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Dear Arun

Implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund

The Discretionary Funding Mechanism is an important feature of the regulatory framework for innovation stimulus. Its importance should not be undervalued. It is intended to provide an appropriate incentive for companies to deliver learning that will benefit customers throughout Great Britain. It is in customers' interests for companies to take on cost risk within projects, deploy valuable finite resources to manage the inherent uncertainty with innovation activity and ultimately successfully deliver learning that may be used by all companies to deliver on low-carbon goals at least cost for all customers.

In this response, we set out our views that:

- Ofgem should ensure that its implementation of the Discretionary Funding Mechanism should maintain the intent that influenced the original design of the governance of low carbon networks projects. The range of risks and rewards were intended to be narrower than for innovation in other markets and if Ofgem changes course then this could weaken the incentive on companies to deliver successful projects and value for customers.
- The assessment of the Successful Delivery Reward should be narrowly focussed on an evaluation of the outputs defined in the Successful Delivery Reward Criteria (SDRC).
- The review of change management is pertinent to the assessment of change requests in the course of the project and also in the evaluation of Second Tier Rewards – it is unnecessary for the Successful Delivery Reward.
- An application window for the Successful Delivery Reward is inappropriate as it reduces the production efficiency for projects and detracts attention from closing the project and rolling out the changes to deliver benefits to customers. We suggest other solutions to alleviate resourcing peaks for Ofgem.

Discretionary Funding Mechanism

Before turning to answer each of the specific questions in the consultation letter, we wish to make some more general comments to highlight the importance of the Discretionary Funding Mechanism and its objectives. In addition to setting the scene for the detailed views we express on the Successful Delivery Reward, this also provides Ofgem with some views on the First and Second Tier Rewards as requested in the letter.

The Discretionary Funding Mechanism enables regulated companies to earn a return on the innovation. This is a proxy for the competitive business environment where companies will typically invest in a range of projects with the expectation that some will flourish and many will fail to deliver a return. Where the regulated innovation framework deviates from the market-led commercial environment is in the expected distribution of benefits.

When the innovation funding arrangements for electricity distribution[1] were established the decision was taken for the innovation framework to reflect the overall approach to risk and reward for this utility sector. Distribution network operators (DNOs) tend to be relatively lower risk investments compared to companies operating in markets traditionally associated with high levels of innovation. As such, the rewards were designed to recognise fewer spectacular successes and, similarly, fewer costly failures.

As Ofgem now consults on how to give effect to the Discretionary Funding Mechanism, it is important to recall these objectives established at the start that guided the creation of the Low Carbon Networks Fund governance. Since the governance was established, there is no new evidence to suggest that this balance of risk and reward should be reappraised or that it is in any way less appropriate today than it was when first developed. This is an important and relevant backdrop to considerations of how to best implement the Discretionary Funding Mechanism.

In our regulated monopoly environment, the discretionary reward is the primary route for companies to earn a return on the low carbon innovation. But it is not the only route; the other being the cost efficiency sharing mechanism that exists within the price control. We do not expect this in itself to provide sufficient reward since companies' business plans for the ED1 period already contain the lower cost for smart solutions to accommodate low-carbon technologies in 2015-23. Therefore, it will be challenging for companies to outperform these unit costs and deliver a return via the cost-sharing mechanism to offset the costs of the innovation.

Rewards should be primarily targeted according to the value delivered for customers. The overall size of the rewards should reflect the benefits provided to customers. These benefits will typically be either or both of service improvements or cost reductions. However, value to customers is not the only aspect that should be rewarded. The rewards framework should also reflect the success of companies in delivering results by managing the risk and uncertainty inherent in innovation projects and overcoming barriers to the delivery of the learning when an easier route would be to halt projects and divert resources to projects with more certain, but less valuable, outcomes for customers. Low carbon innovation, like any other change management programme within an organisation, consumes significant management effort and talented individuals to deliver successfully. These are finite and valuable resources. As such, it is vital that companies can aim for a payback on this substantial people investment as well as the company's direct financial contribution (minimum 10% of project value).

In its second tier LCN fund innovation activity, Northern Powergrid is explicitly seeking both to deliver successfully learning for itself and other DNOs that will enable us to all meet the sustainability/cost/security of supply objectives *and* to deliver a return on our investment. To achieve a return on investment, this requires initially recovering the costs of the project and also competing successfully for the Second Tier Reward. This echoes the intent of the

[1] Since replicated by Ofgem in other transmission and distribution sectors.

incentive regime. When Ofgem designed the LCN Fund, it was explicitly to provide companies with an incentive to seek to achieve a financial return and not simply to cover their costs.

How Ofgem chooses to determine the distribution of all categories of discretionary rewards will have a significant impact on companies' appetite for innovation in the next period and the related Network Innovation Allowance and Network Innovation Competition. In converting policy into working practice, Ofgem needs to ensure that it has set the bar at a level that companies see as reasonable and attainable. This reinforces the point made previously that, for companies, the rewards are viewed as a reasonable expectation for companies that deliver valuable learning. If the sector is successfully delivering projects then the majority will qualify for the Successful Delivery Reward and the best of the projects that deliver the most value for customers should expect to receive a Second Tier Reward.

Before turning to the specific questions on the Successful Delivery Reward, it is useful to reflect on the differences between this aspect of the Discretionary Funding Mechanism and the separate Second Tier Reward. The assessment of whether or not the Successful Delivery Reward Criteria (SDRC) have been achieved should be much simpler than the different assessment of Second Tier Reward. Essentially, the assessment for the former should be more narrowly focussed on an evaluation of the outputs defined in the SDRC. Through the bidding process, companies are required to set SDRC that are SMART[2]. If this is achieved, then evaluating whether they have been met should be more straightforward. In contrast, to assess the Second Tier Reward which is by its nature competitive, a wider set of value-based judgements are appropriate.

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?

No. Instead, Ofgem should adopt a different solution to achieve its goal of smoothing its resourcing profile. The disadvantages of fixing a window in the calendar are that this is detrimental to production efficiency on companies – a cost burden on companies that, like all costs, will ultimately be carried by customers. By providing timely decisions on discretionary rewards Ofgem may play its part in helping to close out projects and enabling all attention to focus on rolling out innovation to business as usual and delivering benefit to customers at the earliest opportunity. Also, Ofgem should better distinguish between the Successful Delivery Reward determination and the Second Tier Reward decisions. As explained in the response to question 3, Ofgem is at risk of burdening itself with an unnecessary level of complexity.

Efficiencies are possible if we seek to achieve synergies between project closedown reporting and the production of evidence to support the Successful Delivery Reward application. Viewing them as unrelated tasks to be undertaken in series is not an efficient process for either Ofgem or companies. There should be significant overlap between the closedown reports and the applications for the reward. These synergies should be captured to maximise the efficiency of producing the necessary information for each purpose.

Combining the timing and the form of the deliverable for both the project closedown and Successful Delivery Reward processes has the benefit of maintaining the momentum when completing projects to ensure that learning is disseminated and adopted as business as usual at the earliest opportunity. Combining the two activities also overcomes a potential practical difficulty that could be presented for companies if there is a substantial period of many months between completing projects and applications receiving scrutiny from Ofgem. It is foreseeable that Ofgem may have questions that will be more challenging for companies to

[2] Specific, measurable, achievable, relevant and time bound.

answer when project teams have been disbanded which will be the norm following project closedown. This issue is more material compared to other determinations made by Ofgem when it is considered that LCN fund project teams span organisational boundaries due to the involvement of partners. This leads to a real and practical consideration that may not have been fully considered.

The solution to overcome peak workload issues within Ofgem is for Ofgem to make the task straightforward and review evidence for SDRCs through the project lifecycle instead of leaving all consideration until the end of the project. Both of these are explored in more detail in response to the questions that follow. In this way, momentum is maximised to roll-out project learning successfully to benefit customers at the earliest opportunity.

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

As explained in question 1, we do not believe that assessment windows are appropriate.

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

Ofgem is at risk of over-complicating the decision-making process for the Successful Delivery Reward. For each SDRC, this should be more of a narrowly focussed on an evaluation of the outputs defined in the SDRC. Much effort goes in to describing SDRCs at the bid stage of projects. An assessment of whether the outputs have been delivered is appropriate. Principles such as timeliness and quality of outcomes may be relevant, dependent on the working of each specific SDRC. Cost effectiveness is less likely to be relevant since SDRCs tend to be associated with outputs as opposed to inputs.

More generally, the Successful Delivery Reward should be associated with judging whether stated SDRC conditions were met rather than re-evaluating the appropriateness of each condition. That deeper and more qualitative judgement (including cost effectiveness) is more appropriate for the Second Tier Reward stage of the process when it could be wholly relevant to consider the cost of the inputs and to weigh up how this relates to the value of the outputs. If companies have improved this balance of value output to cost input compared to the bid stage then that is the appropriate route to reward such outperformance, rather than at the Successful Delivery Reward stage.

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?

There are typically outputs associated with SDRCs (e.g. project reports, presentations, etc.). These should be submitted and reviewed by Ofgem at the time that the milestone is passed. This would both assist Ofgem in its aim of smoothing its resourcing and also ensure that Ofgem is closely informed of project progress more generally – which is of benefit in itself. The six monthly formal reports to Ofgem already offer this route for communicating these outcomes.

It could be a number of years between SDRC being achieved and the project finishing. It is better that any detailed dialogue about the SDRC is held nearer to the event as better information will naturally be available. Again, this strengthens the argument both to include evidence in six-monthly formal progress reports and for Ofgem to assess the evidence through the course of the project to reduce the burden upon itself at the closure stage.

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?

No, this is not the most appropriate stage in a project lifecycle to assess the management of change. There are compelling reasons why assessing change should take place as necessary at an earlier stage during the course of the project or alternatively at a later stage during the assessment of a Second Tier Reward. An assessment of managing change is unnecessary at the Successful Delivery Reward submission as it over-complicates the judgement that Ofgem needs to make.

As described in the response to question 3, Ofgem is at risk of over-complicating the decision-making process for the Successful Delivery Reward if it chooses to vary from a path of making a judgement on whether or not the stated outputs have been delivered as defined in the SDRC. An assessment of the inputs that contributed to the delivery of each SDRC is unnecessary and repeats judgements taken either at the bid stage or during the assessment of project changes through the course of the project. The management of change, in a similar manner to cost effectiveness, is less relevant to the Successful Delivery Reward and is more appropriate to the Second Tier Reward stage.

There are several stages to the governance of low carbon projects. The judgements required for each should not be conflated; with a principle that decisions are made once and at the appropriate time:

- Managing changes during the delivery of the project – change management will be relevant at this stage and involves Ofgem determining whether a company has successfully and appropriately managed externalities affecting delivery of a project.
- Project closedown report – companies deliver the project outputs for Ofgem to review and satisfy itself that these match the commitments made.
- Successful Delivery Reward – judgements made against SMART objectives agreed at the bid stage.
- Competitive rewards – a qualitative judgement and, as already mentioned in response to question 3, managing change could be relevant to this stage since it would be appropriate for the costs of the project to be compared to the value of the outputs. If companies have tilted this balance in favour of customers then there is opportunity for this assessment to provide rewards through this process.

If Ofgem introduces an evaluation of managing change into the Successful Delivery Reward stage then it would in effect be inserting an unnecessary judgement into the process. This will have the disadvantages of:

- adding to regulatory burden – working against one of Ofgem’s stated objectives; and
- placing an additional test for companies to achieve their reward for successful delivery and work against the principles behind the governance framework for low carbon networks projects that expected cost recovery for projects that successfully deliver the outputs defined in the SDRCs.

This last point is particularly important from a company perspective. If Ofgem raises the bar for companies to receive a Successful Delivery Reward this could diminish the appetite from companies to undertake such projects and customers will be disadvantaged as a result.

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?

For the reasons set out above, we believe that the assessment of change management is inappropriate for the Successful Delivery Reward.

Question 7: Do you have any other views on the assessment of the Successful Delivery Reward submissions?
These points were covered in the opening remarks to this consultation response.

Should you have any questions arising from this response please get in touch.

Yours sincerely

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