



Making a positive difference  
for energy consumers

Distribution network operators  
and interested parties

Direct Dial: 020 7901 3869  
Email: [arun.pontin@ofgem.gov.uk](mailto:arun.pontin@ofgem.gov.uk)

Date: 21 August 2014

## **Further consultation on implementing the Discretionary Funding Mechanism under the Low Carbon Networks Fund**

This letter seeks your views on how we propose to assess applications to the Second Tier Reward and First Tier Portfolio Reward mechanisms of the Low Carbon Networks (LCN) Fund.

Stakeholders should send their responses to [arun.pontin@ofgem.gov.uk](mailto:arun.pontin@ofgem.gov.uk) by 3 October 2014.

This consultation follows our decisions on the Second Tier Successful Delivery Reward also published today.<sup>1</sup>

### **Background**

The Low Carbon Networks (LCN) Fund was introduced in 2010. Its main objective is to encourage the distribution network operators (DNOs) 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.

Up to £500m of funding is available under the LCN Fund. Of this, up to £100m is available through the Discretionary Funding Mechanism. This mechanism was implemented to provide a strong incentive for DNOs to develop well-designed and successful projects. The £100m can be awarded across three rewards:

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

Further information on the LCN Fund and the Discretionary Funding Mechanism can be found in the DPCR5 Final Proposals<sup>2</sup> and the LCN Fund Governance Document ('the governance document').<sup>3</sup>

---

<sup>1</sup>The previous consultation and decision are available at:  
<https://www.ofgem.gov.uk/publications-and-updates/consultation-implementing-discretionary-funding-mechanism-under-low-carbon-networks-fund>

<sup>2</sup> DPCR5 Final Proposals – Incentives and Obligations is available at:  
[http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP\\_2\\_Incentives%20and%20Obligations%20FINAL.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP_2_Incentives%20and%20Obligations%20FINAL.pdf)

<sup>3</sup> The LCN Fund Governance Document (v6) is available at:  
<http://www.ofgem.gov.uk/Networks/ElecDist/Lcnf/Documents1/Low%20Carbon%20Networks%20Fund%20Governance%20Document%20version%206.pdf>

The Second Tier Successful Delivery Reward ('SDR') is available to reward projects that have been well managed and completed to at least to the standard that could be expected given the information provided in the project Full Submission.

The Second Tier Reward ('STR') and First Tier Portfolio Reward ('FTPR') provide an incentive for DNOs to actively engage in the objectives of the LCN Fund and deliver exceptional learning for customers. We are seeking stakeholder views on the way we propose to assess applications to the STR and FTPR.

### **Allocating the £100m**

The £100m that makes up the Discretionary Funding Mechanism is not currently allocated between rewards. We believe there is merit in allocating the £100m between the different rewards to ensure that adequate funds are available for each. This will also give stakeholders an indication of the rewards available.

#### *Second Tier Successful Delivery Reward*

The SDR could be up to 10% of Second Tier project costs. The maximum value of the SDR is dictated by the level of DNO compulsory contributions to projects. The LCN Fund competition is in its fifth and final year and we will know its total use and DNO compulsory contributions by December 2014.

The Discretionary Funding Mechanism is also available to cover project cost overruns and shortfalls in direct benefits. Projects that apply for funding to cover cost overruns are not eligible to apply to the SDR. Any payments for cost overruns will come from the SDR.

#### *Second Tier Reward and First Tier Portfolio Reward*

We propose that the remaining funds not required to cover the SDR will be split between the STR and FTPR. We are not proposing that funds set aside for the SDR, and not allocated through that reward, be rolled over to the FTPR and STR. We will not know the funding used for the SDR until all projects have concluded and applications processed.

We consider that an appropriate method of allocating the funding between the rewards is based on the proportion of funding in each of the two tiers. The Second Tier has a total value of £320m and the First Tier of £80m. This results in an apportionment of 4:1 between the STR and the FTPR.

#### ***Example***

If the total value of Second Tier projects is £250m, the funding required to cover the Successful Delivery Reward is £25m. £75m remains for the other rewards.

$$£100m - £25m = £75m$$

Of the remaining £75m, 80% is allocated to the STR and 20 % to the FTPR.

$$£75m \times 0.8 = £60m$$

$$£75m \times 0.2 = £15m$$

This results in £60m being available for the STR and £15m for the FTPR.

We are seeking views on how we propose to allocate the funding.

Question 1: Do you agree with our proposed approach to allocating the £100m across the rewards?

Question 2: Do you have an alternate proposal for how we should allocate the £100m between rewards? Please explain why you think this is a better option.

### **Timing of assessments**

The LCN Fund is in its final year. We now have a good indication of the total number of projects and when they are likely to conclude. This means we can plan when to hold our assessments. We also want to give a clear indication of when these will occur. This will set industry expectations and allow effective planning. The governance document lets us hold up to three assessments for the rewards at our discretion.

#### *Second Tier Reward*

This reward is intended to recognise and encourage exceptional performance. We believe it will be easier to identify exceptional performance if all projects are assessed together. We are proposing that there is only one assessment for this reward. We consider that the assessment could occur in 2020 or 2021 once all projects have concluded.

We appreciate there are some drawbacks to this approach. For example, projects that have concluded or will conclude soon, will have to wait several years to apply and receive a reward.

We are therefore considering a second option of having two assessments. One in 2017 for projects that have concluded by the end of 2016<sup>4</sup> and another in 2020 or 2021 for the remaining projects. In the event of two assessments, the funding available under this reward would have to be split, without disadvantaging any of the projects.

The options we are considering are:

1. one assessment in 2020 or 2021
2. two assessments; one in 2017 and another in 2020 or 2021.

Question 3: Which of the two options for assessment of the STR do you support? Why?

Question 4: If you support having two assessments, how should the available funding be split between the two and why?

#### *First Tier Portfolio Reward*

This reward is intended for the entire portfolio of each DNO's First Tier projects. Our preference is to have one assessment that considers all portfolios of First Tier projects.

We are currently considering the treatment of First Tier projects that begin under the LCN Fund but conclude with funding from the Network Innovation Allowance (NIA). The NIA will replace the First Tier from 1 April 2015. The reward could either consider the outputs of such projects up to the point they were funded by the First Tier (ie 31 March 2015) or consider the project in its entirety (ie up to its conclusion).

There is no equivalent reward in the NIA, so final outcomes of these projects would not be rewarded unless considered in the FTPR. These projects may have been principally funded by the LCN Fund and will deliver significant benefits to customers. Including projects concluding under the NIA would, however, result in a later assessment for this reward.

We anticipate the assessment would take place in 2016, or 2017 if considering NIA concluded projects. All First Tier projects currently registered are scheduled to finish by 31 March 2015. Our preference therefore is not to include in the FTPR any projects concluded under the NIA.

---

<sup>4</sup> We expect roughly half of the Second Tier projects will have concluded by 2016.

Question 5: Do you agree with having one assessment for the FTFR?

Question 6: Should First Tier projects that conclude under the NIA be considered in the assessment? Why?

Question 7: When should we conduct the assessment for the FTFR? Why?

### **Assessment**

The rewards could be of significant value. We are keen to make the process of assessing applications fair, robust and transparent.

#### *Assessment criteria*

The current criteria for the rewards in the governance document are:

- To perform exceptionally against one or more of the Specific Requirements set 2<sup>5</sup> (for First Tier LCN Projects) or the Evaluation Criteria (for Second Tier Projects).
- To invest the DNO's own money (over and above any compulsory funding) to enable the Project to be successfully delivered.
- To undertake exceptional effort to ensure the Project exceeds the expected delivery outcomes and the learning from it is maximised for the good of all DNO customers.

We think that the second two criteria are still useful for assessing discretionary reward applications. However, the Specific Requirements set 2 and the Evaluation Criteria are designed for an upfront project assessment. So, we propose to turn these into *ex post* criteria for the purposes of the discretionary rewards.

Appendix two contains our proposed changes to the criteria. We have explained our thinking in the tables below.

Table 1. Second tier evaluation criteria.

<b>Evaluation criteria (Second Tier)</b>	<b>In evaluation of a proposal</b>	<b>In evaluation of a reward</b>
(a) acceleration of the carbon plan and potential to deliver net benefits	This criterion tests the extent to which a proposal could facilitate the transition to a low carbon economy and provide financial benefits to customers.	Exceptional performance against this criterion can be measured in a number of ways. It could be aspects of the carbon plan which have been facilitated (eg by updated business practices), network capacity released and financial benefits to customers. We think DNOs should provide evidence of how outcomes of the project have been delivered, or in the near future are likely to deliver, exceptionally in these areas.
(b) value for money provided to customers	This criterion seeks to ensure that solutions proposed could provide value for money to customers. It checks that projects themselves are value for money and scrutinises partner contributions in	To be considered to have performed exceptionally against this criterion; DNOs should demonstrate how the financial benefits of the outputs represent value for money against the project cost. Exceptional performance also includes ensuring value for money

<sup>5</sup> The First Tier specific requirements set 2 are similar to the evaluation criteria for the Second Tier and are described on pages 15-17 of the governance document v6.

	relation to their possible benefits.	in delivering the project.
(c) new knowledge shared amongst DNOs	This criterion checks that proposals will generate new industry knowledge and that a project has appropriate dissemination plans.	Exceptional performance against this criterion could cover a number of areas. Firstly, the level of <u>new</u> learning generated, eg was beyond what was originally envisioned? Secondly, the effectiveness of the dissemination of knowledge. Thirdly, the applicability of that knowledge to DNOs and the industry. Finally, the value of intellectual property (IP) generated by the project to consumers.
(d) Involvement of partners and external funding	This criterion seeks to ensure that project participants have sufficient relevant knowledge, experience and appropriate external funding.	Parts of this criterion may or may not be relevant to the discretionary reward. Involvement of appropriate partners is scrutinised at full submission.  The involvement of third parties was one of the goals of the LCN Fund. Exceptional performance in this area (for the purposes of the STR) could result in the DNO or other third parties to fulfilling the role of the project partner in rollout (eg through successful dissemination and skills transfer from the partner).
(e) relevance and timing	This criterion is to ensure projects seek to address likely challenges associated with the transition to a low carbon economy. It also ensures that DNOs have considered how learning from the project will inform their business planning and how the project fits with wider industry developments.	Exceptional performance against this criterion could be demonstrated in two ways. First, the DNO could provide evidence of how the project outcomes are influencing DNO's future business plans. Secondly, the DNO could demonstrate how outcomes of the project are already being used in the DNOs' business activities.
(f) demonstrating a robust methodology and readiness to implementation	This criterion is to ensure that projects have been constructed in a robust manner and that are is deliverable.	Parts of this criterion may or may not be relevant to the discretionary reward. The robustness of plans and project readiness is scrutinised at full submission.  DNOs could, however, demonstrate that the commitments made in the Full Submission.

Table 2. First tier specific requirements set 2.

<b>Specific requirement (First Tier)</b>	<b>In evaluation of a proposal</b>	<b>In evaluation of a reward</b>
(a) acceleration of the carbon plan and potential to deliver net benefits	This criterion tests the extent to which a proposal could help networks facilitate the transition to a low carbon economy and provide financial benefits to customers.	Exceptional performance against this criterion can be measured in a number of ways. It could be aspects of the carbon plan which have been facilitated (eg by updated business practices), network capacity released and financial

		benefits to customers. We think DNOs should provide evidence of how outcomes of the project have been delivered, or in the near future are likely to deliver, exceptionally in these areas.
(b) a direct impact on the distribution system	This criterion is to ensure that only projects that affect the distribution network are trialled.	We do not think that this criterion is relevant to an assessment of whether a portfolio has delivered exceptionally for customers.
(c) new knowledge shared amongst DNOs	This criterion checks that proposals will generate new industry knowledge and that a project has appropriate dissemination plans.	Exceptional performance against this criterion could cover a number of areas. Firstly, the level of <u>new</u> learning generated, was it exceptional or beyond what was originally envisioned? Secondly, the effectiveness of the dissemination of knowledge. Thirdly, the applicability of that knowledge to DNOs and the industry. Finally, the value of intellectual property (IP) generated by the project.
(d) focus on methods at a trialling stage	This criterion ensures that only methods at a trialling stage are tested. Research projects can be funded by other means.	We do not think that this criterion is relevant to an assessment of whether a portfolio has delivered exceptionally for customers.
(e) does not lead to unnecessary duplication	This criterion is to ensure that there is an expectation that a project is innovative and will deliver new learning.	We do not think that this criterion is relevant to an assessment of whether a portfolio has delivered exceptionally for customers.

Question 8: Do you agree with our proposed changes to the criteria?

Question 9: Do you have any suggested alternatives to these criteria? Please explain why you believe they are appropriate.

### **Conducting the assessment**

The Gas and Electricity Markets Authority ('the authority') is the decision maker for funding allocated through the LCN Fund. It can decide to hire consultants (which could be in the form of an Expert Panel) to help assess applications and provide funding recommendations.

DPCR5 Final Proposals and the governance document state that the Expert Panel will make a recommendation to the authority on which projects or portfolios should receive a reward. However, the LCN Fund panel will cease to exist in 2015. We are concerned that the current members of the panel may be unavailable in 2016 or later. We are also considering whether the existing panel is the most appropriate entity to conduct an assessment of project performance, given it selected the projects for funding. As such, we are seeking stakeholder views on the most appropriate body to assess applications.

We could make use of the electricity Network Innovation Competition Expert Panel. This panel may include some of the members of the LCN Fund panel and will have similar skills and knowledge (but would have some of the same drawbacks as using the LCN Fund panel). Another possible vehicle for assessment is our Consumer Challenge Group. This group acted as a 'critical friend' during the RIIO-ED1 business plan assessment and could represent the interests of customers and ensure only deserving projects receive rewards.

Ofgem could also make the assessment, possibly with the aid of consultants. Unlike innovation proposals, the applications for these rewards should demonstrate measurable outcomes and benefits of which we could assess to determine appropriate rewards.

Question 10: What do you believe is the most appropriate way for applications to be assessed? Why?

**Next steps**

We are consulting on the implementation of the rewards for six weeks. This consultation closes on 3 October 2014. We welcome responses from network licensees, as well as any other interested parties. A complete list of the questions and details on how to respond are included in appendix one.

Stakeholders should send their responses to [arun.pontin@ofgem.gov.uk](mailto:arun.pontin@ofgem.gov.uk) by **3 October 2014**.

Depending on the responses received to the consultation, we will consider making changes to the LCN Fund Governance Document. We will have an opportunity to do this is when we make modifications for the purposes of RIIO-ED1. The updated governance document will be in place for 1 April 2015.

If you have any queries, please contact: [Arun.Pontin@ofgem.co.uk](mailto:Arun.Pontin@ofgem.co.uk).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'D. Guzeleva', with a long horizontal flourish extending to the right.

**Dora Guzeleva**  
Head of Networks Policy, Local Grids

## **Appendix 1: List of questions for consultation**

This letter contains 10 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: Do you agree with our proposed approach to allocating the £100m across the rewards?

Question 2: Do you have an alternate proposal for how we should allocate the £100m between rewards? Please explain why you think this is a better option.

Question 3: Which of the two options for assessment of the STR do you support? Why?

Question 4: If you support having two assessments, how should the available funding be split between the two and why?

Question 5: Do you agree with having one assessment for the FTPR?

Question 6: Should First Tier projects that conclude under the NIA be considered in the assessment? Why?

Question 7: When should we conduct the assessment for the FTPR? Why?

Question 8: Do you agree with our proposed changes to the criteria?

Question 9: Do you have any suggested alternatives to these criteria? Please explain why you believe they are appropriate.

Question 10: What do you believe is the most appropriate way for applications to be assessed? Why?

Responses should be received by 3 October 2014 and should be sent to:

Arun Pontin  
Distribution Policy  
SG&G: Distribution  
Ofgem, 9 Millbank, London. SW1P 3GE.

[arun.pontin@ofgem.gov.uk](mailto:arun.pontin@ofgem.gov.uk)

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

Arun Pontin  
[arun.pontin@ofgem.gov.uk](mailto:arun.pontin@ofgem.gov.uk)  
0207 901 3869



## **Appendix 2: Proposed alterations to the evaluation criteria and specific requirements set 2**

### ***Evaluation criteria***

#### **(a) Accelerated the development of a low carbon energy sector & delivered net financial benefits to future and/or existing customers**

A DNO must demonstrate how the Solution or Solutions associated with the Project makes or could make a contribution to the UK Government's current strategy for reducing greenhouse gas emissions as set out in the document entitled "The Carbon Plan", as published by the Department of Energy and Climate Change (DECC). This may be amended from time to time or may be replaced by the Government, such change to be notified to the DNOs in writing by Ofgem. To reduce carbon in the energy sector, the Carbon Plan considers that electricity use may increase. This criterion also requires that the Solution(s) can provide financial benefits compared to the most efficient method currently in use.

In demonstrating exceptional performance against this criterion, DNOs should:

- describe and provide evidence of the aspects of the Carbon Plan that have been facilitated
- describe and provide evidence of the network capacity released
- describe and provide evidence of the financial benefits
- describe and provide evidence of the scale of rollout of the Method(s) (or techniques derived from the Method(s)) across their system and across GB

Exceptional performance could also be achieved as a result of planned rollout of the Solution(s). DNOs could demonstrate the potential benefits that could be achieved by the project by:

- describing and providing analysis and assumptions of the aspects of the Carbon Plan that will be facilitated
- describing and providing analysis and assumptions of the capacity that has been/will be released
- describing and providing analysis and assumptions of the financial benefits that has been/ will be realised
- describing and providing analysis and assumptions of the scale of rollout of the Method(s) (or techniques derived from the Method(s)) across their system and across GB.

#### **(b) Value for money provided to distribution Customers in the delivery of the project**

The LCN Fund is focussed on the role that DNOs can play as GB moves towards a low carbon economy. Therefore Projects will be evaluated on the size of benefits and resulting

learning from the Project that can be attributed to or are applicable to the Distribution System versus elsewhere, taking into account the level of funding requested.

In demonstrating exceptional performance against this criterion, the DNO should:

- describe and provide evidence that the project was value for money to Customers<sup>6</sup>
- describe the size of project benefits in comparison to the project funding (including use of competitive processes to minimise costs)
- demonstrate persistence to deliver a Project through exceptional effort and/or additional external funds that exceeds the expected delivery of outcomes.

### **(c) Knowledge shared amongst all DNOs**

One of the main purposes of the LCN Fund is to generate and share knowledge from Projects to help DNOs prepare for the role they will play as GB moves towards a low carbon economy.

In demonstrating exceptional performance against this criterion, the DNO should:

- describe and provide evidence of the level of new learning generated (including learning from things that didn't work)
- describe and provide evidence of effective knowledge dissemination by the project
- describe and provide evidence of the applicability of the new learning to other DNOs. This evidence should include examples of other DNOs using the learning.
- describe and provide evidence of the value of the IP generated by the project to customers and how the IP has been shared.

### **(d) Involvement of other partners and external funding**

Collaboration between DNOs and other parties in the energy supply chain is a central objective of the LCN Fund.

In demonstrating exceptional performance against this criterion, the DNO should:

- describe and provide evidence of effective dissemination of partner learning to allow the roll to be completed by the DNO or another third party.

### **(e) Relevance and timing**

Consideration will be given to Projects that aim to address those developments that are more likely to happen. However, for the avoidance of doubt, this does not mean we will

---

<sup>6</sup> Customers are defined in the electricity distribution licence as "any person who is supplied or requires to be supplied with electricity at any premises in Great Britain, but does not include any Authorised Electricity Operator in its capacity as such."

necessarily favour the Method that is most likely to be successful, as we recognise that there will be benefits associated with trialling a variety of Methods.

In demonstrating exceptional performance against this criterion, the DNO should:

- describe and provide evidence of how the outcomes of the project are being used in business planning
- describe and provide evidence of how the outcomes of the project are being used in the DNO's day to day activities.

**(f) Demonstration of a robust methodology and that the project is ready to implement**

At Full Submission, projects' methodology and readiness are scrutinised. In demonstrating exceptional performance against this criterion, DNOs should:

- demonstrate that the project's methodology was at least as robust as specified in the Full Submission (eg trials resulting in statistically robust sample sizes)
- demonstrate that the project's readiness was at least the level specified in the Full Submission (eg project begun in timely manner and delivered in line with project plan).

***First tier specific requirements – set 2***

**(a) Accelerated the development of a low carbon energy sector & has delivered net financial benefits to future and/or existing customers**

A DNO must demonstrate how the Solution or Solutions associated with the Project makes or could make a contribution to the UK Government's current strategy for reducing greenhouse gas emissions as set out in the document entitled "The Carbon Plan", as published by the Department of Energy and Climate Change (DECC). This may be amended from time to time or may be replaced by the Government, such change to be notified to the DNOs in writing by Ofgem. To reduce carbon in the energy sector, the Carbon Plan considers that electricity use may increase. This criterion also requires that the Solution(s) can provide financial benefits compared to the most efficient method currently in use.

In demonstrating exceptional performance against this criterion, DNOs should:

- describe and provide evidence of the aspects of the Carbon Plan that have been facilitated
- describe and provide evidence of the network capacity released
- describe and provide evidence of the financial benefits
- describe and provide evidence of the scale of rollout of the Method(s) (or techniques derived from the Method(s)) across their system and across GB.

Exceptional performance could also be achieved as a result of planned rollout of the Solution(s). DNOs could demonstrate the potential benefits that could be achieved by the project by:

- describing and providing analysis and assumptions of the aspects of the Carbon Plan that will be accelerated
- describing and providing analysis and assumptions of the capacity that has been/will be released
- describing and providing analysis and assumptions of the financial benefits that has been/will be realised
- describing and providing analysis and assumptions of the scale of rollout of the Method(s) (or techniques derived from the Method(s)) across their system and across GB.

~~**(b) Has a Direct Impact on the operation of a DNO's Distribution System**~~

**(c) Knowledge that has been shared amongst all DNOs**

One of the main purposes of the LCN Fund is to generate and share knowledge from Projects to help DNOs prepare for the role they will play as GB moves towards a low carbon economy.

In demonstrating exceptional performance against this criterion, the DNO should:

- describe and provide evidence of the level of new learning generated (including learning from things that didn't work)
- describe and provide evidence of effective knowledge dissemination by the project
- describe and provide evidence of the applicability of the new learning to other DNOs. This evidence should include examples of other DNOs using the learning.
- describe and provide evidence of the value of the IP generated by the project to customers and how the IP has been shared.

~~**(d) Focuses on network Methods that are at the trialling stage**~~

~~**(e) Does not lead to unnecessary duplication**~~