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[8] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=T1decision.pdf&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes
[9] More information is available here: http://www.ofgem.gov.uk/Networks/nic/iwg/Pages/iwg.aspx
[10] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=T1decision.pdf&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes
[11] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=GD1decision.pdf&refer=Networks/GasDistr/RIIO-GD1/ConRes

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above. To achieve this, we propose to require that NIA projects meet certain eligibility criteria. Licensees will not be able to spend NIA funding on projects unless they meet these criteria. We are proposing that projects must meet two "gates" in order to be eligible for NIA funding - this is similar to the arrangement currently in place for the LCN Fund.

The first gate would ensure that projects are relevant innovations. To do this the gate would require that projects must either:

- trial new technical, operational and/or commercial arrangements; **or**
- undertake research and development[12] to inform the development of new technical, operational and/or commercial arrangements.

The second gate would ensure that projects are generating new learning and have the potential to deliver value for money. To do this the gate would require that projects must:

- not lead to unnecessary duplication by companies;
- have the potential to develop learning that could be applied across the GB Gas/Electricity Distribution/Transmission System; **and**
- have the potential to deliver net financial benefits to current and/or future consumers.

While we would expect the majority of projects to have the potential to deliver a positive cost benefit analysis, we recognise that some projects may include non-financial benefits. For example, licensees may wish to undertake projects aimed at improving safety or environmental performance. In these circumstances, we are proposing that licensees would be required to seek our permission to fund the project through their NIA.

The high level criteria set out above reflect the policy decision that was made in the March strategy document and the principles introduced on page 3 this letter.

- **Question 3: Do you agree with the proposed high level eligibility criteria? If you do not agree then please explain why.**

- **Question 4: Do you agree with our proposed approach to funding projects with non-financial benefits? If you do not agree then please explain why.**

Project Registration Process

We want to ensure that there is wide visibility of the NIA projects being undertaken. Providing visibility will identify areas of potential duplication and opportunities for collaboration. We consider that the current LCN Fund First Tier approach has been effective in meeting these objectives. We propose, therefore, that licensees be required to register projects with Ofgem before beginning work on the project.

At a recent IWG, feedback from participants in the LCN Fund First Tier was that the existing registration process is not overly onerous for the companies involved. We propose to adopt this process for the NIA. However, we recognise that, given the wider scope of the NIA (i.e. that all RIIO network licensees have funding), there is a risk that this process may become onerous for Ofgem and the companies in the future. Therefore, we propose to keep the effectiveness of the registration process under review.

As is the case with the LCN Fund First Tier, we do not expect to approve projects. Licensees will be required to self certify NIA projects against the eligibility criteria, as set out above. However, we intend to require licensees to seek our permission before registering projects in a limited number of circumstances. These are where:

[12] We propose that projects involving *'blue sky'* research would not be eligible for NIA funding.

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- there is no clear expectation of financial benefits, but environmental or safety benefits could be delivered by the projects;
- the project partners do not intend to conform to the default intellectual property arrangements laid out in the NIA Governance Document; or
- the project requires payments to be made to any undertakings with the same ultimate controller as the licensee.

While we do not plan to approve projects, we will reserve the right to conduct audits on selected projects. This is to ensure both efficient expenditure and conformation with the eligibility criteria, conditions included in the Governance Document or relevant licence conditions. Where projects do not conform with the Governance Requirements we may take enforcement action[13], including clawing back ineligible expenditure.

- **Question 5: Do you agree with our proposal that licensees should self certify projects against the eligibility criteria? If you do not agree then please explain why.**

- **Question 6: Do you agree with our proposal that licensees should register projects with Ofgem before they begin? If you do not agree then please explain why.**

- **Question 7: Do you agree that in the three sets of circumstances, described above, licensees should require Ofgem's permission before registering the project? If you do not agree then please explain why.**

Internal Expenditure

To ensure that NIA projects deliver value for money, we want to incentivise efficient expenditure by licensees. Under previous IFI schemes, only 15 per cent of annual IFI funding could be spent on internal company expenditure as part of a project, unless otherwise agreed by Ofgem. The remaining funding would need to be spent through third parties commissioned to undertake work on the project. This cap was introduced to encourage efficient expenditure and incentivise collaboration with third parties. We are seeking stakeholders views on what they would consider an efficient level at which this cap could be set under the NIA arrangements. We also intend to allow licensees to apply annually to have this cap lifted on an *ex ante* basis.

- **Question 8: Do you agree with our proposal to include an annual cap on internal expenditure? If you do not agree then please explain why.**

- **Question 9: What proportion of a licensee's NIA do you consider would be an efficient level of internal expenditure? Please include evidence and justification of your view.**

Knowledge Transfer

Facilitating knowledge transfer is one of the key principles of the NIA. The NIA provides a considerable amount of funding and projects could generate significant new learning. Ultimately, consumers are funding this work and we want the learning generated to be disseminated as effectively as possible to ensure that all licensees, and therefore all consumers, are able to benefit from projects.

[13] Decisions would be taken in line with Ofgem's published Enforcement Guidelines.

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Proposals

1) Transparency of available information

We consider that the production of reports for each innovation project can provide a useful indication of learning dissemination opportunities. We propose requiring each licensee to produce an annual NIA report for the purposes of learning dissemination[14]. This should include information on ongoing and completed projects. We propose requiring licensees to share these reports through the dissemination portal being established by work stream five of the DECC/Ofgem Smart Girds Forum[15]. This would be available on the Energy Networks Association (ENA) web page. We are also seeking stakeholders' views on which parts of the IFI Annual Report currently work well and should be adopted in the NIA annual reports, as well as what additional information would make the NIA reports most effective as a tool for disseminating learning.

Respondents to the recent LCN Fund two year review considered that the annual LCN Fund Conference was a useful means of sharing knowledge. However, we recognise the scale and scope of the NIA is different to that of the LCN Fund. Therefore, we are seeking respondent's views on whether a NIA/NIC annual conference would be useful and practical given these differences.

2) Access to detailed information

The NIA annual reports and annual conference would increase transparency. Our second proposal seeks to ensure that licensees can access more detailed information, when they require it. To do this, we propose to include an obligation on licensees so that, where they develop relevant new learning as part of a NIA project, they will be required to share that learning on a bilateral basis when they are asked to do so by any network licensee.

- **Question 10: What elements of the current IFI annual report work best; and what would you improve to make these reports more effective as knowledge dissemination tools?**

- **Question 11: Do you agree with our proposal for sharing the NIA annual reports? In addition, what other means are there of disseminating this learning to all interested parties?**

- **Question 12: Would an annual NIA conference be a useful tool for disseminating the knowledge gained from NIA projects? Why?**

- **Question 13: Do you agree with our proposals requiring licensees to share the learning from NIA projects? If you do not agree then please explain why.**

Intellectual Property

Issue

As set out above, a key principle of the NIA is to generate new learning for all network companies. This learning can lower costs and/or improve outputs.

[14] In addition to the NIA Annual Report licensees will have to comply with the regulatory instructions and guidance (RIGs). RIGs reporting will show whether licensees have spent in line with their allowance and any caps that may be placed on types of NIA expenditure. The RIGs will be developed separately to the Governance for the NIA and NIC.
[15] http://www.ofgem.gov.uk/Networks/SGF/Pages/SGF.aspx

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Due to the innovative nature of NIA projects, it is likely that a proportion of the knowledge generated will form intellectual property rights ("IPR"). We think this creates several issues:

1) We are keen to ensure that all licensees and their customers are able to access and benefit from knowledge generated through the NIA (which consumers have funded through their network charges). We want to ensure that IPR do not act as a barrier to the dissemination of this knowledge.

2) We are conscious that projects funded – in full or in part – by the NIA could result in the development of commercial products which, when protected by IPR, could be exploited to make a significant profit. The opportunity to make financial return in this way is a natural incentive for private companies to invest in innovation. As such we need to be mindful of the risks of consumers' money (provided through the NIA) being used to fund innovations which generate IPR for private companies. We consider these risks to be:

   A) the removal of the incentive for companies to invest in innovation for themselves – companies may seek to 'free ride' on consumers' funding. We do not want NIA funding to distort the market for innovation or act as a substitute to private sector investment in it. The aim of NIA is to act as an enabler to investment in innovation by network licensees who would not otherwise participate in projects with a higher level of risk.

   B) consumers potentially paying twice for an innovation (i.e. funding the innovation through NIA and then being asked to pay a premium for a new product which that funding has enabled).

Context – previous arrangements

Under the IFI there have been no formal requirements for companies to enter into specific IPR arrangements. Evidence received from certain IWG members suggests that licensees have sought to enter into a range of different commercial arrangements which provide the licensee with benefit in the event that an innovation which it has funded under the IFI comes to market. Some of this benefit is then passed back to consumers through sharing factors in the price control.

However, under the LCN Fund companies are required to conform to a set of default IPR arrangements. The current default IPR[16] conditions in the LCN Fund:

- Allow project partners to protect the background IPR[17] which they bring to the project.

- Require that relevant foreground IPR[18] be made available to all licensees. Relevant foreground IPR is IPR that other DNOs will need to utilise in order to implement the method being trialled. This provision therefore seeks to ensure effective knowledge transfer.

- Make it clear that foreground IPR within commercial products, where those products will be available for use by the other DNOs after the end of the project, is not deemed to be "relevant foreground IPR" (i.e. this IPR is protected for the party that generates it).

[16] See Low Carbon Network Fund Governance Document v.5
[17] The IPR owned by a party prior to the start of a project.
[18] The IPR created through the project.

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Proposals

The NIA will encompass a broad range of innovation projects. In developing it, we are consulting on what IPR arrangements would be most suitable.

Our objective in developing these arrangements is to ensure consumers obtain adequate value from their investment. We recognise this value comes from the knowledge that is being generated through projects and the benefits this knowledge can create (in terms of improved outputs and/or cost savings). However, we need to ensure that consumers are able to access their share of these benefits.

We believe that, without suitable protection, there is a risk of windfall gains to certain parties on the back of consumers' investment. Therefore, to ensure that consumers benefit in all circumstances, we consider that protection is necessary for all projects funded through NIA – regardless of the technology readiness levels (TRL). In developing such arrangements, we think it is important to ensure that the potential reward for each participant in a project is in proportion to the effort or expenditure they have made in relation to the project (this may vary dependent on the riskiness of the project).

To achieve this, we are proposing the adoption of similar default IPR arrangements as those which exist under the LCN Fund. We propose that these should be applied to projects at all TRLs, as opposed to those at only the trialling stage (as is the case under the LCN Fund).

Discussions through the IWG have highlighted a risk of deterring the opportunity for collaboration with certain types of project partner, if IPR requirements are too onerous or prescriptive. This is a particular concern for projects at a lower TRLs where the potential upside of a successful innovation is less certain. In this regard we are proposing to adopt the same carve out for commercial products as has been included in the LCN Fund default arrangements (as set out above). In addition, licensees will be able to apply for our approval to adopt alternative IPR or commercial arrangements which will provide the best value to consumers (e.g. future discounts on products which come to market). (The section above on project registration provides more detail on this).

However, in light of discussions above we are seeking views on the appropriateness of including this carve out for projects at higher TRLs (i.e. trials). In particular, does its inclusion risk:

- the removal of the incentive for third party companies to invest in innovation themselves; or
- consumers paying twice for an innovation (i.e. funding the innovation through NIA and then being asked to pay a premium for a new product which NIA funding has enabled).

As such, if a carve out is provided at any TRL, we consider that it may be appropriate to include further protections for consumers – such as a requirement for the licensee to enter into commercial arrangements which provide best value for consumers (e.g. to negotiate future discounts, etc).

- **Question 14: Do you agree with our proposed approach on IPR?**
- **Question 15: Should a carve out for commercial products be included with the default IPR arrangements?**
- **Question 16: Should the carve out be limited to projects focusing on lower technical readiness levels?**

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- **Question 17: If a carve out is provided, should other requirements be placed on the licensee to ensure best value for consumers?**

Next Steps

We welcome responses to the questions we have raised in this letter by **28 June 2012**. Responses should be sent, preferably by email, to **networks.innovation@ofgem.gov.uk** or in writing to:

Sam Cope
Ofgem - London
9 Millbank,
London,
SW1P 3GE

Respondents who wish to have their responses remain confidential should clearly mark the documents to that effect. Unless marked confidential, all responses will be published by placing them on our website. We intend to make a decision regarding the issues consulted on in this letter during the summer.

In the meantime we intend to hold an Innovation Working Group meeting on 11 June 2012, to discuss the questions raised in this letter and the next steps for developing the governance for both the NIA and NIC. The meeting will be held at Ofgem's offices in London from 10am to 4pm. There is an open invitation to attend the IWG. If you would like to attend this working group meeting please contact **networks.innovation@ofgem.gov.uk** for further details.

We intend to develop the NIA Governance Document during Summer 2012 and the legal drafting will be consulted upon during the Autumn 2012. Should you wish to discuss the issues raised in this document, please contact Sam Cope at sam.cope@ofgem.gov.uk or on 020 7901 7239.

Yours faithfully,

Dora Guzeleva,
Head of Networks Policy: Local Grids

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