Dora Guzeleva
Head of Networks Policy: Local Grids
Ofgem
9 Millbank
London
SW1P 3GE

98 Aketon Road
Castleford
West Yorkshire
WF10 5DS

28 June 2012

Dear Dora,

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

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 design features of the Network Innovation Competition (NIC) and the Network Innovation Allowance (NIA).

We note Ofgem's desire to reduce bid preparation costs for NIC proposals but we also note that the high level of current cost is driven by the requirements of assessment process. It is difficult to see how we can provide the current quality of submissions for larger projects with the introduction of the proposed annual cap. We recommend that the capping arrangements adopted in the current Low Carbon Network Fund (LCNF) are maintained in the NIC.

To summarise our response on NIA issues, we support the general approach and principles to innovation funding in the NIA set out in the consultation letter. We do however notice several issues where the adoption of the current Low Carbon Network Fund arrangements into governance causes several issues resulting from the different and much broader nature of the projects likely to be performed under the NIA.

The major issues are in the area of intellectual property rights, an area that we have found to be particularly problematic in the past even when we have had a lot of flexibility. The currently described default IPR arrangements seem likely to cause further problems and act as a dis-incentive to some forms of best-practice collaborative working. Our recommendation is that the flexible approach to IPR developed over the life of the Innovation funding Incentive (IFI) is maintained in the NIA but that licensees are required to explain and justify any arrangements put in place.

A further issue is the cap on the internal component of innovation spending. We believe that the DNO community have shown no inclination to excess in this area and that the re-introduction of the cap is an un-necessary and retrograde step.

Our individual responses to all the questions raised in the consultation are provided below.

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.

We do not agree with a fixed annual allowance set at the value outlined. The degree of scrutiny

that LCNF tier two bids are currently subjected to is more akin to a full project design process than a bidding process. This requires a great deal of detailed analysis and decision making to be made at the proposal stage. The costs associated with this tend to be relatively high and a typical benchmark cost, from examination of previous LCNF bids and EU Framework proposals, for such project design is more typically in the range 10-15% of the overall project value.

If the preparation and level of detail required at the bid stage were reduced, along with a commensurate reduction in the expectations of the assessing panel, perhaps to be followed by a further post-bid project design stage then the £175k/5% may be appropriate. This is not however in line with the observed trend through recent LCNF bidding rounds and at this time we are unable to agree with the proposal.

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?

We believe that to encourage a large number of high quality NIC project proposals which do not then impinge on the available funding for licensees to then deliver such projects that funding for bid preparation costs should come from outside of the annual NIC allowance.

Under a regime where bid funding comes from the annual allowance it would be theoretically possible for the bidding to consume all of the available funding leaving nothing for delivery. There should be no disincentive for individual licensees, or the industry as a whole, to put forward a large number of high quality bids at the earliest possible time.

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.

Generally the high level eligibility criteria appear to be sufficiently focussed whilst providing the level of flexibility required to deliver a broad range of projects that will benefit the customer. However the requirement to deliver net *financial* benefits doesn't feel entirely appropriate, recognising that some benefits may not have a financial impact but may improve reliability or availability for example. Assessment of direct financial benefit here is difficult but the utility of improvements in this area of customer service is clear. These types of benefits seem to be different to projects aimed at environmental and safety improvements where the direct customer-benefit is difficult to assess.

We believe that the criteria should be amended to state that projects should have the potential to deliver benefits to current and/or future customers and that the onus then be placed on the licensee to demonstrate and, where possible, quantify that benefit. Where the project benefits are clearly difficult to demonstrate, such as for environmental projects, we are content that the permission of Ofgem to proceed should be sought beforehand.

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.

We agree with self-certification of projects. This has been the successful approach over more than ten years with IFI and the last three years with tier one of the Low Carbon Network Fund.

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.

We agree with the principle that projects are registered. This has been a successful approach to the tier one of the LCNF and we accept that this provides visibility of the projects being undertaken.

Registering projects before they begin suggests that all projects are designed, planned and then executed. This is not the case and the front end of such projects may be quite fuzzy. It may only be clear with some hindsight that a project has come into existence. Some flexibility with registration would therefore be helpful and reflect the reality of how projects are initiated.

Furthermore for low technology readiness level (TRL) projects, funded up to now through IFI, projects evolve and the final project, as delivered, may not reflect the originally held view. This is fundamentally different to LCNF projects, which are primarily deployment, and are therefore easier to plan with some certainty. The current differing governance processes for IFI and LCNF recognise and make allowance for this difference and we believe it is important that this is maintained.

To address these issues we suggest that projects be registered as soon as possible, say within six months of commencement and not at a point beyond 20% (say) of the project's duration, allowing pre-registration costs to be allocated against the project. Furthermore the registration process should be aimed at providing visibility of what is being undertaken and should not be seen as an up-front commitment to particular project designs.

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.

Notwithstanding the earlier point about customer benefits versus financial benefits, we see the validity of seeking Ofgem's pre-registration permission before commencing projects which require payments to related undertakings. For non-standard intellectual property arrangements we do not believe that a default arrangement with sufficient flexibility to cover the broad range of projects required can be drawn up. We address this point in further detail below in response to questions 14 to 16 below.

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.

We do not agree with the proposal to include an annual cap. Notwithstanding the statement made in the consultation letter, most DNOs have had the 15% cap on internal expenditure lifted sometime during the DPCR4 period.

For electricity distribution licensees the original purpose of this cap was to discourage DNOs from using the then newly instituted IFI to build internal R&D facilities. The cap achieved this aim and IFI funding is primarily used to fund work by second and third parties and a successful and varied marketplace for such services has been established.

DNOs have recently and typically used 20-25% of their annual IFI allowance for internal spending to support projects. It is also clear that to ensure that value-for-money is obtained for the customers' money spent that this may need to be somewhat higher in coming years.

Internal spending is required to allow a business to fully implement innovative ideas and

products so that they have the impact intended on the networks. Projects which are likely to have such an impact, even where they are primarily delivered through external parties, tend to have higher internal costs in the implementation phase as learning is embedded within the receiving business and becomes business as usual. Examining the strategic plans that we are now developing shows that more of this internal learning and embedding will be required to deliver and operationalise smart grids and other improvements needed in the ED1 period.

Any inability to fund such activities as the result of a spending cap compromises the speed and flexibility of implementation of good innovation to the customer's detriment. Additionally failure to develop the appropriate embedded learning within our organisations, either leaving it with external parties or failing to capture it at all, means that we have to constantly re-purchase it, again to the detriment of the customer.

Our early estimates are that we could need to spend on average approximately 30-35% on internal costs for innovation projects to have the impact required. This is an average figure and in some exceptional years the value could be more.

A further issue is the potential use of NIA funds to support set-up costs for NIC projects. On previous LCNF projects we have used third parties to assist in project bid preparation. This is relatively expensive. If a cap on set-up costs is applied the option to use external resources on this will be restricted and will therefore require the use of more internal resources. This will therefore mean that the proportion of internal cost to external cost is further increased.

For these reasons we believe that the most appropriate course is as per recent history and that allowances should be set without an internal spending limit allowing network companies to exercise their own flexible judgement as to the most appropriate apportionment of costs. If compelled to suggest an annual cap below this level, which is unlikely to be exceeded without questions of efficiency being raised, we suggest that this should be no lower than 50%.

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?

The current IFI report is reasonably good at acting as an attention directing device with respect to activities being undertaken. The level of detail is sufficient but annual preparation can be onerous and the information may be appearing for the first time over 12 months after project completion.

Much of the value that the report currently has will be overtaken by the project registration requirement. The addition of an outcome and lessons learnt section on the project registration form, to be filled out for complete projects, will provide a constantly updated, and therefore more timely, version of the annual report. We therefore propose removing the requirement for an annual report or significantly reducing its scope.

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?

As outlined above for question 10, the NIA annual reports may be now redundant.

Annual reports for IFI are already shared between licensees and with other parties who request to see them. Reports are usually also available through individual licensees' websites and are likely to be held on the ENA innovation portal in future years. Until recently they were also published annually on the Ofgem website. The reports are therefore pretty much public domain and any further requirement for dissemination of learning to a broad audience, as opposed to focussed dissemination to those with a specific interest, seems un-necessary.

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

The value of an annual conference is difficult to gauge. The large number of innovation projects being undertaken means that all of them could not be covered on an annual basis and only the basic outline of a selection could be covered in any realistically useful manner. It is difficult to see how this would provide dissemination beyond what would be available from the registration and annual reports.

We do acknowledge that knowledge dissemination is important but would question mandating a conference as the vehicle for doing that, especially over an eight-year period.

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.

Certainly DNOs already share their IFI learning with one another, either through a multilateral forum such as the ENA's R&D managers' working group or through alternative bilateral contacts. Occasionally some limit on sharing is necessary but this tends to be of a temporary nature and given shareholders are making a 20% contribution to projects alongside the customer's contribution this does not seem unreasonable.

Given this knowledge exchange we have no general objection to sharing learning with other licensees, although it may seem unfair to have to do so where another licensee is given but refuses the option to collaborate and co-fund such knowledge generation.

We would also prefer to see any such requirement to be limited to other licensees. We see no reason to be compelled to provide such learning to commercial organisations to exploit, especially where much of the learning can be intangible and difficult to protect fully and efficiently from an intellectual property rights perspective.

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?

We do not agree with the approach outlined for IPR. Whilst a good argument can be made for such arrangements for LCNF style projects where the IP is basically set in the product or approach being deployed the situation is very different for IFI style projects.

It is our experience that IP negotiations are often the most difficult and onerous part of developing any innovation contract and are unique to individual project circumstances. A default approach is arguably not in customers' best interests since learning may be constrained even when the risk of value being misappropriated is low,

We appreciate that Ofgem are keen to ensure that the customer benefits from the IP developed as a part of innovation projects however customer benefit is often best served by the bringing of some technology or approach to the marketplace so that it can have an impact for example in reducing costs. The major benefit is not in the underlying IP. However developing and owning the underlying IP may be the only benefit for a collaborator, particularly if that collaborator is an SME or other independent inventor. It may be the basis upon which such an individual has sought and obtained prior investment.

Some projects have other sources of additional funding, such as research councils, with their own view of appropriate IPR arrangements. An inability to freely negotiate IP with such parties may exclude licensees from collaborative opportunities to leverage their NIA funding. This would

be to the detriment of the customer.

We recognise that Ofgem has gone some way to recognising the issue with the proposed carve-outs and the ability to seek permission for alternative IP arrangements. We believe that this leads us open to the circumstance where our potential supplier of innovation is negotiating with Ofgem, or their legal representative, whilst we stand on the side-lines. We cannot believe that this is in the interests of any of the parties concerned.

Licensees are aware of the value of IPR and have shown themselves to be able to act in the best interests of the customer and of other parties to obtain customer benefit. They have been able to do this through a flexible approach to IPR determined on a case by case basis.

We believe that attempting to develop default IP arrangements to avoid some theoretical windfall gain by an undeserving party, a circumstance that we have yet to see in over 10 years of IFI, is likely to reduce the innovation opportunities available to us. We would prefer a requirement that IP is carefully considered by the negotiating parties to a contract and that any arrangements agreed are equitable and recognise the balance that needs to be struck between the competing needs of those parties and of the customer. The licensee should be required to explain and justify those arrangements at project registration but the differing, project specific nature of IP requirements means that we will be seeking Ofgem's permission for the majority of our projects under the current proposals.

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

Chris Goodhand

Innovation Manager