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**Ofgem consultation on the regulatory treatment of CLASS as a balancing service in the RIIO-ED2 network price control**

Dear Sir/Madam,

We welcome the opportunity to respond to your consultation on the regulatory treatment of CLASS as a balancing service in the RIIO-ED2 network price control consultation.

National Grid Electricity System Operator (ESO) became a legally separate entity on 1 April 2019. As the ESO, we use our unique perspective and independent position to facilitate market-based solutions which deliver value for consumers. We procure balancing services to help us efficiently manage the national electricity transmission system. To support this role we welcome innovative new ways to help us undertake these duties at lower cost, and support the development of achieving this through competitive processes wherever possible. To that end we have facilitated the participation of the CLASS technology in the provision of balancing services as we would for any other provider, recognising however that other industry parties have raised concerns with us over perceived conflicts of interest on the part of the providing DNO.

We welcome Ofgem's work to provide greater certainty on the regulatory treatment of CLASS, and overall assessment of potential impacts. We have provided detailed responses to the questions raised in the consultation in the attached Annex 1. We note that whilst the consultation is focused on the treatment of CLASS in the RIIO-ED2 price control period, it does raise some broader policy points as listed below. We would be happy to discuss these points further with you.

- **The use of regulated network assets in the provision of balancing services** – Transmission and distribution network organisations have historically used regulated assets to help efficient system operation. We believe the costs associated with these activities are already incorporated within the price control settlements for these organisations. However, we recognise there is potential for these network organisations to develop innovative new ways of using regulated assets to provide balancing services. Where this occurs, consideration should be given to cost recovery through market based solutions as has been the case with CLASS.
- **National Grid ESO's C16 licence obligations** – We agree that National Grid ESO's C16 licence obligations require us to balance short-term reductions in balancing costs against the longer-term developments. However we note that the obligations set out under C16 were established in a much less complex sector and there is a limit to our current ability to consider the long term effects of market impacts. We therefore believe enhanced review of the statements associated with C16 may be warranted, over and above our regular consultative review.
- **The management of perceived conflicts of interest within a DNO organisation** – We welcome the work that is being undertaken by BEIS and Ofgem and also the Open Networks project to manage perceived conflicts of interest within DNO organisations. Such conflicts can potentially arise between DNOs developing system operator capabilities alongside asset owner and service provider functionalities. We will continue to raise any potential concerns we encounter with Ofgem to ensure DSO develops in a neutral manner that ensures a level playing field for all.

Should you require any further information or would like clarity on any of the points outlined in this consultation response then please contact Andy Wainwright in the first instance at [andy.wainwright@nationalgrideso.com](mailto:andy.wainwright@nationalgrideso.com).

Yours sincerely



Julian Leslie

Head of Networks, National Grid ESO

## Annex 1 – National Grid ESO response to specific consultation questions

*Q1. Are there other options we should have considered? Please provide reasons.*

Ofgem's minded-to position is to continue to allow recovery of costs and revenues for CLASS through DRS8. Whilst we understand the logic for consideration through existing revenue recovery mechanisms, this presumes that there is no need for any new revenue recovery mechanisms. For example, a mechanism which protected consumers from financial risks associated with CLASS whilst not imposing a limit on charges, may be more appropriate.

*Q2. Do you agree that market based mechanisms can provide the most efficient incentive for CLASS participation in balancing services?*

At National Grid ESO we are working to open new opportunities for competitive services and the creation of market mechanisms that facilitate a level playing field for all parties. We would agree that in general market-based mechanisms can provide the most efficient incentive for CLASS participation in balancing services. However appropriate consideration needs to be given to any potential unintended consequences which may distort the market, and we welcome this consultation as a vehicle to highlight such concerns. Related to this, we also note the increasing complexities and challenges associated with ensuring a level playing field across a range of differing business models and technologies.

*Q3. What is your view on DNOs' sharing profits with consumers, even if this means consumers are also exposed to DNOs' losses (including how this might affect DNOs' competitive behaviour noting this is different to other providers of balancing services)?*

It would seem appropriate for any profits to be shared with consumers given the transit of power through the regulated assets is due to consumer demand. However as consumers have not chosen to participate in the provision of balancing services they should be protected from any risks associated with such services.

*Q4. How might limits on charges to the ESO in DRS9 affect investment and utilisation signals for CLASS?*

DRS9 allows DNOs to recover their reasonable costs and a reasonable margin. Whilst such a mechanism may be appropriate for a regulated entity, it has the potential to inhibit market fluidity. For example, if DRS9 cost recovery is much lower than the marginal price of service provision then DNOs may be discouraged from providing a service, even though they could provide a more efficient solution than exists today. The use of limits on charges would not appear appropriate in such conditions.

*Q5. Do you agree that requiring CLASS in the price control would not promote efficient investment signals in CLASS and could distort competitive outcomes?*

The requirement for CLASS within the price control could provide for a level of efficient investment signals, particularly if incentivised appropriately. However, such a regulated mechanism would not be as efficient as a market based mechanism and therefore not create the same level of consumer value.

*Q6. Do you have evidence CLASS could affect the likelihood of system reliability issues?*

Whilst we have no formal evidence that CLASS could affect the likelihood of system reliability issues, we recognise that DNOs are obligated through Grid Code OC6 to provide demand control via voltage reduction. We understand that the assets used for CLASS may be the same assets as those needed for demand control purposes. As such we believe the technology developed under CLASS could be used for demand control, as well as other potential purposes. We would be happy to work with participating DNOs to understand this potential and gain further confidence that CLASS usage will not affect the likelihood of system reliability issues, including their obligations under OC6, going forwards.

*Q7. Do you have evidence competition is currently being distorted or impeded by the participation of CLASS? Do you agree with our assessment that it is unlikely DNOs have or would have market power in future, and the reasons we have provided in Appendix 2?*

We believe that the evidence provided in Appendix 2 of the consultation document provides an accurate view of the current impact of CLASS technology on both Fast Reserve and FFR markets. We note that, in line with the Clean Energy Package, we have now suspended reserve tenders and providers are now submitting optional Fast Reserve prices via PAS. These are dispatched in merit order based on submitted prices.

We believe that there is potential for adoption of CLASS technologies by other DNOs to offer Fast Reserve, FFR and potentially other balancing services. In accordance with our C16 licence condition we will continue to monitor this situation, but believe there may be need for enhanced review of the statements associated with C16 to ensure its continued appropriateness.

We would note that under our balancing services contracts, providers have a financial liability to the ESO for non-delivery of the contracted service. It is not clear how the commercial arrangements around CLASS, particularly with regard to assets which have not actively signed up to deliver the service, back-off this liability.

*Q8. What information could the DNO have privileged access to that that could offer it an unfair advantage in balancing services provision? How might this change in future if the DNO and ESO increasingly coordinate?*

National Grid ESO procures balancing services from providers in a non-discriminatory, technology neutral manner consistent with the obligations laid out in our transmission license. The roles of DNOs as a procurer of flexibility services, a technical assessor of proposals and a provider of balancing services are all new and evolving quickly. We are very conscious that consequentially our interfaces with DNOs are changing and taking new forms. For example, our pathfinder projects are looking for service provision to support efficient operation of the transmission system, for specific needs in a defined region. DNOs support us through the assessment process to understand the relative effectiveness of DER connected to their networks. We are conscious that DNOs may also be looking to offer services into these pathfinder projects as a commercial entity. Where we believe this could introduce the potential for perceived market distortion we have highlighted, and will continue to highlight, to Ofgem. We will also ensure that appropriate mitigations are put in place by ourselves to ensure no party has an unfair advantage in the provision of balancing services.

*Q9. What measures would you consider effective and proportionate to ensure that privileged information the DNO has access to is not used inappropriately to benefit the commercial performance of CLASS?*

We welcome the work DNOs have done to ringfence their DSO activities from other DNO roles and responsibilities but believe there could be merit in making these more transparent and standardised. We also recognise the work conducted through Open Networks to identify and address potential conflicts of interest which provides a good starting point for further work.

*Q10. In what other ways do you think DNOs could take advantage of their DNO role in the context of providing balancing services with CLASS?*

We believe that the assessment provided in Appendix 2 of this consultation provides a good overview of the potential ways a DNO could possibly take advantage of their role in the context of providing balancing services with CLASS. However, there may need to be broader consideration of such effects on competition than simply service provision through CLASS. This consultation also opens the door to other potential future uses of regulated network assets to provide balancing services. National Grid ESO welcomes such innovation which we believe could deliver whole electricity system benefits to the consumer. We do however recognise the need for new proposals to be assessed to ensure a level playing field is maintained and the impacts on long term markets understood. Our C16 licence obligation could support the identification of such needs, but may require modifications to its statements to reflect this extension in usage.

*Q11. How far do you think existing safeguards (including licence obligations and competition law) against DNOs taking advantage of their DNO role in the context of participating in the balancing markets with CLASS are sufficient?*

It is encouraging to see Ofgem considering this area in more detail through this consultation process and we recognise that this is a fast-moving area of development within the sector. As such current safeguards may no longer remain appropriate and new licence conditions, such as the proposed whole system licence condition, may be required. We see our role as both reviewing balancing markets impacts through our C16 licence condition as well as continuing to highlight to Ofgem where perceived risks may occur to allow their consideration. We note that further consideration of the continued appropriateness of the statements associated with C16 may be warranted as part of this work.

*Q12. What additional measures would be effective and proportionate to address actual or perceived risks of DNOs taking advantage of their DNO role?*

We have supported the work that has been progressed through Open Networks to manage unintended consequences of the DSO transition, but recognise that more needs to be done. Ultimately as roles and processes mature, we would expect to see a growing need for frameworks to support the DNO's role ideally through open governance arrangements.

*Q13. Are there other specific effects to competition that are relevant to our decision? What effects would these have on consumers?*

We are not aware of any other specific effects.