



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: 13 August 2012

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

The Innovation Stimulus

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

- a Network Innovation Allowance (NIA) – to fund smaller innovation projects;
- a Network Innovation Competition (NIC) – to fund selected flagship projects; and
- an Innovation Roll-out Mechanism (IRM) – to fund the rollout of proven innovations with proven carbon and/or environmental benefits.

The size of the NIA is between 0.5 and 1 per cent of the licensee's annual allowed revenue, depending on the quality of the Innovation Strategy submitted by each licensee.

Purpose

We published a consultation letter on 29 May 2012¹ on funding the cost of preparing submissions for the NIC and the Governance of the NIA. This letter sets out our decisions on these issues following our consideration of the responses we received² to our consultation. The decisions set out in this letter will be implemented through the NIA and NIC governance documents and licence conditions.

Network Innovation Competition

This section of the letter sets out our decisions on two outstanding aspects of the NIC governance framework related to bid preparation costs.

The level of bid preparation costs

In our consultation letter we asked whether the amount licensees could use to prepare submissions for the NIC should be capped and what level this cap should be set at (we proposed a cap of 175k or 5% of total project costs, whichever is smaller). The responses that we have received suggest agreement in principle to setting a cap on bid costs in order to drive efficiency. Therefore we will cap the amount available to licensees to fund the preparation of submissions in the NIC.

¹ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=349&refer=Networks/nic>

² A summary of these responses is available at annex 1.

Three respondents agreed with the proposed level of the cap with other respondents arguing for higher levels of funding. Alternative suggestions ranged from £250k to £500k. One respondent commented that the proposed cap of £175k per bidding group would have been sufficient in either of the first two years of the LCN Fund competition. This respondent is implementing four projects – demonstrating that they have been able to meet the requirements of the governance framework in their bids. We think that this provides strong evidence to support our view that capping bid preparation costs at a level of £175k (or 5% of Total Project costs, whichever is smaller) should lead to efficient and effective bidding. However, we will re-consider this decision if evidence emerges that this level of funding is preventing the development of effective bids.

Funding the preparation of submissions to the NIC for Non-RIIO Network Licensees

We also asked respondents whether the cost of preparing submissions to the NIC from Non-RIIO Network Licensees³ should be provided from the funds set aside for funding NIC projects (i.e. the £30m electricity pot and £20 gas pot)⁴. Responses to this question were mixed. A number of respondents commented that funding the preparation of submissions in this way would limit the total funding available for NIC projects. Others agreed with our proposals noting the additional cost for consumers of providing this funding from elsewhere.

Our decision recognises the concerns of both sets of respondents. We will fund the preparation of submissions to the NIC by Non-RIIO Network Licensees from the amount currently set aside for NIC projects. However, this funding will only be available for those projects which have demonstrated they are eligible for NIC funding by passing the initial screening process.

Network Innovation Allowance

This section of the letter sets out our decisions on the NIA governance framework.

Eligibility Criteria

High Level Eligibility Criteria

In our consultation letter we proposed criteria which projects would need to meet in order to qualify for funding from the NIA. Respondents largely agreed with the proposed high level eligibility criteria. One respondent commented that licensees should not be allowed to implement projects involving commercial innovation, arguing that licensees should be completing projects of this type as business as usual. Another respondent was concerned that because of our proposals they would not be able to implement projects addressing challenges particular to their own network, where the learning from the project would not be easily applicable to other licensees.

Based on the balance of responses we will incorporate the proposed high level eligibility into the NIA Governance Document. This will include retaining commercial innovation within the scope of the NIA. We consider that licensees are incentivised to undertake commercial innovation through the RIIO framework, but that some higher risk commercial innovation would not be undertaken without dedicated funding. For the avoidance of doubt, only commercial innovation that has a direct impact on the operation of the network for example, projects involving demand side management will be eligible for funding through the NIA. In addition, it will be important for licensees to demonstrate that NIA projects could not be taken forward under business as usual arrangements.

³ See decision on access to the NIC [here](#) where we defined Non-RIIO Network Licensee, and generally would include Offshore Transmission Owners (OFTOs), in the electricity NIC and Independent Gas Transporters (IGTs) in the Gas NIC.

⁴ RIIO Network Licensees' bid costs will be funded from their Network Innovation Allowance.

We also recognise licensees need to address challenges particular to their own network in innovative ways. Therefore, where a specific local challenge has been identified in the licensee's Innovation Strategy then it will be eligible for NIA funding. Licensees implementing projects of this type will still be required to conform to all other aspects of the NIA Governance document regarding learning dissemination.

Quantifying the benefits of NIA Projects

We asked whether projects involving non-financial benefits should require our approval before being implemented. A number of respondents disagreed with this proposal commenting that, in their opinion, we would not have sufficient resources to approve the anticipated number of projects, and that licensees should have adequate systems in place to manage their portfolio of projects to ensure value for money for consumers.

Following discussions at the Innovation Working Group (IWG) about quantifying project benefits we consider that it is possible to calculate potential financial benefits for all NIA projects. For example, carbon benefits can be converted to a financial benefit. Therefore, we will require licensees to work together to develop a best practice guide for quantifying the potential benefits that may be delivered by NIA projects. We will need to approve this document before licensees can implement projects, and licensees will need to use this guide when carrying out the cost benefit analysis for each NIA project. We consider that the existing IFI Benefits Table which is part of the G85 Guidance Document⁵ will be a useful starting point in this exercise.

We expect the guide to provide a common approach for quantifying the potential financial benefits of NIA projects. We recognise it may take some time for licensees to develop this guide. Therefore, if the guide has not been approved by 1 April 2013, licensees will only be able to implement projects which have the potential to deliver a clear financial benefit, until the guide has been approved.

Project Registration Process

We want to ensure that there is wide visibility of the NIA projects being undertaken. This will help 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, in our consultation letter, we proposed that licensees be required to self certify projects against the eligibility criteria and register projects with us before beginning work.

Self Certification

The majority of licensees agreed with our proposals on licensees' self-certification of projects against the eligibility criteria, and, the registration of projects with us. However, one respondent felt that we should have more oversight over proposed NIA Projects. In contrast, a number of respondents were concerned that we would not have sufficient resources to implement the proposed registration process.

We have decided to require licensees to self-certify against the eligibility criteria for each project. In addition, licensees will be required to justify why they are not completing the project as part of their business as usual, and carry out a cost benefit analysis to justify the project. Licensees will need to be able to demonstrate that each project has a positive financial benefit having used the guide referred to above before a project will be eligible for NIA funding.

⁵http://www.energynetworks.org/modx/assets/files/electricity/engineering/engineering%20documents/ENA_ER_G85_Issue_2_071205.pdf

Project Registration Process

The majority of respondents agreed with our proposed approach to project registration but raised concerns regarding the level of resources we might require. Several parties highlighted the development of an Energy Networks Association portal which is being developed as a central database with information regarding all innovative smart grids projects being carried out within Great Britain.

We recognise that holding project information in one central data store can have benefits for transparency. As such we will require licensees to work together to develop a shared online portal which may be the same as the portal currently being developed e.g. Work Stream Five of the Smart Grids Forum referred to above. Licensees will be required to register NIA projects by publishing project details including the company's certification that the project is eligible through this portal. If the portal is not fully operational by 1 April 2013 we will require licensees to publish this information on their own website until the portal is in place. We will require licensees to have a portal in place by 1 October 2013. Licensees will be required to notify us each time they register a project on the portal or their own website.

Approval of Projects

In our consultation we proposed requiring licensees to seek Ofgem's approval of their projects in a limited number of circumstances. Respondents generally agreed that projects involving payments to related undertakings⁶ should require Ofgem's approval before being registered. However, respondents were split on the issues of intellectual property rights (IPR) and projects with non-financial benefits. Again, licensees were concerned about the level of resources Ofgem would potentially require.

We will require projects involving payments to related undertakings and projects that do not conform to the default intellectual property requirements to seek Ofgem's approval before being implemented. As noted above we consider that it is possible to quantify a potential financial benefit for all projects likely to be undertaken under the NIA. We will require all projects to be implemented under the NIA to have the potential to deliver financial benefits based on the guide to be produced by licensees and approved by Ofgem.

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 resources as part of a project, unless otherwise agreed by Ofgem. As part of our consultation we proposed a cap on internal expenditure and sought views on a suitable level for this cap. The majority of respondents agreed with the proposal to have a cap, with a small number rejecting the proposal. Of those who agreed with the proposal, suggestions varied between 15-50% of NIA expenditure as a suitable maximum level of internal expenditure.

We recognise that the IFI is largely focussed on lower technology readiness level (TRL)⁷ projects while the NIA will fund the development of technologies at varying levels of maturity. Further, we recognise that projects involving less mature technologies are more likely to be carried out by organisations other than the licensee, while more mature

⁶ A related undertaking is an organisation with the same ultimate controller as the Licensee.

⁷ TRL is a measure used to assess the maturity of evolving technologies. It is graded on a scale from 1 to 9 where TRL 1 is where scientific research begins to be translated into applied research and development and TRL 9 is a proven technology. The definitions of the TRLs are set out in UK Low Carbon Energy Technology Strategy: September 2008 available at:
http://www.energynetworks.org/modx/assets/files/electricity/engineering/engineering%20documents/ENA_ER_G8_5_Issue_2_071205.pdf

technologies will involve trials on the network and consequently involve a greater amount of internal expenditure.

In their responses and in information submitted to Ofgem following IWG meetings distribution network operators (DNOs) have stated that projects implemented under the First Tier of the Low Carbon Networks (LCN) Fund had a typical level of internal expenditure of 25%, although some were slightly higher. We anticipate that the costs of project implementation are likely to mirror those of the First Tier of the LCN Fund and, as such, we will cap the funding licensees can spend on internal company resources as part of their annual NIA expenditure at 25%. We will nevertheless allow licensees to write to Ofgem to request that this cap be raised on a year by year basis. These requests must be supported by evidence and will be considered on a case by case basis.

Knowledge Transfer

Facilitating knowledge transfer is one of the key principles of the NIA. 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.

Transparency of Available Learning

Most licensees agreed with our proposal that NIA annual reports should be shared. As stated above, we will require licensees to develop the online portal so the details of NIA projects will be published. We will require the licensees to update the details of each project they have registered to highlight new learning on at least an annual basis for as long as the project is generating new learning.

Secondly, we will require licensees to produce a brief summary of all their NIA activities each year highlighting any key learning that has been developed. This summary should include links to appropriate details on the NIA portal. To ensure a suitable level of support and visibility within the organisation we will require this report to be signed by an authorised person such as the responsible director.

We sought licensees' views on whether an annual NIA conference would be a useful knowledge dissemination tool. Most respondents agreed that a conference would be useful for raising awareness of what projects are being undertaken. However, they noted that detailed learning would be more effectively shared through other means. On this basis we consider that an annual conference will improve the visibility of what projects are being undertaken and identify key learning themes. As such we will require licensees to work together to host an annual innovation conference (i.e. covering innovations funded through both NIA and NIC) on at least an annual basis. This should cover both gas and electricity and could initially form part of the LCN Fund conference.

Access to detailed information

The portal and annual conference will increase the transparency of available learning. We will also seek to ensure that licensees can access more detailed information, when they require it. To this end, we proposed 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 asked to do so by another network licensee.

Most respondents agreed with our proposal but commented that intellectual property agreements may affect the ability of companies to share learning. Respondents also felt that we should not be overly prescriptive in how the detailed learning from projects is shared.

We do not want to limit the ways in which licensees share the learning they generate. Therefore we will include a general condition in the governance document requiring

licensees to have suitable systems and processes in place to share learning as effectively as possible with other network licensees.

Intellectual Property

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. Due to the innovative nature of NIA projects, it is likely that a proportion of the knowledge generated will form intellectual property rights ("IPR"). As such we proposed a set of IPR arrangements aimed at ensuring value without putting potential collaborators off from becoming involved in NIA projects.

All respondents agreed that it was important that the arrangements put in place deliver value for money for customers. Half the respondents to the consultation agreed with our proposed approach to IPR, while noting the need for flexibility to allow licensees to negotiate the best IPR arrangements. The remaining respondents who answered this question felt that they should be allowed complete flexibility to deliver value for consumers. While respondents noted the concern regarding research and development (R&D) collaborators' willingness to enter into NIA projects under the proposed arrangements, no R&D partners responded to the consultation.

We also asked whether there should be a "carve-out" for less mature commercial products. Respondents who agreed with our general approach noted that it would encourage participation by academia, small R&D providers and new entrants. A number of respondents felt the "carve-out" should be retained for all projects.

We note that all respondents feel flexibility is key when collaborating with organisations on projects involving less mature technologies. We believe that the proposed default IPR requirements provide a significant degree of flexibility for licensees to negotiate terms which ensure that licensees benefit from the knowledge generated from projects and ensure value for money for consumers. As such we will incorporate our IPR proposals in the NIA governance document (including the "carve out" proposal for less mature commercial products). However, we will take the time to understand any concerns stakeholders have with specific aspects of the IPR clause and seek to address any issues identified through the drafting and consultation process.

Next Steps

We are continuing work over the summer to develop the NIC and NIA Governance Documents. We will consult on the documents in the autumn before a statutory consultation at the end of the year. Should you wish to discuss the issues raised in this document, please contact Neil Copeland at neil.copeland@ofgem.gov.uk or on 020 7901 7193.

Yours faithfully,



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