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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

Thank you for the continued opportunity to participate in the design of the Network Innovation Competition (NIC) and the Network Innovation Allowance (NIA). This response should be regarded as a consolidated response on behalf of UK Power Networks' four electricity distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, South Eastern Power Networks plc, and UK Power Networks (IDNO) Ltd.

I can confirm that this response is non-confidential and can be published via the Ofgem website. Our detailed answers to the considerations you have raised are set out in the appendix to this letter. I hope that you will find our comments helpful. If you have any questions please do not hesitate to contact me.

Yours sincerely

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Appendix:

Consultation on funding the cost of preparing submissions for the NIC

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.

Whilst there has been debate at the Innovation Working Group (IWG) meetings about the level of detail which should be included in a NIC final submission, our approach under the Low Carbon Network Fund (LCNF) Second Tier has always been to put forward fully developed projects which are ready to deliver. We believe that any relaxation of the final submission requirements will lead to an increased level of failed projects at a later stage.

Historically DNO's have been allowed a bidding cost for a LCNF Tier 2 project comprising up to 20% of the LCNF Tier 1 allowance. For UK Power Networks' three licensees this is up to £860k for each LCNF2 project bid. Whilst we have not spent at this level, our experience has been that the level of detail and quality which needs to be maintained in a NIC final submission cannot 0be delivered within a cap of £175k.

For simplicity, we propose that a flat cap of £400k is applied to each DNO group, since this recognises that there is not a direct link between the bid effort required and the final funding request, but already represents a reduction on the amounts that we have found necessary for the Low Carbon London bid and will therefore drive efficiencies in future bids.

Specifically, we are continuing to find that we need to build a team consisting of a single overall bid lead and a small project team. The project team includes: legal and procurement support; domain specific expertise from within the organisation (for example of HV and EHV modelling); constructing innovative commercial solutions; external technical consultancy and expertise in stakeholder management; and external assessment or assurance of the bid.

The table on the next page shows a breakdown of these cost areas within each of our submitted returns for the Low Carbon London and Flexible Plug and Play LCNF Tier 2 bids.

Each of Low Carbon London, Flexible Plug and Play and our current Smarter Network Storage bid will incur less than 5% of their funding request during the bid phase. However, the table demonstrates that bid costs are related to the nature of the project rather than its size and final funding request: for example the Low Carbon London project required significantly more work in managing a large number of stakeholders and a total bid amounting to £543k.

Please note that the aspects of technical consultancy and bid assurance shown in the table on the following page are not necessarily associated with a follow-on role for the relevant parties in the project itself. It follows that there is limited room for them to carry out this work in-kind and their costs generally have to be met during the bid phase. A practical example within our current Smarter Network Storage bid are a number of ecological surveys and topographical surveys required to support the planning process for our candidate site.

Finally, in both the case of Low Carbon London and Flexible Plug and Play, additional partner effort during the bid phase was of the same order of magnitude.

	Low Carbon London	Flexible Plug and Play
Bid lead and project team	£177k	£93k
Legal and procurement	£84k	(not recovered)
Domain specific expertise	(not recovered)	£40k
Technical consultancy	£171k	£98k
Stakeholder management	£82k	£0k
Bid assurance	£30k	£66k
Sub-total	**£543k**	**£296k**
Early start on subsequent year	£2k	£29k
RIGS table C22 total*	**£545k**	**£325k**

*Total at the DNO group level

We recognise Ofgem's concern that the NIC will both increase the number of potential bidders and introduce non-RIIO licensees with whom Ofgem has less frequent regulatory interaction. We also recognise that the requirement for a project to first pass the ISP stage before being allowed to recover its bid costs does not fully mitigate Ofgem's concerns related to an increased cap of £400k per licensee group.

A possible additional mitigation might be to require a bidder to incur at least 15% of its bid costs in house. This would reset the risk/reward balance and ensure that no bidder can take an approach of largely outsourcing a bid to a third party, knowing that its costs will be fully recoverable and thereby presenting a project which may not be of sufficient quality and where the bidder's organisation has not fully committed to it.

Finally, we believe that there is a strong reputational incentive on all licensees not to spend disproportionately large amounts on bidding for small projects, since all recovered bid costs will be transparently reported to Ofgem.

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 recognise that our proposal in question 1 to increase the allowance available for bid preparation costs would require additional funds to be transferred to non-RIIO licensees if they made full use of their bidding allowance. However, we are sensitive to any overall increase in funding expected from gas and electricity customers.

As such, we propose that bid costs for non-RIIO licensees are taken from the funding set aside for the NIC. This would avoid any additional customer funding over and above that already outlined in the RIIO-GD1 and -T1 consultation documents published to date. This proposal also has the advantage that the bid costs could be recovered in the same way as already envisaged for the NIC projects themselves, through the transmission use of system charge.

<u>Consultation on the Network Innovation Allowance</u>

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

We agree with the NIA Project Eligibility Criteria as set out in the consultation document.

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.

We are concerned that the requirement to seek approval for projects with non-financial benefits may lead Ofgem to have to spend time considering projects whose spend levels are not material, and may create unnecessary bureaucracy.

We believe that the current assessment framework detailed in Table A1 in ENA document G85 Issue 2 'Innovation Good Practice Guide for Energy Networks' provides a means by which financial, safety and environmental benefits can be compared and reconciled. We also believe that this framework has been proven to be effective as a tool over a number of years of our Innovation Funding Incentive (IFI) programme. As such, we suggest that the need to seek permission for projects with non-financial benefits is removed, as long as DNOs can demonstrate to Ofgem that this framework is followed.

At the very least, we believe that the need to seek permission is removed for safety-related innovation projects where the forecast spend is below a materiality threshold of £500k. We believe that there is a strong ethical pressure on us to progress safety-related innovation rapidly once ideas and proposals come to light.

<u>Project registration process</u>

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 the proposal that licenses should self-certify projects, and believe that both the Innovation Funding Incentive and the Low Carbon Network Fund first tier have proven this approach to be successful.

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 have no objection in principle with the proposal that licensees should register projects with Ofgem before they begin. However, our preferred approach to ensure an efficient process would be for NIA projects to be registered via an online NIA project catalogue managed by the Energy Networks Association (ENA), as each company approves them internally.

We envisage that this online catalogue would contain key project information necessary to provide visibility of NIA projects, and enable DNOs to identify opportunities for collaboration and avoid duplication. We advocate incorporating this NIA project registration facility within the innovation project database to be developed as part of the current Smart Grid Forum workstream 5 initiative.

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.

We agree with the requirements related to intellectual property and payments to related undertakings, and recognise that these are consistent with the current approach within the Low Carbon Network Fund first tier. However, we propose that the requirement to register where there are no financial benefits is removed, in line with our answer to question 4.

Internal expenditure

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.

We have shared with Ofgem, following previous Innovation Working Group meetings, our internal policy on innovation (document SR 07 002). This policy states that we are comfortable that we will use R&D contractors for a significant portion of the work, since we recognise that it is neither practicable nor reasonable for UK Power Networks to build capacity at the forefront of research across the breadth of issues we need to address.

As such, we are happy to work within a cap but welcome the opportunity to have the cap lifted on an exceptional basis and when and where there is justification.

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.

Our experience of managing IFI projects has shown that successful development and integration of new technology is highly dependent on a strong and continuous involvement from relevant business units within the DNO. We therefore anticipate that the level of internal resources required to successfully manage innovation and transfer of technology will have to be increased.

Therefore, whilst we have not exceeded the 15% cap to date, we believe that an internal expenditure cap of 25% would be appropriate going forward, and provided that DNOs retain the possibility of requesting the cap to be lifted on an exceptional basis.

Knowledge Transfer

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 elements of the IFI annual report which work best from UK Power Networks' perspective are:

- sections of the document presenting the highlights of the portfolio and the benefits delivered
- project progress section within each of the individual project reports.

Although the IFI annual report is useful, improvements could be made to clarify whether a technology is ready for use by other DNOs (or the results of a study should be considered by the industry). The process could be improved even further with the status of the project being tracked in an Online NIA project catalogue (please see our response to question 6).

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?

We agree with Ofgem's proposal, and have already taken the step of publishing our annual Innovation Funding Incentive (IFI) report on our website hence making it freely available to DNOs and other interested parties.

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

While useful in terms of raising awareness we do not believe that an annual NIA conference would necessarily be the best (or only) tool for dissemination of the knowledge gained from NIA projects at the level required for effective replication as business-as-usual options. Although the first LCNF conference has provided a useful platform for advertising to the industry the work carried under the LCNF tier 1 and tier 2 schemes, only a small amount of time is dedicated to each project and complementary dissemination initiatives are also necessary in our view. In particular, we believe that the main learning will come outside a conference, more specifically in subject-specific dissemination sessions, or technical reports produced by DNOs.

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.

It is our policy to share our results with other DNOs and as such, this would not constitute a change from our existing practice.

Intellectual property

Question 14: Do you agree with our proposed approach on IPR? and
Question 15: Should a carve out for commercial products be included with the default IPR arrangements?

We agree with the approach and welcome the same carve-out for commercial products that is currently in version 5 of the Low Carbon Network Fund governance document to be applied to the Network Innovation Allowance. We believe that this will encourage participation by academia, smaller R&D providers and new entrants as it allows such participants to retain intellectual property rights in such products, ensuring that the commercial value of these products is realised whilst allowing DNOs to benefit from the knowledge gained through such projects. It is recognised that as the development of these products is customer funded, participants need to demonstrate value for money in presenting any proposals. We have previously shared with Ofgem examples of innovation projects and their related commercial terms which demonstrate how we continue to drive customer value for money.

Where existing products are to be developed for new applications and such development is being carried out as part of an innovation project, then greater clarity in the default IPR provisions regarding the treatment of Relevant Background IPR would assist DNOs to negotiate with parties to obtain access to IPR.

Question 16: Should the carve out be limited to projects focusing on lower technical readiness levels?

We do not believe that the carve-out should be limited to projects focused on lower technology readiness levels. We believe that the carve-out is equally applicable to modifications to an existing mature product, to allow its use in a new application, as it is to brand new product concepts.

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

Notwithstanding our answer to questions 14 and 15, there may be an alternative approach which better reflects the variety of ways in which we have negotiated IPR arrangements under IFI. DNOs could be required to negotiate contracts for NIA projects on the basis of the Lambert agreements (http://www.ipo.gov.uk/whyuse/research/lambert/lambert-mrc.htm) and to not materially deviate from these.

The Lambert agreements offer a number of different model contracts which suit different maturities of technology and uncertainty in the long-term benefit of the research. These have been used successfully under IFI and LCNF, either as universities' contract offices have put these forward as the basis of agreements or as our legal teams have used them as the starting point for IFI and LCNF agreements. The Lambert agreements also form the basis for the Energy Innovation Centre's model contracts.

In this case, two additional requirements would be:

1. that DNOs can demonstrate to Ofgem that the choice of agreement within the spectrum of Lambert agreements, and the funding amount, are commensurate with one another and have been negotiated with regard to the best interests of customers; and
2. that where the Lambert agreements allow a sponsor to return and negotiate an exclusive licence to a technology which appears to have significant potential for commercialisation, DNOs do not negotiate contracts which would prevent the product from being available to other UK network licensees.