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Dear Arun,

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

Thank you for the opportunity to respond to the consultation regarding the implementation of the Discretionary Funding Mechanism (DFM) for the Low Carbon Networks Fund (LCNF). This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

- **It should not be expected, or viewed as necessary, for the full £100m available to be allocated; we believe only those projects that are judged to be exceptional should receive rewards.**
- **We suggest an alternative method that is compatible with this, and the existing LCNF Governance, and accommodates multiple assessments.**

The DFM *"...enables Ofgem to reward successful delivery and projects that bring particular value in helping DNOs understand what investment, commercial arrangements and operating strategies they should be putting in place to provide security of supply at value for money for future network users, while doing all they can to tackle climate change..."*[1]

The eligibility hurdles and the discretionary nature of these rewards have been emphasised:

[1] Ofgem (2014), 'Low Carbon Networks Fund Governance Document v.6', page 7. See: https://www.ofgem.gov.uk/ofgem-publications/45703/low-carbon-networks-fund-governance-document-version-6.pdf.

"...DNOs may be eligible for a discretionary reward upon successfully delivering the projects which are deemed to have delivered exceptional learning..."[2]

In keeping with the above, we believe the implementation of the DFM should reward projects that advance the intention of the LCNF, deliver exceptional results, contribute to learning within the sector and demonstrate significant customer benefit. It should not be a process of allocating the £100m available to projects.

Review of the proposed allocation of the DFM:

We agree with some features of the proposed allocation. These are:

- *Second Tier Successful Delivery Reward (SDR) could be up to 10% of Second Tier (T2) project costs*: this explicitly links the maximum value of an award under this scheme to the distribution network operator's (DNO's) Compulsory Contributions, as stated in the Low Carbon Networks Fund Governance Document v.6[3] ('*Governance Document'*).
- *Second Tier reward (STR) and First Tier Portfolio Reward (FTPR) apportioned on a 4:1 basis*: this apportionment reflects that up to £320m could be made available through T2 and up to £80m could be made available through the First Tier (T1)[4].

We have also identified a potential weakness of the proposed allocation - it does not fully recognise all of the stated purposes of the DFM. The *Governance Document* states funding may be made available for covering cost overruns or shortfalls in Direct Benefits and for rewarding DNOs under the SDR, STR and FTPR schemes[5]. The proposed allocation does not consider the former purpose and the total funding that could be awarded through the STR and FTPR schemes is increased as a consequence of this. The overall level of rewards should reflect only the relative quality of the projects and not also the extent of cost overruns or shortfalls. Thus, a method of 'ring-fencing' a portion of the DFM to cover the maximum possible requirement for cost overruns or shortfalls is needed to ensure the rewards remain independent of this. The *Governance Document* can be used to calculate the size of this portion, as we outline below.

Alternative allocation:

This two-step approach is comprised of the allocation of the DFM across all the purposes for which it may be disbursed and the calculation of the maximum funding that can be awarded at each assessment for each reward scheme. The advantages of this approach are:

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[2] Ofgem (2013), 'Strategy decision for the RIIO-ED1 electricity distribution price control - Outputs, incentives and innovation', para. 10.7. See: https://www.ofgem.gov.uk/ofgem-publications/47068/riioed1decoutputsincentives.pdf.

[3] Ofgem (2014), 'Low Carbon Networks Fund Governance Document v.6', page 49. See: https://www.ofgem.gov.uk/ofgem-publications/45703/low-carbon-networks-fund-governance-document-version-6.pdf.

[4] Ofgem (2009), 'Electricity Distribution Price Control Review Final Proposals - Incentives and Obligations', para. 1.4. See: https://www.ofgem.gov.uk/ofgem-publications/46748/fp2incentives-and-obligations-final.pdf.

[5] Governance Document page 69.

- The purposes of the DFM are preserved. We believe the equivalent of 5% of the T2 fund (representing the maximum financial support DNOs could receive for covering cost overruns[6]) should be reserved solely for this purpose even if these eventualities do not occur.
- The allocation can accommodate multiple assessments under the SDR, STR and FTPR schemes if it is deemed multiple assessments are appropriate.

This approach is summarised in Table 1 and described in Appendix 1.

We do not suggest how any individual reward may be calculated but we believe there is merit in placing a ceiling of 10% of the Approved Amount on any STR and 10% of the total Approved Allowable First Tier Project Expenditure on any FTPR. This mirrors the ceiling already placed on any individual SDR[7].

Table 1 - Alternative approach to allocation of the DFM

Purpose	Allocation Method	Allocation (£m)	Total reward available at each assessment (£m)
To cover cost overruns or shortfalls in Direct Benefits	5% of the entire T2 Fund (£320m)	16.0	-
To reward DNOs under the Second Tier Successful Delivery Reward	10% of the entire T2 Fund (£320m)	32.0	10% of total Approved Amounts for eligible projects in that assessment.
To reward DNOs under the Second Tier Reward	80% of the remainder of the DFM	41.6	(total Approved Amounts for eligible projects in that assessment/320) * 41.6.
To reward DNOs under the First Tier Portfolio Reward	20% of the remainder of the DFM	10.4	(total Approved Allowable First Tier Project Expenditure for eligible projects in that assessment/80) * 10.4.

We recognise T1 funding may be used for the development of ideas, which may be trialled in a T2 project. We believe it is inappropriate for any DNO to receive a reward for a T1 project (through the FTPR) that delivers inputs for a T2 project and a further reward for the same T2 project (through either the SDR or STR) because multiple disbursements could be made for the delivery of the same final output. While we understand the different emphases of the SDR and STR, the size of the total rewards should be considered in the round in the event any project receives both awards.

Regard should be given to the fair commercial value of Foreground intellectual property rights (IPR) created and related factors (such as the potential ongoing costs for maintaining such IPR) when the level of any reward through any reward scheme is considered. A DNO should not receive a reward through any reward scheme if its share of the potential proceeds from the disposal of Foreground IPR exceeds the value of the reward it would otherwise have been awarded.

[6] Governance Document page 64.
[7] Governance Document page 49.

Suggested screening criteria for projects for each assessment for each reward scheme are in Appendix 2. Responses to the consultation questions are presented in Appendix 3.

We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements

Appendix 1 – Alternative Allocation

An alternative two-step method for the allocation of the DFM is explained below.

Allocation for each reward scheme:
The maximum size of the funding pot for each of the three reward schemes is calculated as follows:

- SDR: as reflected in the original proposal, the maximum funding is 10% of the T2 fund. This equates to £32m.
- STR: the maximum available for the scheme is capped at four-fifths of the remainder of the DFM (the entire DFM less the funding ring-fenced for overruns/shortfalls and the maximum SDR funding). This equates to £41.6m.
- FTPR: the maximum available for the scheme is capped at one-fifth of the remainder of the DFM (the entire DFM less the funding ring-fenced for overruns/shortfalls and the maximum SDR funding). This equates to £10.4m.

Total reward available at each assessment for each reward scheme:
The total reward available at each assessment for each reward scheme reflects the levels of project funding disbursed relative to the total funding available.

The total reward available for each assessment is calculated as follows:

- SDR: 10% of total Approved Amounts of the eligible T2 projects submitted for assessment.
- STR: (total Approved Amounts of the eligible T2 projects submitted for assessment/320) * 41.6.
- FTPR: (total Approved Allowable First Tier Project Expenditure/80) * 10.4.

Appendix 2 – Project Screening Criteria

We believe the criteria for eligibility for rewards should be strengthened so only those well-managed projects that deliver exceptional learning are considered. We suggest the screening criteria below may be adopted to eliminate those projects that do not satisfy these requirements from consideration for reward(s).

Proposed ineligibility criteria for the FTPR:

- Any data protection breach has occurred.
- Unrecoverable Expenditure has been incurred.
- The project was halted, either by Ofgem or the DNO.
- The Close-Down Report has not been submitted or a satisfactory Close-Down Report has not been-resubmitted.
- Ofgem has reduced the DNO's Combined Allowed Distribution Network Revenue because of non-compliance.
- Any compliance breach is identified in the project audit.

Proposed ineligibility criteria for the SDR and STR:

- The DNO cannot adequately demonstrate how the project outputs and outcomes are consistent with and will support the delivery of its RIIO-ED1 business plan.
- Minimum reporting and close-down reporting requirements for T2 projects outlined in the *Governance Document* (or subsequent versions) have not been satisfied.
- The DNO cannot adequately demonstrate how the project outputs and outcomes complement the Evaluation Criteria.
- The project was halted, either by a Project Participant or Ofgem.
- Any failure is identified in the project audit.
- Disallowed Expenditure has been incurred.
- Any breach of the requirements in 'Project Bank Account', 'Customer Protection' or 'Data Protection' sections[8] (caused by any Project Participant) has occurred.
- Financial support is applied for to cover cost overruns[9].

[8] Governance document pages 60-62
[9] Projects on which cost overruns occur are already ineligible for the SDR. See Governance Document page 64.

Appendix 3 – Responses to the consultation questions

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.

We do not believe the proposed approach fully recognises all the stated purposes of the DFM. We outline an alternative method in Appendix 1.

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

We do not have a strong preference for either option presented in the consultation. However, adequate notice of rewards is required before DNOs are permitted to recover them through Distribution Use of System (DUoS) charges.

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

The alternative allocation method we propose accommodates multiple assessments on an equitable basis. If two assessments are conducted, each project should be considered during only one.

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

Yes.

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

Any funding of projects provided under the NIA should not be eligible for reward under the LCNF DFM. We do recognise that some First Tier projects started during DPCR5 may require NIA funding to conclude. We consider it appropriate to assess the success of these projects once completed but any reward should be pro-rated to reflect the level of funding provided via the LCNF as opposed to the NIA.

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

The assessment should be conducted once all T1 projects have been completed.

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

The suggested broad criteria appear reasonable. We suggest the detailed criteria are consulted on when developed.