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Dear Edwin,

Regulatory treatment of CLASS as a balancing service in RIIO-ED2

Thank you for the opportunity to comment on this consultation. This response is on behalf of ScottishPower's renewable generation and retail businesses. Our networks business, SP Energy Networks (SPEN), is responding separately from its perspective as a networks licensee.

In principle, we support the provision of CLASS by DNOs and wish to see progress being made under Work Stream 3 (DSO Transition) of the ENA's Open Networks Project to drive DNO neutrality and manage conflicts of interest.

We feel that Ofgem's minded-to position to allow DNOs to provide CLASS in RIIO-ED2 will ultimately reduce costs to consumers through increased competitive pressure in balancing services markets and a reduction in DUoS charges.

Ofgem is clear that DNOs should not undertake activities that can be done by third parties. We agree with this stance in the DNO-DSO transition and believe it will help to ensure that balancing services markets remain open to non-DNO service providers.

Should you have any questions on this response, please do not hesitate to contact Ricardo da Silva (Tel: 014 1614 8341, ricardo.dasilva@scottishpower.com) in the first instance.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

Annex 1

REGULATORY TREATMENT OF CLASS AS A BALANCING SERVICE IN RIIO-ED2 NETWORK PRICE CONTROL – SCOTTISHPOWER RESPONSE

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

No. We believe the four options Ofgem has considered (listed below) represent the obvious and feasible ways to treat CLASS a *commercial* balancing service over the timescales of the RIIO-ED2 price control.

Option 1a: CLASS competed as a Directly Remunerated Service 8 (DRS8)
Option 1b: CLASS competed as a Directly Remunerated Service 9 (DRS9)
Option 2: CLASS provided as a price control service
Option 3: CLASS is prohibited

Voltage control under OC6 of the Grid Code covers the provision of this service as a mandatory balancing service. Ofgem observes in paragraph 1.7 that, "CLASS does not and shall not undermine the ability of DNOs to deliver their Grid Code obligations. It is the responsibility of DNOs to ensure they take any necessary measures to ensure compliance".

We believe the consultation would benefit from a clearer explanation of how CLASS does not compromise a DNO's ability to continue to meet its Grid Code demand reduction obligations and maintain the quality of supply to customers.

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

Yes. As Ofgem notes in paragraph 2.19, a market-based mechanism where a DNO providing CLASS is in competition with other providers would set efficient incentives for DNOs to participate with CLASS only where it is cost effective to do so and create opportunities for greater competition in balancing services markets.

The safeguards Ofgem proposes with market-based mechanisms are to monitor DNOs' participation and to drive forward a wider package of measures to improve transparency and address any actual or perceived conflicts of interest in DNOs' decision-making.

Work Stream 3 (WS3)[1] of the ENA's Open Networks Project (ONP) will be important in this context. A key aim of WS3 is to further understand and investigate perceived conflicts of interest and unintended consequences, to identify appropriate mitigation measures, monitor progress made on these measures and provide industry visibility of this. Our view is that certainty and confidence in the market will improve as products in WS3 are implemented.

[1] WS3 – DSO Transition: https://www.energynetworks.org/electricity/futures/open-networks-project/workstream-products-2020/ws3-dso-transition/

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)?

We agree with Ofgem's view that is appropriate for consumers to share in any of the profits a DNO makes from the provision of CLASS on the basis that the service requires use of network assets that have been paid for by consumers and builds on consumer funded learning via the low carbon network fund (LCNF) project.

Option 1A creates incentives for DNOs to participate where there is a good investment[2] case for it to do so. Therefore, we think it is a proportionate risk for consumers to also be exposed to a DNO's losses from the provision of CLASS.

In DRS8 there is no restriction on the price at which the DNO can offer its balancing services. The freedom to price, constrained only by competition in the tender process, and the possibility of retaining a share of the profits are sufficient incentives to encourage competitive behaviour from DNOs.

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

Following on from Q3, we do not think that categorising revenue from CLASS as DRS9 would be as beneficial a solution for consumers as DRS8. The absence of a sharing in factor in DRS9 removes the possibility of consumers benefitting from lower DUoS charges.

We agree with Ofgem's view that the limit[3] DRS9 places on pricing by the DNO makes it complex to identify and demonstrate compliance. We also support the view that the administrative burden associated with ensuring compliance could blunt incentives on a DNO to offer CLASS even if there is a possibility it could lower balancing costs.

Each licensee is likely to arrive at different levels of 'reasonable costs' and maintaining regulatory oversight over a range of charges is both impractical and disproportionate.

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

Yes. Ideally, a DNO should be incentivised to invest in CLASS only where it would be a cost effective balancing service. The opportunity to recover CLASS costs through a price control for investment cases of varying strengths could weaken this incentive unless the price control includes an incentive regime or output measures linked to the utilisation rate of CLASS services.

The price control is a robust and proven regulatory framework but as Ofgem notes, the ESO will be obliged to utilise the volume available from CLASS first as the service has already been funded by consumers. Under these circumstances the price control is inferior to Option 1A as it locks out non-network providers from competing for the proportion of the ESO's requirements that are met by CLASS.

[2] 'CLASS capability requires DNOs to invest in additional communications and control systems' – Paragraph 1.8.
[3] To a level that allows DNOs to recover its reasonable costs and a reasonable margin

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

No. However, we would expect the pre-qualification process for any provision of CLASS to be subject to DNO pilots and robust testing by the ESO to mitigate any risks to system reliability.

ENWL's CLASS Closedown Report[4] reached the following conclusion on the impact to the standard of system reliability and codes governing the operation of the system:

> 'A review of the National Electricity System Security and Quality of Supply Standard, SQSS, and other relevant standards and codes, was undertaken to determine if the CLASS methodology required changes in their application. Following the results from CLASS trials it was concluded that no changes were required. However, significant learning was identified through the trials and this improved understanding can inform other processes and considerations'

We believe it is important that the recommendations in that the report are reviewed and updated before the policy decision is taken for RIIO-ED2. In general, we believe that increasing and diversifying the pool of providers and range of technologies available to the ESO should improve system reliability.

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 do not have evidence that competition is currently being distorted or impeded by the participation of CLASS.

The table below summarises the conclusions Ofgem reaches in Appendix 2.

Factors evaluated	**Conclusion**
A DNO's ability to have or to gain market power	Evidence of a large number of participants, diverse providers and work to increase access indicate it would be unlikely for a DNO to gain market power and raise and sustain excessively high prices, as other providers would have the ability and incentive to enter the market if prices were high. The ESO's monopsony role as procurer of balancing services and its incentives reduce the ability for a DNO to gain market power, and more broadly promote the long-term competitiveness of balancing services.

[4] CLASS Closedown report and summary
https://www.enwl.co.uk/zero-carbon/innovation/key-projects/class/learning-and-key-documents/class-closedown-and-summary/

A DNO's ability to discriminate against its competitors in its monopoly role to artificially restrict competition	There are existing protections to mitigate these risks. • Condition 4 of the electricity distribution licence requires that DNOs do not abuse their special position. • Condition 19 prohibits discrimination, including in the provision of connection services and use of system. • In the Utilities Contracts Regulations 2016, DNOs are required to procure without discrimination. • Price control incentives which deter poor connection services. • A joint BEIS/Ofgem letter instructing DNOs to proactively engage with concerns around conflicts of interests and address them with appropriate mitigation measures. • Ofgem's work programme on DSO key enablers will increase transparency of network data.
Indirect impact on other markets which could outweigh consumer benefits of CLASS	DNOs currently offer a small proportion of balancing services, and thus displacement of providers is small. Ofgem does not have evidence that DNO participation will increase substantially, either in volume or in the number of products provided. The ESO has an obligation when procuring balancing services, through both its licence and incentive scheme, to take into account the impact such actions have on competition in the wholesale electricity market and on the total system.

We believe the evidence base supports the view that DNOs will not have market power in the short term. However, there is insufficient evidence and scenario analysis of the market beyond RIIO-ED2 timescales to conclude that it is unlikely DNOs have or would have market power in future.

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

The following scenarios outlined by Ofgem already cover the areas where DNOs could be perceived to have access to privileged information:

- DNOs using their role to exclude or limit a connected participant's ability to offer balancing services so that CLASS performs relatively better.
- As a buyer of flexibility services, a DNO may have privileged information about competitors' bidding strategies and also be able to discriminate in its procurement process.
- DNOs might have an actual or perceived advantage in the information they have about the ESO's requirements that it has gained from its monopoly role.

However, we think the safeguards listed in our response to Q7 offer a sufficient deterrent to a DNO's ability to discriminate against its competitors and to artificially restrict competition.

It is incumbent on DNOs and the ENA to provide more transparency of the 'DNO neutrality and conflicts of interest' controls in place and for Ofgem to expand on how it reviews the effectiveness of these controls to generate confidence in the market.

We think it is increasingly important for DNOs and the ESO to coordinate to deliver optimal whole system solutions. In addition to the safeguards mentioned above, the ESO's evolution towards real-time procurement of balancing services makes it even less likely that a DNO is able to act in advance to discriminate against competitors.

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?

According to the ENA's ONP, some DNOs are already considering ring-fencing DSO activities and conducting audits to ensure that privileged information is not used inappropriately. These measures coupled with the more holistic regimes that Ofgem appears to be encouraging DNOs to adopt for managing conflicts of interest would be effective and proportionate.

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 think it is unlikely that DNOs would have taken advantage of their role in the past given the robustness of the price control framework and the existing legal and licensing obligations. DNOs will react to incentives within the regulatory framework so we would expect DNO behaviour to be guided by legal requirements, licence obligations and appropriately designed incentives within the CLASS policy.

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?

We would expect DNOs to take compliance with licence obligations and competition law seriously and believe that these should provide adequate safeguards against abuse by DNOs of their monopoly position.

The consultation notes that, 'some DNOs have proposed to have independent audits of their decisions, and ring fencing or separation of teams' and that Ofgem feels it may be more effective for DNOs to develop holistic regimes to manage conflicts of interest rather than a range of bespoke conflict management approaches for different activities. We believe more transparency over these measures would complement safeguards in the licence and competition law.

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

As noted above, we believe that the implementation of products in WS3 of the ONP will be helpful in addressing any actual or perceived risks of DNOs taking advantage of their DNO role.

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

We believe that the downward pressure on prices from using market-based mechanisms and the sharing factor in DRS8 would ultimately lead to lower DUoS and BSUoS charges to consumers.

As Ofgem notes, the ESO has an obligation when procuring balancing services, through both its licence and incentive scheme, to take into account the impact such actions have on competition in the wholesale electricity market and on the total system. The ESO's forward plans and its ability to strike this balance should be a relevant factor in Ofgem's decision on CLASS.

ScottishPower
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