

RIIO Team
riio2@ofgem.gov.uk
Ofgem

Our ref: RIIO2

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RIIO-2 sector specific methodology consultation: EA Technology's Response

Dear RIIO Team,

EA Technology welcomes the opportunity to respond to Ofgem's consultation on the RIIO-2 framework. EA Technology is an employee-owned SME with a long history of innovation in the electricity distribution industry.

While we do not feel qualified to address all of the questions in the consultation, we would like to respond to cross-sector questions CSQ44-50, under the heading 'Innovation'.

CSQ44. Do you agree with our proposals to encourage more innovation as BAU?

No. We do not agree with your proposals to encourage more innovation as Business As Usual (BAU).

While we generally agree with the statement in 8.6 that "totex [...] equalises incentives between capital expenditure and operational expenditure", we disagree with the assertion that "the totex incentive mechanism encourages [...] innovation".

Innovation does not deliver benefits to customers until it is implemented as BAU. This implementation requires expenditure – which may increase totex within the current price control period. Effective innovation would be expected to deliver efficiency improvements over many years, and such savings may endure well beyond a price control period. This potentially leaves an extremely small window of only a few years in which to realise benefits for the network owner, due to the way in which any efficiency savings are effectively 'reset' at the start of each price control.

As a result, not only is there currently minimal reward for deploying innovation as BAU, but also the incentive mechanism may discourage deployment by providing a perverse incentive to delay implementation until the next price control period.

While the provisions of 8.16, 8.17 and 8.18 for increased transparency, reporting and accountability are welcome, we do not believe that the proposals in this consultation address the fundamental issue of rewarding *implementation* of innovation as BAU.

We have made alternative proposals in our answer to CSQ49 that we believe would encourage more innovation as BAU.

CSQ45. Do you agree with our proposals to remove the IRM for RIIO-2?

Yes. We agree with your proposals to remove the IRM for RIIO-2

We agree with Ofgem's view that the IRM is not effective in incentivising innovation as part of BAU.

CSQ46. Do you agree with our proposals to introduce a new network innovation funding pot, in place of the Network Innovation Competition, that will have a sharper focus on strategic energy system transition challenges?

Yes. We agree with your proposals to introduce a new network innovation funding pot.

We strongly support the proposal to increase the focus of the funding on transformational EST projects (8.25). Whilst the NIC mechanism has resulted in some excellent projects, it is our view that the requirement for NIC projects to deliver "material benefit {to networks}" has resulted in activities that are solely focussed on the needs of networks, while neglecting the (more general) needs of the whole energy system.

CSQ47. Do you have any views on our proposals for raising innovation funds?

Yes. We support the proposals to continue the raising of innovation funds from use of system charges.

CSQ48. Do you think there is a continued need for the NIA within RIIO-2? In consultation responses, we would welcome information about what projects NIA may be used to fund, why these could not be funded through totex allowances and what the benefits of these projects would be.

Yes. We think there is a continued need for the NIA within RIIO-2.

In our view, the NIA has been highly successful in encouraging effective innovation. It has resulted in the creation of dedicated innovation teams who have developed excellent links with the supply chain to source the delivery of innovation activity from the open market. This activity has increased competition among innovation providers and resulted in significantly higher levels of innovation activity than would otherwise have been achieved. International studies show that the UK spends three times more on innovation on a per capita basis when compared to Australia¹, while Ofgem's own analysis shows that this innovation returns up to six times this value to customers².

As previously explained in our response to CSQ44, existing and proposed totex incentives alone do not provide an incentive to innovate; in fact, the totex incentives provide a strong disincentive to innovate, by encouraging network operators to spend as little as possible in any regulatory period.

In a normal, unregulated environment, the prospect of future savings and rewards provide a strong incentive to innovate. In the RIIO totex environment, any incentive to innovate is firstly diminished (currently 50-70%) by the incentive sharing mechanism, then removed altogether at the end of the regulatory period (currently five to seven years).

¹ Network Innovation Discussion Paper, Energy Networks Australia, July 2017, p.2

² An Independent Evaluation of the LCNF, Pöyry report for Ofgem, October 2016, p.2.

If the NIA were to be removed, we would expect levels of innovation to revert to pre-NIA levels, with a corresponding immediate reduction in benefits to customers. This would also result in the elimination of a significant part of the existing innovation supply chain, further impeding network operators' flexibility and resilience in the face of future developments and challenges.

CSQ49. If we were to retain the NIA, what measures could be introduced to better track the benefits delivered?

We believe that the NIA continues to be highly effective in encouraging innovation activity. However, this question hints at what we believe to be fundamental flaws in the current NIA mechanism. These are:

- 1) Unlike the NIC, there is little or no incentive to disseminate or share the usable outputs of NIA-funded innovation. We do not perceive that network operators are actively hiding the outputs of innovation; however, it is not always easy (or possible) to access the results and data that would enable such innovation to be deployed by other network operators, primarily because such dissemination activities are not part of BAU.
- 2) There is no mechanism to report or document the actual benefits that result from implementation of NIA-funded activities as BAU.
- 3) There is no incentive or reward to implement innovations into BAU - other than the possibility of a modest, short-term reward for small-scale rollout under the totex incentive. Large, cross-network BAU rollouts are effectively discouraged by the totex incentive, unless significant benefits can be realised within the current price control.
- 4) There is no clear pathway to innovation funding eventually becoming part of BAU, meaning that essential innovation activity remains wholly dependent on the NIA.

The above issues create a lack of transparency on NIA outputs, leading to a perception that the NIA spend is not effective or transparent^{3,4}. Furthermore, the lack of incentives to deploy as BAU means that good innovations may not always result in the maximum level of benefit to customers.

We believe the NIA arrangements can be improved so that they:

- 1) Ensure dissemination of innovation outputs, to enable GB-wide adoption
- 2) Provide a transparent, auditable measure of the benefits returned to customers as a result of NIA-funded innovation
- 3) Appropriately incentivise network operators to implement innovation outputs into BAU
- 4) Provide a clear pathway toward the eventual removal of the NIA

We have outlined some proposals to address these issues for electricity distribution companies in our response to CSQ50.

³ Networks' Good Intentions: A report on how energy networks' social obligations are delivered by Citizens Advice, 2016

⁴ <https://publications.parliament.uk/pa/cm201617/cmselect/cmenergy/267/26707.htm>

CSQ50. Do you agree with our proposals for electricity distribution companies prior to the commencement of RIIO-ED2?

No. We do not agree with the proposals for electricity distribution companies prior to the commencement of RIIO-ED2.

The proposals for electricity distribution companies appear to be aimed solely at harmonising NIA funding arrangements, rather than addressing the fundamental issues with NIA. We think that this consultation presents an opportunity to address the issues identified in CSQ49.

Our alternative proposals are as follows:

- As part of the RIIO-ED2 business planning process, Ofgem request that DNOs collect and submit audited evidence of totex savings that they claim arise directly from the deployment of NIA-funded innovation being translated into BAU during RIIO-ED1. To simplify the data collection process, this could be limited to, say a single year only - but could of course be extended to multiple years if required.
- Each 'claim' would be linked to a specific NIA project on the Smarter Networks Portal⁵, either a project funded by that DNO or, importantly, any other DNO.
- Each 'claim' would be independently audited and verified by an independent 3rd party.
 - *This would provide Ofgem and other stakeholders with clear, auditable evidence of the effectiveness (or otherwise) of NIA-funded activities to date in reducing totex*
- Ofgem complete the RIIO-ED2 business planning process as normal, with the following change: "Where totex savings achieved in RIIO-ED1 are deemed and accepted by Ofgem to have arisen directly from NIA-funded activities, the "network operator" component of such totex savings (after applying the incentive sharing mechanism) will be excluded from the re-baselining of costs for RIIO-ED2". This would effectively provide a reward for network operators in RIIO-ED2 for deploying innovation into BAU in RIIO-ED1.
- Network operators would be free to make no claim with regard to totex savings arising from NIA-funded activities, in which case any totex savings will be treated in accordance with current arrangements and accordingly re-baselined for RIIO-ED2.
 - *This would provide network operators with a clear reward for implementing NIA-funded innovation into BAU*
 - *This would provide customers with demonstrable benefits arising from NIA-funded activities*
- Given the above incentive for RIIO-ED2, we would expect network operators would respond by making every effort to maximise the effectiveness of innovation deployment into BAU during the remaining period of RIIO-ED1
 - *This would significantly accelerate the realisation of benefits to customers from NIA-funded activities*

⁵ <http://www.smarternetworks.org/>

- Ofgem would retain a similar mechanism for RIIO-ED3 i.e. an audited account of the benefits delivered by NIA funding during RIIO-ED2, followed by appropriate rewards to network operators during RIIO-ED3. This would reduce the dependence on NIA to drive innovation and ultimately replace it with a transparent, auditable BAU process.
 - *This would enable Ofgem to reduce (or remove) the NIA at an appropriate time, while having clear evidence that innovation will continue to deliver benefits to customers as BAU*

We hope you find our response to this consultation useful. We believe passionately that innovation has the potential to drive down costs and enable the transformation of the energy system. We would therefore be delighted to discuss any of these points in more detail (if required) and look forward to seeing the outcome of the consultation process.

Yours faithfully,



Dave A Roberts

Director – Strategy & Interventions, EA Technology Ltd

t. +44 (0) 151 347 2318

e. davea.roberts@eatechnology.com