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Direct Dial: 020 7901 7159
Email: Andrew.burgess@ofgem.gov.uk

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Assessment of benefits from the rollout of proven innovations through the Innovation Roll-out Mechanism (IRM)

We[1] have considered responses to our consultation of 7 January 2015 on the assessment of benefits for the IRM. This letter describes our decision and the guidance we will circulate to licensees making proposals for IRM funding this year. The guidance is for licensees to use when developing their submissions for funding under the IRM.

The IRM Licence Condition[2] contains the high level evaluation criteria we will use to assess whether a proposed roll-out should be funded. If implemented, proposed roll-outs should deliver carbon benefits and/or other environmental benefits and provide long-term value for money for network customers.

Methodology for the presentation of benefits

Decision

The methodology should largely be based on the cost benefit analysis (CBA) used as part of the RIIO-ED1 fast track process. Our guidance will make it clear that for proposals to be considered for funding, the licensee must comply with the criteria set out in the IRM Licence Condition, [3] before we will allow a licensee to recover funding under the IRM we must be confident the rollout:

(a) will deliver carbon benefits, or any wider environmental benefits,

(b) will provide long term value for money for customers,

(c) will not enable the licensee to receive commercial benefits from the roll-out within the price control period (for instance, where the Roll-out of a Proven Innovation will lead to cost savings (including benefits from other incentives) equal to or greater than its implementation costs within the price control period); and

[1] The terms "we", "us" and "the Authority" are used to refer to the Gas and Electricity Markets Authority in this letter.
[2] Special Condition 5D of the National Grid Gas Transmission's Gas Transporter Licence.
Special Condition 3D of the Gas Distribution Networks Operators Gas Transporter Licence.
Special Condition 4J of National Grid Electricity Transmission's Electricity Transmission Licence.
Special Condition 6E of Scottish Hydro Electric Transmission and Scottish Power Transmission Limited's Licences

(d) will not be used to fund any of the Ordinary Business Arrangements of the licensee.

In addition we expect licensees seeking IRM funding to:

- explain and justify the costs of the proposed roll out;
- explain and justify the costs of potential alternative methods, ie how the licensee would address the problem if the novel solution was not available;
- clearly explain the carbon benefits of the proposed roll out compared to potential alternative methods; and/or
- clearly explain and justify the environmental benefits of the proposed roll out compared to potential alternative methods.

The ED1 CBA guidance does not cover non-carbon environmental benefits. HM Treasury's Green Book[4] contains a method for calculating non-carbon environmental benefits. Using this would be consistent with the methodology for demonstrating carbon benefits, which refers to the Green Book.

We expect licensees to provide a robust justification for all the benefits that are claimed. Without a strong benefits case supported by a robust justification we will not be able to approve a proposed rollout.

Reason for our decision

We have chosen to base our guidance on that used in RIIO-ED1 for a number of reasons. This is a robust methodology which was used to set allowances for those licensees who were not fast tracked. There is a clear and consistent methodology for the presentation of financial costs and carbon benefits. It requires licensees to present the cost of different methods of delivering the same output in an easily comparable way.

Summary of responses

We asked respondents to propose methodologies that could be used to show the costs and benefits of proposed rollouts. Respondents proposed a number of options. These included the RIIO-ED1 CBA methodology.

Others proposed methodologies which have been used for assessing the benefits of innovation projects: the Network Innovation Allowance project benefits guide, and the methodology for assessing benefits as part of the Low Carbon Networks Fund. These methodologies have been developed or, in the case of ED1, are being developed to assess the benefits of innovation projects. Innovation projects are time-limited and the benefits are by their nature uncertain. Licensees should be more confident about the benefits of a rollout rather than an innovation project. We do not consider these methodologies to be appropriate for presenting the benefits of larger scale rollouts where assets are being installed on the network for a presumed asset life equivalent to that used in the relevant licensee's price control (40-45 years).

Another respondent suggested that the long-term costs and benefits of proposals should be compared, and rollout should be funded if the long-term benefits were greater than the long-term costs. We did not consider this was sufficient on its own to justify IRM funding.

[4] https://www.gov.uk/government/publications/green-book-supplementary-guidance-environment

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Ensuring the IRM is only used to fund a rollout where it is necessary to do so

Decision

The guidance will make it clear that licensees should explain why IRM funding is necessary to fund the rollout of a proven innovation. Licensees will need to provide evidence to show that:

- they cannot fund the proposed roll-out using their existing price control allowance;
- there is not an alternative price control mechanism that could be used to fund the rollout; and
- the licensee does not have a financial incentive to implement the rollout.

As part of their price control allowance licensees can recover charges to fund the efficient implementation of their business plan. The IRM should only be used where the allowance is insufficient. Rather than funding the full cost of a rollout, the IRM will only fund the increment between what has been funded through the base allowance and the increase in cost caused by the proposed rollout.

Reasons for our decision

Licensees are incentivised, through the sharing mechanism, to roll out innovations where the novel method will deliver lower network costs than the current method in use. Therefore, the IRM should not be used to fund a rollout where the licensee can afford to use its existing allowance. The second condition above recognises that there are a number of mechanisms that incentivise licensees to bring innovation into business as usual. For example, gas distribution licensees are incentivised to reduce shrinkage while transmission licensees can make use of the Strategic Wider Works mechanism for large-scale strategic investments.

Summary of responses

Most respondents argued that licensees should use their business plans to show that the proposed rollout was not within their original plan and therefore was not explicitly funded. Another respondent argued that a licensee should have to demonstrate that it could not have considered the technology it proposes rolling out when developing its original plan.

We agree that these are points that should be covered in a licensee's case for funding. However, we do not think that a novel investment should be funded simply because it was not in the original plan.

Another respondent proposed comparing the long terms costs and benefits of each proposed rollout. The respondent proposed that where the benefits are greater than the costs then the rollout should be funded. We recognise in the first section of this letter that a positive CBA is an important factor. However, that alone is not sufficient to justify IRM funding.

Ensuring the IRM is used to fund novel investment

Decision

The guidance will make it clear that licensees will need to explain why the technologies they wish to roll out do not fall within the definition of an ordinary business arrangement (as defined within the IRM licence condition).

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9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Reasons for our decision

Licensees already receive significant allowed revenues to deliver the price control outputs. The costs and benefits of delivering these outputs using business as usual methods have already been assessed as part of the review. The IRM should only be used to fund delivery of additional benefits, where these benefits will be delivered using novel approaches.

Summary of responses

Respondents proposed that a check could be made to understand whether a proposal was in common use by other licensees. Where this was the case then the proposal should not be eligible for funding. However, one respondent thought that just because some licensees are using something it does not mean that another should not be able to make use of the IRM. This is because different licensees can face different barriers to rollout.

We can understand both sides of this argument. If another licensee is already using the proposed approach, we will consider, alongside any evidence from the applicant, why its circumstances create barriers to rollout without IRM funding. One respondent said that there was a case for an independent engineering audit of proposals. We consider that licensees should make a strong argument as to why something does not fall into the definition of an ordinary business arrangement. We can then test this justification using internal and external resource as appropriate.

<u>Next steps</u>

We will publish our guidance to licensees shortly. Licensees will then be able to make submissions between 1 May 2015 and 31 May 2015. We aim to issue our decision on any proposals we receive within four months of the application window closing.

Should you wish to discuss the issues raised in this document, please contact Neil Copeland at neil.copeland@ofgem.gov.uk or on 020 7901 7193.

Yours faithfully,

Andy Burgess.

Andrew Burgess
Associate Partner, Transmission and Distribution Policy

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**