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Dear Arun,

Implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund

On behalf of EA Technology, I am pleased to be able to respond to your consultation letter, dated 31 January 2014.

Background

EA Technology was established in the mid-1960's as the UK Electricity Supply Industry's Research Centre, specialising in the Distribution and Use of Electricity. We are today an independent employee-owned SME[1] and have remained focussed on supplying innovative solutions to the Distribution and Supply sectors of the energy supply chain, within the UK and overseas. In recent years we have been heavily involved in the Low Carbon Networks (LCN) Fund, including roles to help DNO(s) get the most from implementing the outputs of projects into their Business-as-Usual activities.

We are currently involved in Northern Powergrid's Customer-Led Network Revolution (2010 competition), SSEPD's New Thames Valley Vision (2011 competition), and following the 2012 competition we are the only non-DNO running a Tier 2 project via Innovation Squared – Electric Vehicles (I²EV)[2]. We aim to deliver high value-add solutions to our customers, to the countries and regions we operate within, and we are not afraid to push boundaries in order to do so. This is particularly pertinent to our role in the I²EV Tier 2 project, where we are proactively testing ways that non-DNOs can get involved in LCN Fund projects. It is giving us a unique insight into both the opportunities and the challenges posed by the structure of this funding mechanism.

Observations on the current situation

It is our understanding that the £100m available by way of a 'discretionary' award to Distribution Network Operators (DNOs) through the LCN Fund projects is to ensure that:

- Projects deliver on their goals stated at the bid submission through enabling the return of the DNO **compulsory contribution** (a maximum of £40m[3]); and
- Projects are incentivised to out-perform their stated goals in order to be eligible for discretionary payments under **exceptional learning** awards (c£60m[4]).

[1] EA Technology Ltd income for FY13 was £21.9m, £417k EBIT and 225 employees.
[2] The public name for I²EV is "My Electric Avenue"
[3] Assumed to be 10% of the £400m available of the combined Tier 1 and Tier 2 fund.

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This is designed to reward those projects that are well managed and completed at least to the standard that could be expected given the information provided in the Full Submission.

Compulsory Contribution

At present, the compulsory contributions are paid into the project bank account held by the DNO over the first 12 months of the project. This money, combined with the funding received from the LCN Fund, finances delivery of the project in line with the original bid submission and any subsequently approved Change Requests. It is noted that in some instances (e.g. I²EV) significant contributions are being made by non-DNOs (i.e. us) to part fund the compulsory contribution[5]. We have previously recommended that this contractual position is maintained for any future project of this nature as it helps to align the risk between the 'hosting' DNO and the project manager. It is however predicated on the basis that this funding **will** be returned to those taking the financial risk when the SDRC milestones are met in line with the Bid (akin to a project 'bond').

Given the relative magnitude of investment, it is important for smaller organisations to understand how the value of this payment would be determined in advance of SDRCs being reached. Based on our current understanding, any payment awarded to the DNO or Project Lead may be determined by either of the following methods:

1. Taken as an all-or-nothing approach whereby payment is returned to the project lead following completion of the project if all pre-requisites are met; or
2. Determined on a pro-rata basis whereby some payment is granted based on the number and level to which stated SDRCs are achieved.

For EA Technology, these two scenarios pose different financial treatments. The former would result in 'writing off' of the compulsory contribution on the company Profit and Loss (P&L) account in year 1, with a potential windfall in a future year; whereas the latter would be the allocation of a pro-rata amount against creditors / debtors on the company Balance Sheet which would be adjusted over the duration of the project[6]. Our preference is, perhaps understandably, for option 2, and we intend to work with our financial auditors to determine the best approach at the end of FY14.

We note that at present, there is limited evidence of the approach taken by DNOs or the intended approach by Ofgem when evaluating applications of discretionary awards; for this reason we are watching the outcome of recently completed Tier 2 projects with extreme interest.

Ultimately, we believe that the use of a compulsory contribution is appropriate in driving projects to deliver, but this is on the clear basis that projects that are delivering will get their contributions back, in full, as stated in the LCN Fund Governance document(s).

We propose that the SDRCs are considered to be equally weighted, with the evaluation of whether targets have been met, and any subsequent payment to be undertaken annually. This should be considered the standard approach but any project should have the ability to propose a new evaluation structure in the bid submission or project direction to accommodate project specific criteria.

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[4] Assumed to be £100m less £40m.
[5] EA Technology is paying c£120k, 25% of the compulsory contribution for I²EV. This equates to c30% of our net profit from FY13.
[6] This allocation of 'credit' would be dependent on the project success at meeting the project targets.

Exceptional Reward

We understand that the Discretionary Funding made available as part of the DPCR5 Final Proposals includes an allowance to reward any DNO or Project Lead that has undertaken a Second Tier LCN Project that is deemed to be exceptional.

This funding provides an incentive for the Project Lead to exceed the project goals stated during the bid submission and generate additional value from the project for the electricity industry and the country as a whole. We welcome and support this approach. It is noted that as the project, on achieving all the originally stated learning and outputs, will already have provided value for money as this is one aspect of the criteria by which the project is evaluated at the bid stage.

As such, any outputs or learning generated beyond the original goals could significantly increase the value of the project. We believe therefore that these wider benefits, where providing gains to the profile of the electricity industry, economic activity within the UK or to the service provided to customers should be considered as meeting the requirements for the exceptional reward.

It is of note that truly 'exceptional' learning seldom comes for free, and so investment will have to have been made somewhere along the line. In assessing the quality of project outputs, consideration should be made to the funding routes, whether they are additional input from the private sector, external leveraged funding or indeed efficient spend of LCN Fund monies.

Questions Raised

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? and

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

EA Technology supports the introduction of an annual window for applications as this would provide a certainty to companies. Whilst we recognise that different companies have different year ends, it would certainly suit us for this review to be held in Q4 (January to March). To support this further, we would recommend that the proposed timing be scheduled such that the decision would be formally announced by the end of each financial year (i.e. before the end March).

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

EA Technology strongly agrees with the principles of utilising timeliness and quality of outcomes for assessing project performance and SDRC delivery. However, cost effectiveness is rarely a simple evaluation and therefore the true value of benefits to the customer should be considered. This requires accounting for the level of leveraged contributions from partners, including those that go beyond what was envisaged during the project development - some projects involve sums of funding that may well exceed those put in via the LCN Fund.

In addition to delivering the core project, cost-effectiveness to electricity customers may also include the launch of additional projects instigated as off-shoots from the primary project. These would provide further learning beyond that allowed for by the available funding.

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

The six monthly reports, already submitted by LCN Fund projects provide comprehensive evidence relating to adherence / meeting of SDRCs. Ideally, no further information should be required. It is acknowledged, however, that further questions with the option for face-to-face dialogue would be appropriate to allow discussion around specific issues that may not be suitable for placing into the public domain. We strongly support the use of face-to-face dialogue for the purposes of clarifying information as this avoids the loss of context that can occur in long e-mail chains or reports with limited added value to customers.

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?

We strongly endorse the management of change as criteria for assessing SDRCs as this is an essential element of any innovative project, a key component of LCN Fund projects. Irrespective of how well planned, any project (particularly ground breaking work such as that funded through LCN Fund) will be exploring the unknown, making it impossible to predict every eventuality up front. Indeed, it could be considered that if the unexpected doesn't happen then the boundaries of innovation were not being pushed far enough with the ambition and potential learning not great enough.

We believe that the intent of the SDRCs should be considered within the context of the desired project outcomes. Where alternative methods have been employed, that are perhaps counter to SDRCs, this should not preclude the granting of the SDRC if the learning can be demonstrated to have been achieved.

Similarly where a project has failed to meet SDRCs for reasons outside the control of the project, a better process should be implemented to ensure the DNO or project lead is not negatively impacted (e.g. the threat to 'halt' a project if a specific permutation of customers is not engaged). We strongly believe that fixed contract terms can stifle the amount of innovative ambition in a project.

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?

Ultimately, allowing for the fact that changing, or unforeseen factors are a reality in all projects, change should be considered a certainty in every LCN Fund project. The true measure of how well that change is managed should be considering the project deliverables against those planned in the bid submission and required in the project direction.

If a project, despite requiring significant changes in the planned approach, including changes to timescales or allocation of funds within the originally agreed budget still achieves the original outputs then it should be considered to have been effectively managed.

We strongly believe that the change request process could be slicker and less confrontational, perhaps with more face-to-face dialogue between all parties. In our opinion this would allow projects greater flexibility, which would lead to better outcomes for DNOs, key partners, and ultimately electricity customers.

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

We would recommend that consideration is given to the factors under which exceptional delivery may be deemed to have been met. Projects that provide a wider economic benefit to the UK as a whole should be heavily considered for discretionary rewards. This wider benefit may derive from additional leveraged work, assisting the uptake of low carbon technologies such as electric vehicles or wider facilitation of the low carbon economy.

I hope the above will be useful in your evaluation of the area but please do not hesitate to contact me if you would like to discuss anything covered in further detail.

Yours sincerely,

R. P. Davis

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