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All network licensees, electricity consumers and their representatives, and other interested parties

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Implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund

The Low Carbon Networks (LCN) Fund includes a Discretionary Funding Mechanism, which allows for up to £100m to be awarded to Distribution Network Operators (DNOs). This funding is available to provide discretionary rewards to certain projects that bring particular value to the challenge of preparing networks for the low carbon economy.

This letter seeks your views on our proposed framework for assessing applications to the Second Tier Successful Delivery Reward (which is one aspect of the Discretionary Funding Mechanism).

We are not yet consulting on the other aspects of the Discretionary Funding Mechanism (the First Tier Portfolio Reward and Second Tier Reward). However, we welcome any early views on the structure of these competitive rewards to inform future consultation.

Background

The LCN Fund was introduced through the current electricity distribution price control, DPCR5, in 2010. The main objective of the LCN Fund is to encourage the DNOs to use the DPCR5 period to prepare for the role they will have to play as Great Britain moves to a low carbon economy. The fund enables DNOs to run trials to gain experience of new technologies, and new commercial and operating arrangements.

The total funding available under the LCN Fund is £500m. Of this, up to £100m is available through the Discretionary Funding Mechanism. The latter was implemented to provide a strong incentive to DNOs to develop well-designed and successful projects. The total £100m can be awarded across three distinct rewards: the Second Tier Successful Delivery Reward, the First Tier Portfolio Reward and the Second Tier Reward.

Further information on the LCN Fund and the Discretionary Funding Mechanism can be found in the DPCR5 Final Proposals[1] and the LCN Fund Governance Document ('the governance document').[2]

[1] DPCR5 Final Proposals – Incentives and Obligations is available at: http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_2_Incentives%20and%20Obligations%20FINAL.pdf

[2] The LCNF Governance Document (v6) is available at: http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/Low%20Carbon%20Networks%20Fund%20Governance%20Document%20version%206.pdf

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Second Tier Successful Delivery Reward

The Second Tier Successful Delivery Reward ('Successful Delivery Reward') is available under the Discretionary Funding Mechanism to reward projects that are well managed and completed at least to the standard that could be expected given the information provided in the project Full Submission.[3] This provides an incentive for DNOs to deliver projects effectively.

The Successful Delivery Reward, as set out in the governance document, cannot exceed the level of the DNO Compulsory Contribution toward project funding. This makes up 10% of overall project cost.

The sections below set out our views on how to assess applications to the Successful Delivery Reward. We are seeking stakeholder views on our approach to the timing and assessment of the Successful Delivery Reward. Further, we would appreciate any other comments relating to the implementation of the Successful Delivery Reward.

Timing

The governance document currently requires that DNOs are able to apply for a Successful Delivery Reward once we have approved a Project Close Down Report. The governance document requires us to determine the level of the Successful Delivery Reward that will be payable to the DNO and to notify the DNO of this within 30 working days of having sufficient information to make a decision. We consider there may be merit in adapting the existing process in this area.

We are keen to minimise the risk of the Successful Delivery Reward submissions causing resource constraints at busy periods in the annual LCN Fund Second Tier competitive process (for both us and DNOs). If this risk is not managed it could reduce the quality of Successful Delivery Reward submissions. Under the current annual competitive process, DNOs experience busy periods when preparing submissions and responding to information requests in March-April and June-October, and we are required to assess these submissions in May and September-November.

We consider an annual window for Successful Delivery Reward applications could be introduced in order to minimise resource constraints at existing busy periods for the LCN Fund. This would aim to ensure that DNO applications are of sufficient quality for us to make a robust judgement on the level of reward. Our view is that an annual window for the assessment of Successful Delivery Reward submissions could be introduced between mid-January and mid-March (with a deadline for receipt of submissions in early January). We are proposing a two-month window in order to allow time for any necessary clarifications regarding submissions. We would expect the first window to open in January 2015.

We currently issue a Funding Direction to DNOs once a year and would anticipate including any monies payable through the Successful Delivery Reward within this mechanism. A risk of an annual assessment window approach is that companies may have to wait to submit applications for a Successful Delivery Reward. This may delay the payment of any reward funding. We consider that this is a manageable risk.

[3] As described in LCN Fund Governance Document v.6, Section Two, Chapter 3, paragraphs 3.26 to 3.30.

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Question 1: Should we introduce an annual window for Successful Delivery Reward applications? What do you consider are the advantages and disadvantages of this approach?

Question 2: Do you have any views regarding the proposed timing of an assessment window for the Successful Delivery Reward?

Assessment

We are consulting on the principles that should be applied in assessing DNOs' applications to the Successful Delivery Reward. Once these principles are finalised they will be implemented through necessary changes to the governance document.

The governance document stipulates that a Successful Delivery Reward will only be made if there is evidence of the project having been well managed and of having achieved the Successful Delivery Reward Criteria (SDRCs) set out in the Project Direction.

A key aspect of a project being well-managed is how well change is handled. Good project management can ensure project outcomes are delivered successfully and efficiently despite any changes. As such, we propose assessing eligibility for a Successful Delivery Reward by considering both progress against project-specific SDRCs and how well the project has managed change. We propose assessing these against three key themes of project management – timeliness, cost effectiveness and quality. Our initial thoughts on these are below.

Assessment against SDRCs

When assessing the performance of the projects and determining whether or not to make an award under the Successful Delivery Reward, we will consider performance against the SDRCs.

We would expect to see evidence of how projects have maximised performance against the three assessment principles of timeliness, cost effectiveness and quality. We recognise that such evidence will vary from project to project, given that the projects will be aiming to meet different sets of SDRCs. However, there are common areas across projects that we may expect submissions to consider. Some examples of how the principles can be applied when assessing progress against SDRCs, and of evidence that we may expect projects to consider, are noted below.

1) Timeliness: Is there evidence of the project delivering its SDRCs against the pre-defined timescales?

2) Quality of outcomes: Are the delivered or achieved outcomes corresponding to the Successful Delivery Reward Criteria of sufficient quality to merit additional funding under the Successful Delivery Reward?

- *Suitable evidence may include information such as proof that the project has delivered high-quality knowledge dissemination, which allows other DNOs to replicate the success of the project; or proof that the stakeholder engagement undertaken for a project has been of high quality, such as a history of events organised or a log of how stakeholder queries have been managed effectively.*

3) Cost effectiveness: Did the project deliver the outcomes in an efficient manner? Are the costs incurred in delivery of these outcomes within the original project budget? Was there any project overspend? If so, how did this improve project outcomes? Was any funding returned to customers?

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- *Suitable evidence may include information such as proof that contracts and commercial partnerships have been delivered in a manner that has kept overall project costs down; or evidence that technical testing or equipment installations have been delivered in a manner that is consistent with the theme of cost-effectiveness.*

Question 3: Are the three principles of timeliness, quality of outcomes and cost effectiveness appropriate for assessing project performance and delivery of SDRCs?

Question 4: What sort of specific evidence should be submitted to us in order to allow us to assess against SDRCs?

Assessing management of change

We recognise that projects will often undergo change and have to adapt, sometimes as a result of circumstances beyond the DNOs' control. Indeed, we have received project change requests from DNOs.

We recognise that there are both benefits and risks of rewarding projects that undergo change through the Successful Delivery Reward. Providing these projects with access to the Successful Delivery Reward maintains incentives for good management for projects that have undergone change. However, there is a risk that poorly managed projects can still access funding. We consider that this risk can be overcome through use of explicit assessment criteria. We consider this is an important incentive for effective change management.

We therefore propose to assess how DNOs have managed changes that have occurred during the project life. We consider that this management of change will also be assessed in terms of cost-effectiveness, quality and timeliness.

Projects that are well designed and managed may not require changes. For the avoidance of doubt, projects that undergo no changes would be considered to have met this criterion but would still undergo the assessment described on page 3 of this letter.

Question 5: Do you agree that we should assess management of change when assessing Successful Delivery Reward submissions? What do you consider are the advantages and disadvantages of this approach?

Question 6: Do you have any views on the most effective way to assess the way that change has been managed during the life of a project?

We also seek views on how we could develop the detailed assessment criteria for a Successful Delivery Reward (both assessment against SDRCs and of change management). It is important to note that these criteria need to be developed in a way that is applicable to a range of different projects.

We will review responses to this consultation and consider whether further consultation is needed before making any necessary changes to the LCN Fund governance document.

Question 7: Do you have any other views on the assessment of the Successful Delivery Reward submissions?

Further development of proposals for First Tier Portfolio Reward and Second Tier Reward

We will be considering whether any changes to the current LCN Fund Governance Document are needed in order to implement the First Tier Portfolio Reward and Second Tier

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Reward. There are a number of areas for further consideration relating to these competitive rewards. We intent to develop our thinking on these areas, including:

- Allocation of funding between the remaining rewards
- Timing (when to hold competitions for the rewards)
- Number of competitions to hold for each reward
- Funding allocation between competitions (within rewards)
- Relevant factors in assessment of the First Tier Portfolio Reward and Second Tier Reward.

At this stage, although we are not consulting on options for implementing the competitive rewards, we would welcome any early stakeholder comments on the areas flagged above. We recognise that there are interactions between these areas and welcome views on the most appropriate approach to developing an efficient overall framework.

We aim to publish a further letter later in 2014, consulting on our approach for the First Tier Portfolio Reward and Second Tier Reward.

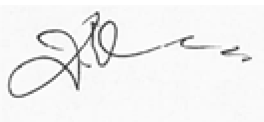
Next steps

We are consulting on the implementation of the Successful Delivery Reward for 8 weeks. This consultation closes on 28 March 2014. We would welcome responses from all network licensees, as well as any other interested parties. Information on how to respond is included in Appendix 1.

We are interested in hearing stakeholder views on these proposals and in engaging with stakeholders during this consultation period. During the consultation period we will be hosting an Innovation Working Group to discuss the proposals outlined in this consultation letter on 19 February 2014. If you are interested in attending, please contact: networks.innovation@ofgem.gov.uk.

Depending on the responses received to the consultation, we will consider making changes to the current LCN Fund Governance Document or implement the changes when we modify the Governance Document for the purposes of RIIO-ED1. We intend to consult on the First Tier Portfolio Reward and the Second Tier Reward later in 2014. If you have any queries, please contact: Arun.Pontin@ofgem.co.uk.

Yours sincerely,



Dora Guzeleva
Head of Networks Policy, Local Grids

Appendix: List of questions for consultation

This letter sets out the following questions for consultation. We would also like to hear the views of any interested party in relation to any of the issues discussed in this letter.

Question 1: Should we introduce an annual window for Successful Delivery Reward applications? What do you consider are the advantages and disadvantages of this approach?

Question 2: Do you have any views regarding the proposed timing of an assessment window for the Successful Delivery Reward?

Question 3: Are the three principles of timeliness, quality of outcomes and cost effectiveness appropriate for assessing project performance and delivery of SDRCs?

Question 4: What sort of specific evidence do you think that you may be able to submit to us in order to allow us to assess against SDRCs?

Question 5: Do you agree that we should be assessing management of change when assessing Successful Delivery Reward submissions? What do you consider are the advantages and disadvantages of this approach?

Question 6: Question 6: Do you have any views on the most effective way to assess the way that change has been managed during the life of a project?

Question 7: Do you have any other views on the assessment of the Successful Delivery Reward submissions?

Responses should be received by 28 March 2014 and should be sent to:

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Any questions on the content of this letter should, in the first instance, be directed to:

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