Network licensees and interested
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Decision on implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund

Following our public consultation - 'Implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund', we have taken the following decisions about assessing applications to the Second Tier Successful Delivery Reward:

- Timing: We will introduce an annual assessment window from May to July. DNOs can make submissions to us any time until 1 May each year. These will be assessed by us and a decision made within three months, on or before 31 July.

- Assessment against criteria: We will assess whether the project has been well managed and Successful Delivery Reward Criteria (SDRCs) achieved on the basis of quality, cost and time. DNOs should provide evidence of this.

- Assessment of change management: We will assess all projects on their management of uncertainty and change. DNOs should provide evidence of how they did this.

We will implement our decisions through changes to the Low Carbon Networks (LCN) Fund Governance Document ('the governance document').[1] An opportunity to do this is when we update the governance document for the next price control period, RIIO-ED1. The updated governance document will be in place for 1 April 2015.

In addition to this letter, today we have published a further consultation seeking views on some other aspects of our approach to administering the Discretionary Funding Mechanism. That consultation relates to the Second Tier Reward and First Tier Portfolio Reward.

Background

The consultation closed on 28 March 2014. You can see the consultation and responses here.

There is a detailed background on the LCN Fund and the Discretionary Funding Mechanism in the DPCR5 Final Proposals[2] and the governance document.

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[1] The LCNF Governance Document (v6) is available at:
http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/Low%20Carbon%20Networks%20Fund%20Govern ance%20Document%20version%206.pdf
[2] DPCR5 Final Proposals – Incentives and Obligations is available at:
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_2_Incentives%20and%20Obligat ions%20FINAL.pdf

The total funding available under the LCN Fund is £500m. Of this, up to £100m is available through the Discretionary Funding Mechanism. 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. It was developed to create a strong incentive to DNOs to design and manage successful projects. The total £100m is available for three rewards:

- the Second Tier Successful Delivery Reward
- the First Tier Portfolio Reward
- the Second Tier Reward.

The consultation sought views on our proposals for assessing applications to the **Second Tier Successful Delivery Reward.**

The Second Tier Successful Delivery Reward ('SDR') 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 is an incentive for DNOs to deliver projects effectively.

The SDR is the only aspect of the Discretionary Funding Mechanism that has an equivalent in the Network Innovation Competition (NIC). It is likely that the decisions and implementation of this reward will influence the operation of the NIC SDR.

Consultation decisions

Our consultation sought views on three key aspects of the assessment of applications:

1) timing
2) assessment against Successful Delivery Reward Criteria
3) assessment of change management.

We now describe each of the proposals we made, respondents' views on our ideas and our final decision for each of the aspects.

Timing

The governance document currently allows DNOs to apply for a SDR once we have approved a Project Close Down Report. The nature of the innovation competitions results in peak times of work for the DNOs and for us each year. We are concerned that this could affect the quality of applications. The consultation proposed to introduce an annual assessment window between January and March each year.

Consultation responses

Five respondents supported introducing an assessment window. Reasons included that the window would allow DNOs and Ofgem to plan resources effectively.

Two DNOs did not agree with introducing an assessment window. A third stated that introduction of a window needed careful consideration. The three DNOs shared the same concern: that delaying the application and assessment would result in key project staff and partners moving on and that relevant knowledge would be lost.

No DNOs supported the timing of the proposed window. The key concern was that the majority of LCN Fund projects conclude in the winter. Because of this, they would miss the first proposed window following completion. This increases the delay to DNOs receiving any rewards. The DNOs also argued that missing the window makes completing applications

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

and responding to queries more difficult, as key project staff may have moved and project partners may no longer be under contract.

Our decision

We will introduce an annual assessment window from May to July. Submissions can be submitted by the DNO at any time until 1 May each year. These will be assessed by us and a decision made within three months, on or before 31 July. DNOs will be able to choose to enter any assessment window following completion of their project.

Reasons for our decision

We are keen to ensure that applications are good quality. We think that introducing an annual assessment window to allow DNOs (and us) to plan effectively for developing and reviewing applications, ensuring their quality.

We note the concerns about the proposed timing of the window, and we consider there is merit in altering its timing. Holding the assessment window between May – July will allow projects that conclude in the preceding winter to enter. We also agree that projects should be able to choose which window they enter.

Assessment against Successful Delivery Reward Criteria

DNO applications must include evidence that a project has been well managed and that the Successful Delivery Reward Criteria (SDRCs)[4] have been achieved. We are keen to develop a common approach to assessing this. The consultation proposed that this would be assessed on the three principles of quality, cost and time. It also sought views on the kind of evidence that should be submitted by DNOs.

Consultation responses

Respondents generally agreed that the proposed principles were appropriate, with some caveats. Three queried whether cost was as appropriate as the other criteria. The main concern was that budgets may not be designed to track expenditure on individual SDRC outputs. One DNO said that the quality of outputs shouldn't be considered as it is too subjective and is not contained in the governance arrangements or SDRCs.

Respondents commented on how each of these areas could be assessed. Several DNOs said that timeliness should be assessed on achievement of delivery dates against the project plan. Respondents commented that cost should be assessed on whether the project and outputs were delivered on or below budget. Several said a factor in the consideration of output quality could be third party endorsement.

Most respondents commented on the types of evidence that could be provided with applications. One said that detailed evidence was required for the provision of any rewards and this should be made available to wider stakeholders. Another said that evidence requirements should not be too prescriptive as there is likely to be a wide range of project specific evidence that could be relevant.

Several respondents said that most of the relevant evidence would be in documents already produced (eg SDRC reports). Two DNOs commented on the format of applications. Proposals included limiting applications to 20 pages and a five section report format.

Our decision

We will assess whether projects have been well managed and SDRCs achieved against the three areas of quality, cost and time. DNOs should provide evidence that outputs have

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[4] The SDRCs are project specific success criteria that relate to major project deliverables.

been delivered in a timely, cost effective manner and were of sufficient quality to have satisfied their SDRC requirements.

We will not prescribe the format of applications or the type of evidence that should be submitted.

Reasons for our decision

Producing quality outputs is an important part of delivering a project successfully. If projects produce outputs (eg reports) that aren't of sufficient quality, the projects' learning will have little or no value. This is an important factor in determining whether DNOs have delivered return on the investment made by customers. We consider that scrutinising the quality of outputs can help us check whether a project has successfully delivered its SDRCs.

We note the comments of several respondents that the cost effectiveness of the overall project should be considered rather than for individual SDRCs. SDRCs should relate to key project deliverables. We think that DNOs should be able to track their expenditure on them. Consideration of financial benefits and partner contributions is beyond the scope of the SDR.

All respondents supported evaluating whether SDRCs were delivered on time. We agree that delivery of outputs to specified timescales is an important part of whether a project has been well managed and successfully delivered.

Looking at each of these three areas when determining if SDRCs have been achieved provides a clear framework for our assessment. It also allows us flexibility in assessing a wide range of projects. We think that this is part of the longstanding requirement that DNOs provide evidence that SDRCs have been achieved and is not an extra requirement.

We accept that projects are diverse. Being prescriptive with the types of evidence and the report formatting could impact some projects more than others. We will not set strict structures for applications nor mandate the types of evidence that are required. But we may provide guidance to DNOs ahead of the first application window. We encourage DNOs to consider the types of evidence that have been suggested in response to this consultation when developing their applications.

Given the scale of potential rewards, we agree that the applications and evidence provided should be made publically available. DNOs should also consider consulting with stakeholders on their applications. We may also consult publically on the applications submitted. The views of stakeholders on the applications may be taken into consideration when determining if a project has been delivered successfully.

Assessing management of change

We recognise that projects will sometimes change and have to adapt as a result of circumstances beyond the DNOs' control. Our consultation sought views as to whether and how we should assess change management.

Consultation responses

Respondents supported allowing changed projects to apply for the reward.

Four agreed that change management within the project should be assessed. They said that innovation projects would probably encounter unforeseen circumstances and change was likely to be beneficial to customers, as long as the original outcomes were achieved. Several respondents commented that change management is part of normal project delivery.

Three respondents said that assessing change management was outside the scope of the reward and that it should be made when change requests are processed. They suggested that this would complicate the overall reward assessment and was more relevant to the second tier reward.

There was a range of views on assessing change management. Comments included considering whether the project had delivered the originally proposed outputs and if it had, the project should be considered to have managed change well. Some respondents stated that the assessment should not be limited to projects that had formal change requests.

Our decision

Projects that have undergone changes will be eligible to apply for this reward.

We will assess all projects on how they manage uncertainty (and change) as part of our assessment of whether a project has been well managed. When providing evidence that their project has been well managed, DNOs should explain and provide evidence of how they managed uncertainty and change to ensure successful delivery of the project.

Reasons for our decision

We agree with the respondents that because they are innovative, all LCN Fund projects will be managing uncertainty and change. Doing this well is an important part of good project management and is not only applicable to projects that have submitted change requests.

We do not agree with respondents who said that assessing change management was beyond the scope of this reward. The reward was always intended to incentivise the DNOs to manage their projects well (of which change management is an important part). When change requests are assessed, consideration is given to whether there has been a material change in circumstances and whether any proposed changes are in the interests of customers. By approving change requests, we are not making an evaluation of the DNO's management of change.

We recognise that the types of evidence of successful change management (and project management) will vary between projects. As such, we will not prescribe the types of evidence that should be submitted with applications. We expect that applications should include evidence on how well the project has been managed, the approaches to managing uncertainty and risk, including evidence of appropriate project governance, risk mitigations (including speed of implementation) and impact of risks on project outcomes.

We agree that a key consideration of a project's management of uncertainty is its performance against the original project aims and objectives.

Next steps

Alongside this decision we have published a consultation on our approach to the Second Tier Reward and First Tier Portfolio Reward.

We will implement our decisions through changes to the LCN Fund governance document. We will be updating the governance document for the purposes of the next price control period, RIIO-ED1 later this year. The updated governance document will be in place for 1 April 2015.

This document constitutes notice of our reasons for our decision in accordance with section 49A of the Electricity Act 1989.

If you have any queries, please contact: Arun.Pontin@ofgem.co.uk.

Yours sincerely,

Dora Guzeleva
Head of Networks Policy, Local Grids

Appendix: Summary of consultation responses

1.1.   We received eight responses to the consultation.

1.2.   Responses were received from the six DNOs, one energy supplier and one technology supplier. Not all respondents answered each of the questions in the consultation documents. We have published all non-confidential responses on our website.[5]

1.3.   The following is a summary of responses. We have summarised the views of the respondents for each consultation question.

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?

1.4.   Five respondents agreed with the introduction of an annual window for Successful Delivery Reward applications. Respondents stated that this would support resource planning. One of these respondents noted that the introduction of a window could create another resource peak and proposed that DNOs should include an application as part of their closedown report. They stated that this could include a table of evidence in the closedown report or that has already been published.

1.5.   Two respondents did not support the introduction of an application window. A third said that this approach required careful consideration. The key concern was that if a project missed the application window, it would have to wait an extended period to be eligible to apply for a reward and key project personnel and knowledge may no longer be available.

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

1.6.   One respondent supported the proposed application window. The respondent commented that if the proposed window is used, it would welcome a decision before the conclusion of the financial year.

1.7.   Four respondents raised concerns about the proposed timing of the application window. These concerns echo those from the question on the delay between project completion and submitting an application for the reward. A number of respondents stated that as the majority of projects are scheduled to complete in the winter, they could miss the closest application window and have to wait over a year to receive their reward. They argue that this could result in a loss of project personnel (particularly in project partners) and expertise by the time the project is eligible to apply. Two respondents suggested having two annual windows could mitigate this risk, with another respondent suggesting that projects could enter either the first or second window that occurred after project conclusion. Two respondents stated that the application should be submitted with the closedown report. One respondent stated that the existing arrangement should be retained (ie for applications to be submitted when ready) but to extend the Ofgem decision period beyond the current 30-day limit.

1.8.   One respondent also stated that the proposed window coincides with a busy period for DNOs who will be developing Initial Screening Process (ISP) submissions for that year's innovation competition.

1.9.   Another respondent stated that the proposed window would conflict with the timing of DNO tariff setting and that stakeholders should be given sufficient notice of any changes.

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

1.10.   Five respondents supported the use of the three principles proposed in assessing delivery of SDRCs.

1.11.   One DNO suggested that specific consideration should also be given to whether the project was "well managed". The respondent suggested that the extent to which the project had achieved the broad goals of the full submission: the efficacy of the learning dissemination and the successful project planning, governance and risk management. For timeliness, this respondent stated that projects should only be eligible if the dates specified in the SDRCs were achieved. This respondent stated that the outcomes described in the SDRC should be considered as a minimum standard and consideration of quality should include whether the project has exceeded these. The respondent contended that as projects and SDRCs vary, the assessment of quality shouldn't be too prescriptive. This respondent also contended that cost-effectiveness should be assessed on the project as a whole, as budget reporting may not relate directly to SDRCs.

1.12.   One respondent noted that cost-effectiveness would be difficult to assess for individual SDRCs and suggested that benefit to customers is included as part of this assessment. This respondent also said that consideration should be given if costs had been met by external funding or the project had resulted in 'off-shoot' projects.

1.13.   One DNO stated that assessment should focus on timeliness and quality.

1.14.   One respondent said that timeliness should be clarified to mean the delivery of the SDRC against the project plan, as opposed to the overall timeliness of the project. This respondent also stated that if an annual window is introduced, quality of outcomes should only be assessed based on performance at the end of the project. It said that quality may appear better in projects that conclude well in advance of the application deadline as a longer period is available for outputs to be rolled out.

1.15.   One respondent commented that only the exceptional should be rewarded and not the ordinary.

1.16.   Two respondents stated the performance should be based on solely on whether the SDRC had been delivered (ie delivered on time and on budget). One of these respondents said that quality would be too subjective to assess. It also stated that assessment of quality is not contained in the governance document. The other respondent conceded that timeliness and quality of outcomes may be relevant considerations.

<u>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?</u>

1.17.   Three respondents considered that documents already submitted to Ofgem (eg progress reports) should contain the majority of the evidence required for the assessment. One of these respondents considered that it provided detailed evidence in its 'SDRC reports' and could resubmit these as part of its evidence.

1.18.   One DNO stated that detailed evidence should be provided that the project has been well managed and achieved the SDRCs. The respondent stated that management of a project should be assessed by reviewing project starting assumptions, project management (including change) and a review of project achievements (SDRCs).

Timeliness could be assessed through achievement of SDRC delivery dates and quality. This respondent suggested that a factor to consider when assessing quality is third party endorsement of outcomes. Consideration should also be given to dissemination and adoption of learning.

1.19. Two DNOs stated that evidence should be based on the SDRC outputs. One of these DNOs stated that SDRC evidence should be assessed when submitted to avoid creating work peaks. The other DNO stated that the assessment should only include whether the output was delivered on time and on budget.

1.20. One DNO proposed that DNOs submit an application with evidence that is split into five sections. The first section would include information on timeliness and quality of SDRC delivery and should include evidence of how these have been achieved. The DNO suggests one or two pages per SDRC may be appropriate and should include references to SDRC reports. The second section should cover cost-effectiveness and include details of how tenders and contracts have delivered savings or budget outcomes. Other evidence could include efforts to keep costs within budgets, controls on contingency funding and appropriateness of financial incentives. The next section would include details of the project starting aims and objectives and the extent to which these have been achieved including evidence from the closedown report. The fourth section would include details of the project's learning dissemination and its impact. The final section would cover effectiveness of project planning, governance and risk controls.

1.21. One respondent stated that applications should be limited to a length of 20 pages. This respondent stated that timeliness should be assessed based on timing of delivery against the original project plan or approved changes. It stated that quality should be assessed with reference to industry feedback and reports already provided to Ofgem. It also stated that cost-effectiveness should be assessed through financial reporting of the project against the project budget whilst considering any approved changes. The DNO stated that the evidence provided should be based on performance against the SDRCs in the full submission.

1.22. One respondent also considered that 'face-to-face' discussions would be beneficial to put the application in context and allow a response to clarifications.

1.23. One respondent stated that Ofgem should substantiate any reward with detailed evidence that should be available for stakeholders to review.

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?

1.24. Four respondents agreed that change management within the project should be assessed. These respondents noted that innovation projects were likely to encounter unforeseen circumstances and that change was likely to be beneficial to customers, as long as the original outcomes were achieved. Respondents also stated that change could often be positive for a project. One respondent stated that projects should still be eligible for reward if some SDRCs are missed or changed.

1.25. Three respondents stated that assessment of change management was outside the scope of the reward and that an assessment should be made when change requests are processed. These respondents said that projects that have undergone change requests should not be precluded from applying for the reward. One of these respondents also said that assessing management of change would increase regulatory burden and complicate the assessment.

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?

1.26.   Respondents provided a range of views on effective ways to assess change management.

1.27.   Three respondents stated that consideration should be given to whether the project had delivered the originally proposed outputs and if it had, the project should be considered to have managed change well. One of these respondents stated that projects that have undergone changes should provide evidence that the change was in the interests of customers and allowed learning to continue to be developed. This respondent stated that projects that had not undergone changes should explain their approach to change management.

1.28.   One respondent stated that change management could be evaluated with consideration given to project planning, governance and risk controls. The respondent also said that this assessment should not be limited to projects that have had formal change requests.

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

1.29.   One respondent stated that consideration should be given to what constitutes exceptional delivery. The respondent proposed that projects that had delivered wider economic benefit to the UK (including assisting the uptake of low carbon technologies) should be considered for discretionary rewards.

1.30.   One DNO agreed that additional consideration is needed beyond whether or not the project had delivered solely against the project direction.

1.31.   One DNO stated that the review should be undertaken by the Expert Panel who funded the project. They stated that the Expert Panel who funded the project would be best placed to determine if it had delivered successfully and this would remove the burden of assessment from Ofgem.

1.32.   One DNO stated the implementation of the reward schemes should reflect the initial intent, that companies could seek a financial return, not only cost recovery. The DNO also stated that the implementation could affect company appetite for innovation in ED1 and that the bar to achieve a reward should be reasonable and achievable.

1.33.   Another DNO stated that the purpose of the mechanism is to allow shareholders to recover costs rather than reward performance. The respondent said that adding more criteria now could stifle innovation in the future.