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Dear Neil

The Network Innovation Review: Ofgem Proposals

The implementation of the Low Carbon Network Fund (LCNF) has significantly changed the innovation culture of regulated companies in the UK. Prior to the funding mechanism there was very little incentive for network operators to devote resources or funding to potentially high risk or low reward innovation projects. With the support of the LCNF fund UK network operators typically employee a team of staff specifically focused on innovation delivery, business as usual transition and promoting innovation culture.

It is clear that Ofgem's long term goal is to change the behaviours of network operators to the point that they continue to support and develop innovation without the need for funding mechanisms or incentivisation. This is a challenging prospect and not fully supported under the current regulatory regime. To date, successful innovation projects have only generated benefit for network operators within the current price review settlement (whilst also generating benefits for customers). At the start of each price control these benefits have effectively been embedded into the price control, passing all future benefits onto customers. Network operators will not fully embrace Ofgem's vision of self-sustained innovation with such a short window of benefit.

We are open to a more collaborative approach between network operators, including a common innovation strategy. This strategy will need to be at a highly strategic level, however, focusing on the medium to long term goals of the industry. Otherwise there is likely to be significant reworking of a strategy due to the fast moving nature of short term innovation projects.

It should be emphasised that there is a very real challenge for network companies to prepare NIC bids of sufficient quality. This requires commitment and dedication from key staff, including a full internal sign-off process. The costs and risks associated with this can be borne by network operators, however NIC bids are unlikely to be successful without the support of consultancy support, analysis and evidence. These are the costs that were captured within the NIC preparation costs. With increased competition for the reduced NIC funding, the risk that preparation costs and time are lost on unsuccessful bids will increase. This may have the adverse effect of reducing the appetite for network operators to undertake NIC bids in future. This will be further reinforced by the removal of the successful delivery award mechanism.

By allowing network operators to define and promote research and innovation priorities, there has been a focus on solving current and future network challenges. Our innovation projects have made it possible to connect over 100MW of generation through Active Network Management that would otherwise have been unable to connect until 2023, resulting in customer and wider societal benefits of £18m. We are open to the engagement of third parties in the innovation funding mechanism, however to ensure that value is returned to UK customers we believe that network operators should maintain a leadership role in defining the focus of innovation, ensuring that it will deliver tangible benefits to our customers.

The recent independent review of the Low Carbon Network Funding¹ identified £800m to £1.2bn net benefits created to date through the innovation mechanisms available to network operators. The potential for even greater benefits was highlighted within the consultation². With the challenges that the industry currently faces in transitioning to a smart, low carbon network now is not the time to risk reducing DNO engagement in innovation. Especially considering the value that the LCNF has demonstrated, supporting the development that have given us great insight into a smarter system.

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¹ https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation_of_the_lcnf_0.pdf

² https://www.ofgem.gov.uk/system/files/docs/2016/12/innovation_review_consultation_final.pdf

1 BACKGROUND AND SCOPE OF OUR REVIEW

The Low Carbon Network Fund (LCNF) review highlights the qualitative and quantitative benefits that the LCNF mechanism has created. Considering the historic position of network companies on innovation, this mechanism has been a huge success, providing value to customers, network companies and ultimately preparing the UK for a low carbon future.

2 EVALUATION OF THE LOW CARBON NETWORK FUND

We were fully supportive of the independent evaluation of the Low Carbon Network Fund, however we would also highlight that smart grid benefits of c.£1bn were built into the RIIO ED1 settlement and are effectively already accruing to customers. Continued support of the LCNF is essential for network companies to realise these benefits.

The review also highlights the additional benefits implicit if network companies adopt each other's innovation project findings. Whilst we agree that network companies need to do more to ensure that their shared learning is adopted into business as usual, it should also be recognised that due to regional or network differences, not all projects are of equivalent value to all network companies.

3 PROPOSALS FOR DELIVERING GREATER VALUE FOR MONEY

Question 1: What are your views on our proposals to introduce a requirement for the network companies to jointly develop an industry-wide innovation strategy?

- **If you agree, should companies retain their own strategies, and in addition should there be a single system strategy, or one for gas and another for electricity?**
- **How often should the strategy be updated?**

We agree with the proposal for network companies to develop an industry-wide innovation strategy. This should be in the form of an overarching strategy for regulated electricity network companies, with each network company retaining their own strategy. The industry-wide strategy should be at a strategic level focusing on the medium to long terms goals of the industry rather than short term innovation priorities. This will ensure that individual companies still have the capability to innovate and drive industry benefits without the need to align short term priorities with the overarching industry strategy. It is our view that electricity and gas should retain separate innovation strategies, however, going forward the two industries could work more collaboratively to consider a whole system approach to network design and innovation priorities. To achieve a compromise between keeping the strategy relevant and a process of constant iteration, updating the strategy every two years would be sensible.

Question 2: What are your views on our proposals to help facilitate increased involvement of third parties in the NIC via the network companies?

We are broadly supportive of opening up the NIC process to third parties and it is worth noting that many of the successful NIC bids already have significant involvement and buy in from third parties. The process should continue to be led by network companies, to ensure that the NIC projects align with current or future network challenges. This will also help to ensure that benefits ultimately accrue to UK customers. The outlined Call for Innovation approach will help to ensure that third party projects match the needs of network companies and our customers. The Call for Innovation process moving forward should also align with any industry-wide innovation strategy as outlined in Question 1.

Question 3: What are your views on providing direct access for third parties to the NIC?

As outlined in our response to Question 2 above, we would caution direct access unless it can be demonstrated that benefits will accrue to network companies and ultimately to UK customers.

Question 4: What are your views on our proposals to remove the Successful Delivery Reward and the provision to recover Bid Preparation Costs?

We disagree with the approach of removing either the Successful Delivery Reward or Bid Preparation Cost mechanisms. We are approaching a time of significant change in what is expected of network companies and the capability of our electrical networks. Innovation will be an essential component of meeting these challenges. In a time when innovation is essential, we should not be removing the incentive to drive innovation in the industry. The NIC process is already time consuming, labour intensive and ultimately risky. Without the successful delivery reward and bid preparation costs, and with greater competition for the NIC pot, we believe that these proposals will introduce a significant disincentive for network companies to come forward with future NIC bids.

It is clear that Ofgem's long term goal is to change the behaviour of network operators to the point that they continue to support and develop innovation without the need for funding mechanisms or incentivisation. This is a challenging prospect and not fully supported under the current regulatory regime. To date innovation successful innovation projects have only generated benefit for network operators within the current price review settlement (whilst also generating benefits for customers). At the start of each price control these benefits have effectively been embedded into the price control passing all future benefits onto customers. Network operators will not fully embrace Ofgem's vision of self-sustained innovation with such a short window of benefit.

4 PROPOSAL FOR FUTURE FUNDING LEVEL OF THE ELECTRICITY NIC

Question 1: What are your views on the rationale for reducing the level of electricity NIC funding pot?

Given the historic level of subscription we believe it is fair to reduce the overall NIC pot and that doing so will not have a negative impact in the immediate term.

Question 2: What are your views on the proposed funding level of the electricity NIC?

The proposed level of funding is fair based on historic subscription levels to the NIC funding. However this should be reviewed no less than 2 years after opening up to 3rd parties to ensure that the scale of funding is not limiting potential innovation projects that could provide real value to UK customers or help to facilitate future low carbon networks.

5 OTHER PROPOSALS FOR GOVERNANCE ARRANGEMENTS

Question 1: Do you agree with our proposals to clarify the circumstances we do and do not expect change requests are submitted to us?

- If you agree, do you think our proposed draft explanation of material changes is clear?
- If you think alternative drafting would achieve this more effectively please provide this drafting.

We agree with the proposals. They are a positive step to reduce the burden on both Ofgem and network companies in managing the delivery of NIC projects. The drafting outlined within the consultation is sufficiently clear, however, additional examples may help to clarify exactly when a network company or third party should come forward with material changes.

Question 2: Do you have any feedback on our proposal to publish a plain English guide to our default intellectual property (IP) requirements?

This would be of great benefit to third party developers seeking to partake in the NIC competition as IP for many SME's will be one of their main sources of benefit in leading and part funding a NIC bid.

Question 3: Do you have any views on our proposals to improve the visibility of the NIA projects? What are your suggestions for a proportionate way to get assurance that the NIA is being used by network companies in an appropriate way?

We agree that greater governance of the NIA portfolio will help to ensure that the NIA funding is being used in an appropriate way. There are a number of options to provide greater assurance:-

- **Review/refine registration documentation**
If there are concerns over the appropriateness of NIA funded projects then it is likely that the registration and/or closedown reports are not providing enough information for Ofgem

to assess the appropriateness of projects. A review of these documents may provide greater assurance that NIA funding is being used appropriately.

- **Improved categorisation of NIA projects**
One of the challenges with the NIA portfolio is the volume of projects and range of topic areas that are covered. Better categorisation of NIA projects, including their alignment to company and industry innovation strategies may provide greater assurance as to their appropriateness
- **Peer review of NIA portfolio**
With Ofgem seeking a more aligned innovation strategy it may be a sensible approach for network companies to review (as a group) registered and closed projects on an annual basis, providing a summary report to Ofgem and flagging any concerns. We would support Ofgem being involved with this process, in the interest of transparency.
- **Sample audit of NIA projects**
The volume of NIA projects across the UK network companies would make a detailed review a daunting prospect, both for Ofgem to audit and for network companies to prepare for any such audit. A sample audit approach may be more appropriate reviewing selected projects for their applicability and ultimate benefit to the industry.

Question 4: Do you have any comments on any of our other proposals?

Consideration must be given to the fact that this is a time of significant change for networks, and for the UK as a whole. Ofgem needs to ensure that there are sufficient incentives to innovate to meet the challenges of the future network, at the lowest cost to customers. Otherwise, they could be seen to be a barrier to realising a low cost, low carbon future.