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Date: 28 February 2014

Dear colleague,

Provisional Network Innovation Allowance for all Distribution Network Operators

In November we consulted on our initial assessment of Distribution Network Operators' (DNOs') innovation strategies submitted as part of their RIIO-ED1 business plans¹. Based on this assessment we proposed values for the DNOs' Network Innovation Allowances (NIAs).

We evaluated these strategies in parallel with the assessment of the RIIO-ED1 business plans. Under RIIO, companies have the chance to have their business plans agreed early, providing they are of sufficient quality across the board. This is known as fast-tracking. In November 2013 we published our assessment of the business plans and our proposal to fast-track the four licensees owned by Western Power Distribution. Today we published our decision to fast-track WPD. Non fast-tracked companies will resubmit their business plans in March 2014 as part of a slow track assessment. Our November business plan assessment did not include the innovation strategies. We issued a separate consultation on our initial assessment of the innovation strategies at the same time.

The NIA is a set allowance available to each DNO to spend on innovative projects – the default amount available is 0.5 per cent of the total annual base revenue awarded to each DNO licensee. The NIA sets the maximum amount DNOs are allowed to spend on innovative projects that are registered under the NIA. This letter sets out the provisional NIAs for the DNOs based on our assessment and following our consultation in November. These amounts are provisional as all DNOs will have the opportunity to resubmit their innovation strategies in March 2014. At this point licensees will have the ability to ask for an increased NIA. In our 'Guidance on submission of innovation strategies for ED1' published on 4 June 2013² we said that the opportunity to resubmit the innovation strategy would apply to all DNOs, included those being fast-tracked. This was because slow-track DNOs would have the ability to respond to the feedback provided in our November assessment, and we decided that it was appropriate to give fast-track companies the same opportunity.

We did not receive any responses to our NIA consultation. However, one respondent to our RIIO-ED1 business plan assessment and fast-track consultation raised a concern that Western Power Distribution's licensees had been deemed eligible for fast-tracking despite having an innovation strategy which did not fulfil all the minimum requirements. The minimum requirements which we expected DNOs to meet in their innovation strategies were set out in our strategy decision. In response to this comment, we would highlight that

¹ <https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-business-plan-assessment-and-fast-tracked-consultation>

² <https://authors.ofgem.gov.uk/publications-and-updates/guidance-submission-innovation-strategies-riio-ed1>

the assessment of innovation strategies did not form part of the fast-track proposal. Where a DNO's innovation strategy did not meet our minimum requirements, we expect them to submit an updated strategy in March, even if they are not seeking more than the default NIA. We have included our views on each strategy in the appendix, these have not changed since November. Table 1 below sets out the provisional NIA for each licensee for the RIIO-ED1 period.

Table 1: provisional NIA amounts

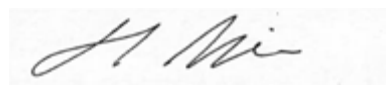
Licensee	Provisional NIA (percentage of annual base revenue)
Electricity North West Limited	0.50
Northern Powergrid: Northeast	0.60
Northern Powergrid: Yorkshire	0.60
Western Power Distribution: West Midlands	0.50
Western Power Distribution: East Midlands	0.50
Western Power Distribution: South Wales	0.50
Western Power Distribution: South West	0.50
UK Power Networks: London Power Networks	0.50
UK Power Networks: South East Power Networks	0.50
UK Power Networks: Eastern Power Networks	0.50
SP Energy Networks: Distribution	0.50
SP Energy Networks: Manweb	0.50
Scottish and Southern Energy Power Distribution: Scottish Hydro Electric Power Distribution	0.50
Scottish and Southern Energy Power Distribution: Southern Electric Power Distribution	0.50

Next Steps

All licensees (including fast-track companies) will have the opportunity to resubmit their innovation strategy in March. Following receipt of any resubmitted innovation strategies we will consult on revised proposed NIA amounts alongside draft determinations for slow-tracked companies in July 2014. These will be based on our assessment on the revised strategies. Our final decision on the NIA amount will take into account responses to the July consultation. We will publish this decision alongside the final determination for slow-tracked companies in November 2014. The NIA amount will then be incorporated into the licence for each licensee.

If you have any comments or questions on this letter please contact RIIOED1@ofgem.gov.uk.

Yours faithfully,



Hannah Nixon
Senior Partner, Smarter Grids and Governance: Distribution

Appendix 1

Assessment of licensees' innovation strategies

Electricity Northwest Limited

Electricity Northwest Limited (ENWL) requested an innovation allowance of 0.8 per cent of base revenue per annum. This is 0.3 per cent above the default amount.

ENWL's submission meets three of the minimum requirements for an innovation strategy set out in our Strategy Decision. However, it does not explain the risks associated with innovation projects and it only briefly explains the consequences if innovation does not occur. ENWL sets out a good process to identify opportunities for innovation projects. It will work in collaboration with EA Technology Limited as well as through engaging with customers and other stakeholders to identify these opportunities. Ideas will be evaluated against stakeholder priorities and a cost benefit analysis will be carried out to assess which innovation projects to implement. We consider this is one of the stronger aspects of ENWL's strategy.

ENWL highlights the key challenges it expects to face in the next price control period. However, it does not explain why innovation is the best way to address these challenges. The extent to which ENWL has used its stakeholder engagement to identify these is not clear. ENWL does not explain what will happen if innovation does not take place. Finally, ENWL does not specifically identify or justify why extra funding beyond the default amount is needed.

We do not consider that ENWL has provided sufficient justification for its proposed additional allowance. We need to be satisfied that an additional allowance will provide clearly defined additional value to existing and future customers. Therefore we consider that ENWL's current innovation strategy warrants an NIA of 0.5 per cent. We look forward to ENWL submitting a strategy that fulfils all of the minimum requirements.

Northern Powergrid

Northern Powergrid (NPg) requested an innovation allowance of 0.6 per cent of base revenue per annum.

NPg's submission meets all of the minimum requirements for an innovation strategy set out in our Strategy Decision. It presents a good case for further funding above the default amount. In particular NPg provides a robust assessment of the relative priorities, risks, benefits, value for money and potential customer impacts. Another strong aspect of NPg's strategy is the explanation of the process by which it intends to identify opportunities for innovation projects. NPg also explains how it will assess the relative benefits of different innovation opportunities. It also explains that it will identify opportunities for future innovation projects on the basis of the learning from its existing projects. In addition, it will review the outputs of other industry and academic partners' projects. NPg provides a strong range of deliverables that address the challenges it expects to face. It also explains where it has utilised learning it (and other DNOs) have developed into business as usual. This provides us with confidence that future innovations will also be incorporated into its business as usual.

While the strategy fulfils all the minimum requirements, it would have been stronger still if further detail had been included. In particular NPg could have explained why innovation projects are required to address the challenges it has identified. It would also have been useful if NPg had explained its process for assessing the value of rolling out innovations.

On balance, we consider that NPg has provided sufficient justification for its proposed additional allowance 0.6 per cent. We are satisfied that an allowance of 0.6 per cent will provide additional value to existing and future customers.

Western Power Distribution

Western Power Distribution (WPD) requested the default innovation allowance of 0.5 per cent of base revenue per annum.

WPD fulfils three of the minimum requirements of an innovation strategy set out in our Strategy Decision. WPD sets out the challenges it expects to face in the next price control period. An area where the strategy is stronger, relative to the rest of the document, is WPD's approach to ensuring value for money. This is one of its key objectives when implementing projects. WPD includes a project review process within projects to ensure successful delivery.

In many other areas WPD's strategy is vague. WPD notes that 75 per cent of stakeholders endorsed its innovation strategy and view of the future. However, it is not clear exactly what stakeholders were asked to endorse. WPD identifies the challenges it faces as a business but provides no detail on the innovative methods it will use to address these challenges. No explicit learning outcomes or deliverables were detailed in this innovation strategy. WPD indicates that transitioning innovative solutions into business as usual is a key priority. However, it does not provide sufficient detail in the strategy on how it will do this. While WPD states its strategy is subject to continuous internal review it does not explain how it will do this or how stakeholders will be involved in this process. It has an innovation contact for each DNO whose responsibility is to learn as much as possible from other DNOs' innovation projects and feed this back into WPD's business. However, it is not clear on the process it will employ to transfer learning, developed internally or at another DNO, from the innovation team into the broader business.

We consider WPD has failed to achieve the minimum requirements in a number of areas. Even though WPD only requests the default amount we expect all licensees to meet all the minimum requirements. We look forward to WPD submitting a strategy that achieves this.

UK Power Networks

UK Power Networks (UKPN) requested an innovation allowance of 0.5 per cent of base revenue per annum. This is the default level set out in our Strategy Decision.

UKPN's innovation strategy meets all the minimum requirements set out in our Strategy Decision. It is particularly strong in two areas. It demonstrates that stakeholders were closely involved in the development of the strategy and highlights the use of a number of tools it has used to engage with stakeholders. These include forums, its website and telephone surveys. This has led to a good multi-phased approach to stakeholder engagement. In addition, UKPN identifies where elements of the strategy changed as a result of stakeholder feedback. UKPN sets out a clear process for reviewing its innovation strategy at least every two years and how changes in the strategy will inform other aspects of the business plan. In addition, UKPN identifies a number of other triggers for reviewing the strategy. These include: major technology breakthroughs, substantive changes to

innovation funding arrangements and learning from innovation projects completed by other DNOs.

UKPN provides a good justification for the key challenges it expects to face. It is not clear the extent to which its stakeholder engagement informs this aspect of the strategy. UKPN explains the sources of ideas within the business for innovation projects. However, it does not explain what the process and criteria for deciding which ideas to take forward are. UKPN sets out a number of metrics for measuring progress in innovation projects. However, it does not explain how these metrics will be tracked. It is also not clear the extent to which the benefits a project might deliver informs the decisions on which projects to implement. We consider that UKPN's innovation strategy meets our minimum requirements and we consider it is worth an NIA of 0.5 per cent.

SP Energy Networks

SP Energy Networks (SPEN) requested an innovation allowance of 0.8 per cent of base revenue per annum. This is 0.3 per cent above the default amount.

SPEN's submission meets all but one of the minimum requirements for an innovation strategy set out in our Strategy Decision. Three aspects of SPEN's strategy stand out. It explains the consequences if innovation does not occur, such as: hindering the low carbon transition; losing an opportunity to reduce costs for consumers; and continuing to adopt asset intensive methods. SPEN includes a clear innovation road map, listing seven areas of focus and includes deliverables linked to RIIO-ED1 outputs. SPEN draws attention to ways in which DPCR5 innovation funding has delivered technical, procedural and commercial improvements, and therefore savings for customers.

In our view SPEN has not justified, other than by reference to stakeholders' views, why innovation projects should be undertaken to address challenges identified in the strategy. It is not clear the extent to which stakeholders have contributed to the content of the strategy rather than an assurance that they felt there was value in investing a certain amount. While SPEN discusses its relative priorities and its methods for assessing these it does not appear to consider the impact of innovation projects on customers. While SPEN explains how innovation is transferred into business as usual across the organisation, this aspect of the strategy would benefit from further detailed explanation. In particular, we would like to understand how SPEN achieves internal support for transferring innovative methods and practices in to its day-to-day business.

We consider that SPEN has not provided sufficient justification for its proposed additional allowance. SPEN explains how it will prioritise its activities based on when challenges will arise. However, it does not include specifics or an assessment of the benefits which additional funding will deliver. We are not satisfied that an additional allowance will provide clearly defined additional value to existing and future customers. We therefore consider that SPEN's innovation strategy currently warrants an NIA of 0.5 per cent. We look forward to SPEN submitting a strategy that fulfils all of the minimum requirements.

Scottish and Southern Electricity Power Distribution

Scottish and Southern Electricity Power Distribution (SSEPD) requested an innovation allowance of one per cent of base revenue per annum. This is the maximum amount.

SSEPD's innovation strategy meets six of the minimum requirements set out in our Strategy Decision. SSEPD sets out a strategic approach to identifying opportunities for innovation. It also describes how an innovation screening tool will be used for selecting

innovation projects. SSEPD provides an explanation of how innovation and learning funded through DPCR5 has been transferred to business as usual and the procedures it has in place to do so.

While SSEPD identifies a number of challenges it expects to face, it does not explain how innovative approaches could be used to address these. SSEPD identifies a number of key stakeholders it has engaged with on innovation issues. However, it is not clear how these stakeholder's views have influenced the development of SSEPD's innovation strategy. SSEPD does not explain what deliverables will result from the research and development activities it intends to undertake with its NIA. More broadly, it does not explain what work will be carried out with the extra funding beyond the default level, or what value this work will provide to customers.

SSEPD has not fulfilled all the minimum requirements we set out in our Strategy Decision. It has not explained what value it will deliver if it receives funding beyond the default amount. We consider that SSEPD has not provided sufficient justification for its proposed additional allowance. We are not satisfied that an additional allowance will provide clearly defined additional value to existing and future customers. Therefore we consider that SSEPD's current innovation strategy warrants an NIA of 0.5 per cent. We look forward to SSEPD submitting a strategy that fulfils all of the minimum requirements.