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Legal annex to Centrica's Consultation Response

Summary and introduction

1. We have been instructed by Centrica to assess whether Ofgem's consultation document, '*Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control*' (the **Consultation Paper**), provides a lawful basis for DNOs to offer CLASS services in RIIO-ED2.

2. Our conclusion is that it would not be lawful for Ofgem to proceed on basis outlined in the Consultation Paper.

3. The Consultation Paper explains Ofgem's 'minded to' position. Essentially, Ofgem's 'minded to' position is that allowing CLASS is 'the best way to ensure the most efficient overall solution' and that 'our objective for competition in balancing and ancillary services is to drive lower costs for consumers' (p 5).

4. Ofgem is right to direct its mind to consumers' interests. However, the proposal is fundamentally flawed in numerous respects:

    a. First, it is straightforwardly *ultra vires* (assuming Ofgem proposes to implement its 'minded to' decision by extending the current Direction): it is outside Ofgem's legal powers to direct that CLASS services are treated as 'value added services' under the existing distribution licences, or indeed to direct that they are treated as directly remunerated services (**DRSs**) at all.

    b. Secondly, Ofgem's proposal fails to properly understand and apply its statutory duty to carry out its functions in a manner it considers is best calculated to further protection of the interests of consumers, wherever appropriate by promoting effective competition. Ofgem has abandoned the basic principles of competition law, including an understanding of the market it is concerned with, and instead appears fixated on protecting the existence of CLASS services as an end in itself. In doing so, Ofgem has set an unlawful standard (requiring evidence that there 'will' be anti-competitive conduct, rather than merely a risk of such conduct); ignored its previous decisions; and paid no regard to the evidence that its position will undermine the effectiveness of competition. Ofgem freely admits it is

inappropriate to 'protect individual market participants',[1] and yet its own decision prioritises one particular technical solution at the expense of a level playing field.

c. Thirdly, Ofgem has failed to give appropriate weight to the risks of its proposal for consumers: meaning it has fundamentally failed to perform its core statutory duty. Ofgem has evidence that the proposal to allow widespread rollout of CLASS services could have serious negative impacts on consumers – both direct and immediate harm, and long-term consequences caused by allowing monopoly providers to adopt a position where they can take on unnecessary commercial risks and distort competition in contestable markets.

d. Finally, Ofgem's proposal fails basic principles of procedural fairness: lacking any quantification of impacts, and failing to undertake adequate inquiries so that Ofgem can properly understand the implications of what it is proposing to do, and so that stakeholders have a fair opportunity to comment on the assessment of those implications.

5. In summary, we do not consider that it is possible for Ofgem to lawfully implement its 'minded to' decision through a Direction; we consider that the proper path forward is for Ofgem to reflect the existing licence regime, which does not envisage extrinsic and risky commercial activities being allowed or their costs being recoverable.

6. Furthermore, Ofgem appears to have reached the view that CLASS services will offer reduced prices compared to existing competing balancing services providers. Ofgem has provided no reasoning to support this view. Even if it were true and supported by evidence, this would not be sufficient because Ofgem cannot lawfully limit itself to examining short-term price impacts. Ofgem needs to address all of the short-term and long-term negative consequences and risks of its decision, for other stakeholders, for functioning competition, and for innovation and investment. Therefore, even if Ofgem was able to lawfully implement its 'minded to' decision, the reasoning put forward in the Consultation Paper cannot form the lawful basis for a decision: Ofgem would be ignoring a whole series of relevant considerations.

7. If Ofgem did go beyond short-term price impacts and examine the short- and long-term risks of its decision, its reasoning would need to be supported by a proper evidence base. To do so, Ofgem would need to undertake significant inquiries and analysis, including a cost benefit analysis, to properly understand and quantify the risks and consequences. Ofgem has failed to fulfil these fundamental public law obligations, which are essential to ensure Ofgem itself understands the implications of what it is proposing to do, and so

[1] Consultation Paper para 3.10.

that stakeholders have a proper opportunity to understand and comment on those implications.

8. We conclude by noting briefly that the only other option Ofgem has put forward for allowing CLASS – that is, by including it in the price control – would have serious damaging consequences for consumers and competition and would be manifestly unlawful.

Ofgem's proposal is unlawful

9. Ofgem has not explained how it intends to implement its policy on CLASS, including most critically the powers under which it proposes to act. This is a fundamental failure, because it follows that Ofgem cannot have turned its mind to the relevant statutory framework and the considerations that it must take into account. Nor can consultees have a proper opportunity to provide intelligent comment. Consultation on the process Ofgem intends to adopt (and not merely the substance of the proposal) is critical; and the way Ofgem decides on its policy must follow the relevant statutory regime. Ofgem's current plan, by contrast, appears to assume that it can reverse-engineer its legal analysis to fit with its (currently flawed) policy thinking.

10. In the absence of any explanation from Ofgem of the legal powers it proposes to use, our assumption is that Ofgem is intending to extend the existing Direction for CLASS services, rather than make any changes to the underlying licence conditions.

11. If this is correct, then it appears likely that Ofgem's proposals are simply unlawful and cannot proceed.

12. This is simply because any direction made by Ofgem must fall within the scope of the licence conditions. This means that:

    a. any determination under special condition 5C.10 that a service should be treated as a directly remunerated service (**DRS**) can only include a service which meets the 'General Principle', being that:

        a service provided by the licensee as part of the normal activities of its Distribution Business within the Distribution Services Area is to be treated as a Directly Remunerated Service if and to the extent that the service so provided is not already remunerated under any of the income categories set out in paragraph 5C.5 …[2]; and

    b. any DRS that Ofgem determines to be DRS8 (Value Added Services) must '*utilise Relevant Assets … under commercial arrangements between the licensee and another person*'.

[2] Special licence condition 5C.4.

13. The first requirement is not met because the provision of CLASS services is not a 'normal activity' of the 'Distribution Business'. 'Distribution Business' is defined to include the business activities of distribution, the provision of metering services and equipment, and the provision of data services, including 'any business that is ancillary to the business in question'. There is no proper basis to understand the provision of balancing services as 'ancillary' to distribution activities. Distribution and balancing are independent activities – the balancing business would not 'support' or 'assist' the distribution business, and is not necessary for that business, as is evident from the fact that DNOs (other than ENWL) do not provide CLASS services today.

14. The second requirement (to categorise the service as DRS8) is not met because, although 'Relevant Assets' are involved, they are not sufficient: in fact the services rely on additional assets and equipment which must be added to the system and are unnecessary for the distribution of electricity (i.e. they are not 'part of the licensee's Distribution System', as required to meet the definition of a Relevant Asset).

15. The very name for DRS8 services – i.e. Value Added Services – reflects the intention in the licence that such services reflect 'incidental' commercial opportunities without requiring investment in additional assets. A rationale can be put forward for the inclusion in DRS8 of activities that rely solely on existing assets and do not require any significant incremental investment – because these 'quick wins' carry little risk. Clear examples of are listed in the licence condition itself, namely:

    a. allowing existing assets to be used for advertising; and

    b. allowing the installation of communications equipment.

16. However, there is no proper and lawful basis for trying to 'shoe-horn' services like CLASS – which, as explained further below:

    a. require investment in new assets that would not otherwise be needed;

    b. distract and potentially detract from DNOs' core business; and

    c. introduce additional investment risk.

17. This was never the purpose of DRS8. CLASS services are fundamentally different to the existing Value Added Services, which require no further assets and generate no additional investment risk. Ofgem's power to issue directions does not extend to directing that business activities requiring significant new investment and with associated business risks are treated as 'Value Added Services'.

18. It is essential that Ofgem uses its power to issue directions in a way which is lawful and where its reasons are transparent. The fact that other industry stakeholders did not challenge the direction made during RIIO-ED1, despite it being unlawful at the time, does not provide Ofgem with any lawful basis to repeat its legal error by extending the

Direction, in particular by continuing to treat CLASS services as if they could meet the criteria for inclusion in DRS8. Our further arguments below are entirely without prejudice to our position that Ofgem's proposal is simply *ultra vires*.

Ofgem's proposal fails to properly understand and apply its statutory duty to promote effective competition

Consumers' interests are served by effective competition on a level playing field

19. Ofgem's primary duty is to protect consumers, in a manner '*best calculated to further the principal objective, wherever appropriate by promoting effective competition*'.[3]

20. Ofgem has already set out its position that it is appropriate to promote effective competition in this context, having stated that:

> *we want to see effective competition between flexibility providers, enabling all relevant providers to engage in markets, in order to put downward pressure on prices, promote innovative business models and widen choice*.[4]

21. 'Effective competition' means competition on the merits, on a level playing field, such that no provider can act without effective constraint from its competitors and there are no market distortions. A fundamental and classic market distortion arises where a supplier in a *non-contestable* market is able to leverage its monopoly position to distort competition in a *contestable* market.

22. Ofgem has long recognised that this concern applies to DNOs when undertaking activities in contestable markets. In undertaking its role as a distribution system operator, Ofgem has repeatedly confirmed that DNOs:

> *need to be entirely impartial in the way they undertake their functions. This means making sure that they do not have any conflicts of interest, including when making decisions about where and when to invest in the network, or how to operate their networks at any given moment.*[5]

23. Ofgem has similarly stated that: '*network operators should act as neutral market facilitators in the provision of flexibility and that the competitive provision of flexibility can best support innovation*'[6] and that a primary of aim of its relevant policy is '*to ensure that*

[3] Electricity Act 1989 s 3A(1B).
[4] Ofgem, DSO Position Paper; Consultation Paper para 3.4.
[5] Ofgem, *Enabling the competitive deployment of storage in a flexible energy system: changes to the electricity distribution licence* (29 September 2017) para 1.4.
[6] Open letter from Ofgem (20 December 2018) https://www.ofgem.gov.uk/ofgem-publications/145656 p 6.

conflicts of interest … are avoided'.[7] Ofgem's previous position has been that where there are conflicts of interest, DNOs should not be able to participate in the relevant market; but if there is an inability for any third party to provide a suitable service in the free market, 'licensees may seek an exception'.[8]

24. We can simply cite Ofgem itself which, in reviewing whether DNOs should be permitted to undertake energy storage, correctly understood how its statutory duty applies:

> *1.7. Where competitive activities are carried out by monopoly network operators, there is potential for competition to be distorted, for new market entrants to be deterred, and for network operators' incentives to invest efficiently in their networks to be affected.*
>
> *1.8. Because network companies control the infrastructure needed to trade energy and flexibility services, they have the ability to restrict the activities of market participants by denying (or otherwise impeding) their network access. If a network company is also participating in the competitive market, it may have a strong incentive to use this ability to gain an unfair advantage over its rivals. The network companies' incentives to invest efficiently in the network can also be affected, if decisions are driven by shorter-term market signals, rather than longer-term investment signals. Finally, there can also be circumstances where the network company has information not available to the wider market, which might give it an undue advantage in competitive activities. It is important that these risks are managed.*
>
> *1.9. New technologies and business models are creating new opportunities for competition. We must ensure that the expansion of DSO roles does not cross the boundary into activities which can efficiently and practicably be left to a competitive market.*

25. Ofgem's position in that case was well-justified and reflects the situation of European energy regulators generally. The Council of European Energy Regulators (**CEER**) has said that:

> *DSOs are now becoming more important in the electricity sector because many new services and developments are happening at local distribution level. … European Energy Regulators advocate that DSOs must act as neutral market facilitators performing regulated core activities and not activities that can efficiently and practicably be left to a competitive market*.[9]

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[7] Open letter from Ofgem (28 September 2018) https://www.ofgem.gov.uk/system/files/docs/2018/09/storage_unbundling_stat_con_cover_letter_2.pdf p 2.
[8] Ibid p 6.
[9] ACER/CEER, *European Energy Regulators' White Paper #2: The Role of the DSO Relevant to European Commission's Clean Energy Proposals* (15 May 2017) section 3.

26. Ofgem's position in the case of storage also fully reflects the provisions of the EU Electricity Directive, requiring that balancing services are 'provided in a fair and non-discriminatory manner *and … based on objective criteria*' (2009 Directive art 37(6)(b)). The Directive clearly sets out that these are required 'In order to ensure effective market access for all market players' (2009 Directive recital 35).

27. It is also noteworthy that the Directive specifically requires that member states ensure no distortion of competition; and that DNOs are required to comply with strict ring-fencing requirements to avoid distortion of competition. Ofgem has agreed with the view that these ring-fencing requirements '*need to be seen as a minimum standard for unbundling rules across Europe*'.[10]

Ofgem must assess whether CLASS activities are part of a competitive market

28. This context is critical in construing Ofgem's duty under the Electricity Act 1989 (EA89) to protect consumers, in a manner '*best calculated to further the principal objective, wherever appropriate by promoting effective competition*'. It is therefore essential that Ofgem, as a first step, identifies the relevant market and examines the nature of competition in the market – and, in particular, assesses whether CLASS activities are part of a competitive market.

29. Although Ofgem does accept in one part of the Consultation Paper that '*provision of balancing services is contestable*', most parts of the Consultation Paper in fact reveal that Ofgem has entirely misunderstood its fundamental legal duty by failing to conduct a market definition exercise.

30. Instead, Ofgem takes as its starting point – and openly bases its 'minded to' decision on the conclusion – that CLASS services can only be provided by DNOs:

> *our starting position is that DNOs should not undertake activities that can be done by third parties; individual circumstances may lead us to conclude that it is in the consumer's interest to take an alternative stance. In this case, CLASS services can only be provided by DNOs.*[11]
>
> …
>
> *Considerations of conflicts have formed part of our reasoning in preventing DNOs from engaging in storage or commercial aggregation. Unlike those, as a network solution CLASS can only be delivered by DNOs.*[12]

[10] Open letter from Ofgem (20 December 2018) https://www.ofgem.gov.uk/ofgem-publications/145656 p 4.
[11] Consultation Paper p 6.
[12] Consultation Paper para 3.12.

31. It may or may not be *technologically* correct that CLASS services can only be delivered by DNOs; Ofgem has not considered the question at any level of depth, including any possibility for third party access to DNO assets for this purpose. In any event, even if that were true, it does not assist in the legal analysis Ofgem is required to undertake, because Ofgem makes no findings about the definition of the market. It provides no lawful basis for any decision about the interests of consumers. A decision premised on the basis that 'CLASS can only be delivered by DNOs' would be unlawful.

32. This fixation on 'protecting' a single technological solution is odd, because the Consultation Paper itself recognises that CLASS services compete with other balancing services, which are procured by the ESO. Although the services procured by the ESO fall into various categories (and so not all balancing services are fully interchangeable), it appears that CLASS services currently compete in the ESO procurement process as both firm frequency response (FFR) and fast reserve (FR) services. While Ofgem would need to undertake a full market definition exercise, there is therefore prima facie evidence that CLASS services would compete in a market with dozens of market players.

33. Accordingly, unless there is some compelling reason why to do so would be inappropriate, Ofgem's primary duty of protecting consumers *must be* met by promoting competition in that market. Its duty is not to ensure that every service which is technologically possible is allowed to be provided, regardless of the impact on competition. In allowing its 'minded to' decision to be driven by a misapprehension that CLASS services somehow need to be provided, and without properly defining the market or impact on market dynamics, Ofgem has erred in law.

The danger to competition is significant

34. If Ofgem conducts a proper market definition exercise – as, legally, it must – and concludes that CLASS are in the same market as other balancing services, then it must move on to assess the impact of CLASS services on competition in that market. We are instructed that CLASS services can *only* compete with other balancing services by using DNO assets; and that DNOs do not currently provide access to their assets for third parties to provide CLASS services. This is, therefore, an archetypal example of the type of situation which Ofgem had previously committed to avoid – i.e. one where:

    a. There is already an effectively competitive market – indeed Ofgem openly says that there is no evidence of competition being ineffective;[13] and

    b. DNOs providing CLASS services would have the ability and incentives to distort competition in that market.

35. Ofgem dismisses these concerns out of hand, noting in the Consultation Paper that:

[13] Consultation Paper para 3.19.

a. '*We have no evidence that ENWL is leveraging (or has leveraged) its monopoly position as network operator to improve its relative commercial performance'* and '*Our analysis and engagement has not provided any evidence to suggest that distortions will occur if other DNOs are to invest in CLASS*';[14] and

b. *'We have existing protections in place to mitigate these risks*'.[15]

36. We deal with each of these in turn.

Evidence of distortions

37. The reference to previous and future evidence of distortions is extraordinary. It is legally incorrect and abandons principles of competition law and economic regulation; it is inconsistent with Ofgem's previous decisions; and it ignores important and relevant evidence.

38. First, Ofgem's approach is legally incorrect and fundamentally out of step with accepted competition law principles and principles of economic regulation in the UK. This is because effective competition is not only threatened where there is evidence of past anti-competitive conduct, or evidence that there 'will' be anti-competitive conduct in future. It is well established that even the risk of anti-competitive conduct – e.g. where market structures give rise to incentives and ability for discrimination – is sufficient to raise investment risk and deter new market entry and expansion. All UK economic regulators have adopted this principle in practice. To provide just one example, in Ofcom's recent Strategic Review of Digital Communications, Ofcom insisted on stronger separation of BT and Openreach because '*the current model … has failed sufficiently to remove the incentive and ability to discriminate against competing providers*'[16] and noted that '*Openreach should behave like, and be seen to behave like, an independent company*'.[17]

39. The principle that *risks* to competition are enough to deter investors is the very reason for *ex ante* regulation and in particular the separation and independence requirements that feature across the UK regulated sectors. In case evidence was needed: the Electricity Directive (and the associated elements of EU law) go to enormous lengths to isolate monopoly DNO activities from many other elements for the value chain. They do so because of the *inherent* risks of allowing a monopoly to leverage its assets in contestable markets – without requiring any evidence of past or future actual anti-competitive

[14] Consultation Paper para 3.9.
[15] Consultation Paper para 3.14.
[16] Ofcom, *Making communications work for everyone: Initial conclusions from the Strategic Review of Digital Communications* (25 February 2016) para 1.39.
[17] Ibid para 1.43.

conduct. This is a clear indicator of the risks of DNOs distorting competition and one which is entirely ignored by Ofgem.[18]

40. Ofgem has therefore applied the wrong legal test and adopted an approach fundamentally contrary to accepted competition law principles and principles of good economic regulation, in purporting to require evidence of past misconduct or that future misconduct 'will' occur.

41. Secondly, a requirement to prove past anti-competitive conduct or future market distortions is inconsistent with Ofgem's previous decisions, which (as noted above) have repeatedly referred to the need to avoid '*conflicts of interest*' – i.e. any situation where a DNO has an *incentive* to distort competition. Ofgem has previously adopted the correct position when it amended the DNO licence conditions in 2018 to prohibit DNOs from operating storage facilities.[19] Nearly the entire industry agreed with Ofgem's proposals. Ofgem correctly identified that '*the operation of storage assets by network licensees could present risks to the competitive deployment of storage*'.[20] The concerns raised by Ofgem can helpfully be repeated at length:

> *We believe that there is a risk that markets for flexibility at distribution level could be stifled if monopoly entities are able to participate as they have competitive advantages as compared to third-party storage providers. For example, because network companies control the network infrastructure needed to trade energy and flexibility services, they have the ability to restrict the activities of market participants by denying (or otherwise impeding) their network access. If a network company is also participating in the competitive market, it may have a strong incentive to use this ability to gain an unfair advantage over its rivals. The network companies' incentives to invest efficiently in the network can also be affected, if decisions are driven by shorter-term market signals, rather than longer-term investment signals. Finally, there can also be circumstances where the network company has information not available to the wider market, which might give it an undue advantage in competitive activities.*

42. So, Ofgem has previously correctly identified that ability or incentive to distort the market or gain an unfair advantage are sufficient. Ofgem has also adopted this same approach in other contexts – for example, Ofgem required WPD to shut down part of its Project Entire solution, which allowed for commercially aggregating connected customer demand:

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[18] See also *Royal Mail plc v Office of Communications* ([2019] CAT 27): prices announced but not implemented constitute an abuse; a risk that prices *might* be introduced is enough to be an abuse; what is required of competition authorities is simply to '[take] account of all the relevant economic and legal circumstances' whether or not abusive pricing is actually implemented or not.
[19] Open letter from Ofgem (20 December 2018) https://www.ofgem.gov.uk/ofgem-publications/145656.
[20] Ibid p 2.

'*Ofgem highlighted that they did not see models in which the DNO operates as a commercial operator in the long term interests of customers. As such these elements of the project were removed …*'.[21] There is no evidence that Ofgem reached this decision only after determining that misconduct had occurred, or that distortion would occur, in future.

43. Thirdly, requiring previous or future evidence of distortions ignores important and relevant evidence CLASS services can be unfairly advantaged over other balancing services, by virtue of their connection to DNO assets. CLASS services rely on tight integration between CLASS assets and DNO assets. There are many ways in which this could offer opportunities for DNOs to give CLASS services an unfair advantage over third party balancing solutions, including:

    a. Not needing to pay imbalance costs;

    b. Not needing to wait to connect to the distribution network;

    c. Not needing to incur connection charges or other network charges;

    d. Not needing to be allocated any of the costs of the underlying DNO assets, even though these are essential inputs and competing services would need to price in a way that recovers all of the costs of their inputs; and

    e. Not having to account for wear and tear to the underlying DNO assets caused by the CLASS services, even though other balancing services would be normally required to pay for any wear and tear they caused to third party equipment (this issue has been clearly identified: '*there is an issue around contact wear in the tap changer which could be of concern if there were significant increases in load current. A doubling of current will increase the erosion of the contact by a factor of 4 and would therefore impact on maintenance schedules*'[22]).

44. All of these are likely to give CLASS services unfair cost and time advantages over other balancing services, which arise solely due to DNOs' ability to leverage their existing monopoly assets – unfairly undermining the business case, and the expectations of a 'level playing field', on which existing service providers have invested. This is likely to have a 'chilling effect' on the market and on the willingness of investors to enter the market, to expand their existing investments, and ultimately to innovate in ways that serve consumers far better in the long term.

[21] Western Power Distribution, *Project Entire: Closedown Report* (10 June 2019) p 27.
[22] ZD Wang and J Spence, *WP3, Final Report* (28 September 2015) p 1.

Protections to mitigate risk

45. Secondly, Ofgem claims that there are sufficient protections to mitigate against risk, citing:

    a. low barriers to entry and likely innovation;

    b. the fact that the ESO has to take the development of the market into account in its procurement;[23] and

    c. that there are regulatory obligations requiring the DNOs not to discriminate.

46. None of this provides any proper or lawful basis for negating the permanent, structural advantage that a DNO would have in balancing markets. These reasons fail to comply with even the most basic principles of competition law. For example, low barriers and innovation are only relevant to the extent that they operate as an *effective competitive constraint*. Ofgem has not addressed this issue at all; nor has it made any quantification of the chilling effect that this regulatory decision (particularly since it is at odds with investors' expectations and Ofgem's well-established regulatory principles) will have on future innovation. The potential addition of new players or new solutions is irrelevant unless Ofgem can show that the required innovation will not be deterred by its decision, and that any new entry or innovation could be sufficient to overcome the permanent structural advantages that a DNO would have in the market, and drive prices for CLASS services to the level that could be expected in a competitive market.

47. It is equally insufficient that DNOs are required not to discriminate or cross-subsidise their activities or that the ESO has 'soft' obligations to take market development into account in its procurement decisions. Regulators in other sectors have repeatedly struggled with the problems inherent with regulated providers also providing non-regulated activities, despite having generalised non-discrimination obligations – for example, BT and Openreach were subject to broad non-discrimination obligations for more than ten years under functional separation, and yet Ofcom still acknowledged at the end of that period that the situation was untenable and unsatisfactory for competitors. It is well acknowledged that such obligations leave significant opportunity for 'regulatory gaming', including for example through self-serving cost allocation methodologies and through investment choices that are informed by the desire to earn commercial returns in the contestable market. Even the most sophisticated economic regulators, such as Ofcom, have taken many years to identify even 'plainly inappropriate' cost allocation methodologies – for example, Openreach and BT adopted such methodologies for many

[23] Consultation Paper, para 3.9.

years before Ofcom was able to identify the problems.[24] There is a notable failure to address issues of appropriate cost allocation in the Consultation Paper.

48. It is widely accepted that generalised non-discrimination obligations are not sufficient to prevent market distortion, in contexts where a market player has a systemic advantage. Indeed, this is precisely why the EU regime, and the UK legislative framework, require DNO activities to be ring-fenced. It is also precisely why ring-fencing obligations have been imposed in many other regulated sectors.

49. Furthermore, this is an extraordinary departure from Ofgem's existing policy that conflicts of interest must be avoided, rather than mitigated. Ofgem has not provided any explanation for why it has suddenly changed course, and now considers conflicts of interest to be acceptable if they are 'mitigated'.

50. For all these reasons, Ofgem has erred in law – failing to ask itself the right questions, define the market, or reflect a reasonably consistent approach to decision making.

Ofgem has failed to give appropriate weight to the risks of its proposal for consumers

51. Furthermore, Ofgem has evidence that the proposal to allow widespread rollout of CLASS services could have serious negative impacts on consumers. Yet such evidence is not taken into account.

Direct and immediate impacts have not been quantified or taken into account

52. Ofgem will be aware of evidence that harm will be caused to consumers. There is no indication that Ofgem has taken any of this into account. For example, Ofgem will be aware that there are concerns on the impact of CLASS on end user equipment and on DNOs' own equipment. The ENWL trial does not appear to have provided any quantification of the risks on larger-scale rollout. This section provides some examples of the type of harm that may be caused.

53. First, widespread rollout of CLASS services could have serious consequences for commercial and industrial customers that are likely to have more sensitive equipment or more specific requirements than consumers. However, the project report commissioned by ENWL only appears to have measured quality of service customer impacts relevant to consumers.[25] In fact, the Baringa report acknowledges:

[24] See, eg, Ofcom, *Review of BT's cost attribution methodologies* (12 June 2015).
[25] E.g. by informing customers that '*a kettle that takes three minutes to boil, a +/-2 % change in voltage would increase or decrease the boiling time by +/-8 seconds respectively. It is understood that this was not considered to be a significant issue with customers during the trial*.' See Baringa, *Assessing the impact of CLASS on the GB Electricity Market* (31 May 2016) pp 58-59.

> *It may be that as CLASS is deployed more widely that there are specific customer types that are more affected, but the potential scale of this effect, if it exists, cannot be estimated*.[26]

54. This reflects past experience, when previous DNO experiments in altering voltage levels had significant impacts on industrial sites which had sensitive equipment. This drove many industrial sites to make additional investments of their own to install voltage protection equipment. Ofgem should be fully aware of these potential consequences – and that, at the very least, they are 'known unknowns'. However, rather than make reasonable inquiries about these concerns, Ofgem has simply ignored them: none of these costs have been quantified or considered.

55. Secondly, Ofgem is also aware of evidence that CLASS services do not merely 'use' distribution network assets, but also contribute to 'wear and tear' of those assets. This is likely to lead to a potentially significant increase in maintenance costs caused by CLASS services. It is not evident that any work has been done by Ofgem to quantify this impact. Nor has Ofgem considered at all how these additional maintenance costs would be allocated – indeed, extraordinarily, Ofgem implies that CLASS services would not have to account for any of the costs of assets they rely on.

56. Ofgem must be aware of these issues, and yet the Consultation Paper does not reveal that they have been considered in any detail or that any estimates have been made of the impacts and effects on specific customer groups. Ofgem is required to '*take reasonable steps to acquaint [it]self of the information relevant to [its] decision*': *Secretary of State for Education and Science v Tameside Metropolitan Borough Council* [1977] AC 1014, 1065B. It has failed to do so. Ofgem therefore has no proper basis for reaching any decision about whether continuing to allow these services, and at scale, would be consistent with its statutory duty. Indeed, were it to continue without addressing this situation, it would almost certainly be doing so having failed in its duties to undertake reasonable inquiries.

Indirect impacts have also been ignored

57. Further, Ofgem's 'minded to' decision fails to pay any regard to the long-term costs of allowing DNOs to become involved in commercially risky investments.

58. DNOs role is to invest in the distribution network – being required to act as 'neutral market facilitators' but conversely having the right to a reasonable opportunity to recover their costs. It is well understood that this model of economic regulation requires that the regulated company not take extraneous and unnecessary 'bets', premised on assumptions about how they would perform in a contestable marketplace. Doing so increases the level of risk in the DNO's business.

[26] Baringa, *Assessing the impact of CLASS on the GB Electricity Market* (31 May 2016) p 58.

59. Ofgem's restriction on non-distribution activities reflects these objectives. Specifically, it is described by Ofgem as intended to:

    a. '*Guard … against a licensee assuming material risks that are unrelated to its regulated activities and which may jeopardise its financial position in the event of an adverse outcome*';[27] and

    b. '*prevent any diversion of management, financial or other resources to extraneous activities which may also involve unacceptable levels of commercial risk*'.[28]

60. These objectives are highly relevant to DNOs' involvement in CLASS services. ENWL's own commissioned report concludes that, for DNOs seeking to roll out CLASS, there is a serious commercial risk:

    > *The key risk to consider is around ensuring payback of investment costs, especially in the context of the following market risks:*
    >
    > *- The potential for CLASS being classified as a static provider (reduces the range of pricing options available to CLASS while retaining a competitive edge)*
    >
    > *- New market entry from other providers of CLASS (which could lower market prices)*
    >
    > *- New market entry from other low cost providers (DSR, and potentially some storage business models) (which again could lower market prices)*
    >
    > *…*"[29]

61. This highlights the fact that CLASS services will be competing in a contestable market, and there is no guarantee of success in that market. Therefore, there can be no certainty about the level of demand for CLASS services, making them precisely the type of uncertain investment which was specifically intended to be prohibited.

62. This means that *even if those bets pay off*:

    a. the DNO business will be perceived as riskier and investors in DNO business will require a higher cost of capital; and

    b. DNOs assets and spare capacity will be devoted to maximising commercial opportunities rather than their intended purpose (e.g. being used to connect more customers).

63. If those bets *don't pay off*, there will be obvious detriment to consumers, they will end up paying more to cover the loss (or the DNO will not be able to maintain the level of investment in the distribution business it otherwise would have) – directly (via loss-

[27] Consultation Paper p 8.
[28] Consultation Paper para 1.16.
[29] Baringa, *Assessing the impact of CLASS on the GB Electricity Market* (31 May 2016) p 63.

sharing) or indirectly (via higher cost of capital). Ofgem's proposal to categorise the service as DRS8 implies that consumers effectively cover approximately 50% of any losses. There is no reason for consumers to bear this risk. Consumers do not bear the risks for any non-DNO investments in balancing services.

64. This is entirely inappropriate for a regulated entity, and highlights the level of competitive distortion. Furthermore, it creates an asymmetric situation because DNOs have a high degree of certainty that their business viability will be assured through Ofgem's price controls even if their contestable investments fail, but would still get to keep the majority of the 'upside' if those investments succeed.

65. It is unclear how Ofgem could rationally and lawfully ignore these serious consequences for consumers. In the Consultation Paper, Ofgem appears to 'write off' the prospect of losses, by assuming that investment in CLASS will self-evidently be efficient, and noting that '*DNOs' share of that risk should drive good commercial discipline*.'[30] This is nonsensical and not backed up by any evidence. These investments are, in fact, likely to be *less disciplined* given that – unlike for other providers of balancing services – DNOs will not have to face the full amount of their loss.

Lack of impact assessment and adequate inquiry

66. Finally, we note that Ofgem has not carried out an impact assessment, so that it (and its stakeholders) can properly understand the impacts of its proposal. An impact assessment is vital, not just to fulfil its statutory duties, but more fundamentally to ensure:

    a. that Ofgem is reaching a decision having undertaken all proper and reasonable enquiries to understand the consequences of what it is proposing to do. As we have outlined in earlier parts of this annex, there are clear 'known unknowns': risks of significant negative consequences if Ofgem proceeds with its 'minded to' position. Ofgem does not appear to have undertaken any analysis or quantification of the likelihood and potential severity of those consequences; and

    b. a fair procedure, with stakeholders able to properly understand how Ofgem has quantified various risks and impacts – and therefore to comment on Ofgem's assumptions, analysis and quantification. We would expect, given the recent findings of the High Court that Ofgem failed to afford procedural fairness to market participants when setting the default tariff cap,[31] that Ofgem would recognise and indeed welcome the opportunity to conduct a thorough and open consultation – so that its resulting decision will be legally robust.

[30] Consultation Paper para 3.8.
[31] *British Gas Trading Ltd v Gas and Electricity Markets Authority* [2019] EWHC 3048 (Admin) (13 November 2019).

67. Furthermore, under Section 5A of the Utilities Act 2000, Ofgem has a duty to carry out an impact assessment where Ofgem considers a proposal to be 'important'. There can be no serious question that this proposal is indeed important, in light of the potential consequences for all providers of balancing services and, indeed, for consumers. Indeed, for Ofgem to proceed as if this matter is unimportant would be plainly irrational – as Ofgem is aware, many stakeholders are strongly opposed to its proposal, and this proposal marks a serious move away from Ofgem's long-established policy position.

68. It is alarming, in this respect, that Ofgem's Consultation Paper provides virtually no quantification of risks and impacts, and nor has critical information such as the methodology for allocating costs between ENWL's distribution business and the CLASS service been properly disclosed. This is despite – as noted above – potentially quite serious direct and indirect impacts on consumers and competition. Ofgem's general approach in the Consultation Paper appears to be to 'wave away' concerns by reference to general obligations on DNOs (e.g. not to discriminate) and the ESO (e.g. to have regard to development of the balancing market), instead of taking a rigorous, evidence-based and properly informed decision.

69. In light of the serious concerns we have raised above, in our view, Ofgem cannot lawfully proceed with its 'minded to' proposal – in particular, in light of the paucity of evidence available to Ofgem and its nearly complete reliance on a limited set of qualitative information. This is extraordinary given the risks involved. Moreover, much of the information which Ofgem needs it cannot expect any other market participants to be able to provide in response to the Consultation Paper – e.g. information and data about the potential negative effects on customer equipment cannot be provided by anyone except the DNOs themselves (and in this case, likely only ENWL). Yet ENWL has no incentive to provide any such information, nor to commission research that mind undermine the case for CLASS services. It is therefore essential that Ofgem make its own inquiries.

70. In this situation of significant asymmetry of information, it is especially incumbent on Ofgem to provide a full and comprehensive analysis of risks and benefits – including making all reasonable inquiries and commissioning its own research if necessary. This is essential and the only way that other stakeholders in the industry will have a fair opportunity to understand and, if necessary, critique, the basis of the decision Ofgem proposes to take. The current Consultation Paper fails to fulfil this fundamental requirement of procedural fairness, and therefore cannot serve as a lawful basis for the decision Ofgem proposes to make.

Including CLASS services within the DNO price control

71. Finally, we note briefly that the only other option Ofgem has put forward for allowing CLASS is to require '*DNOs to provide it to the ESO outside of market mechanisms and thereby cover the costs in the DNO price control*'.[32]

72. The price control option would result in CLASS being free to the ESO; the price control would therefore define the extent to which the ESO would consume CLASS services.

73. First, we note that Ofgem has provided no explanation of how this would comply with the Electricity Directive requirements that balancing services are 'provided in a fair and non-discriminatory manner *and … based on objective criteria*' (2009 Directive art 37(6)(b)). The Directive clearly sets out that such criteria must 'ensure effective market access for all market players' (2009 Directive recital 35).

74. Ofgem rightly concludes that the price control approach would lead to significant market distortions, reduce commercial opportunities for providers of competitive balancing services, and could increase costs to consumers.[33] Such an approach would therefore result in Ofgem breaching its statutory duty to protect consumers wherever appropriate through promoting effective competition – unless Ofgem had concluded that it was not appropriate to promote effective competition.

75. Ofgem has clearly signalled to the market that competition is appropriate in balancing services:

> *we want to see effective competition between flexibility providers, enabling all relevant providers to engage in markets, in order to put downward pressure on prices, promote innovative business models and widen choice*.[34]

76. A conclusion that open and effective competition is not appropriate would be an extraordinary change in approach. Ofgem appears to accept that such a change could not be rational. Eliminating competition in favour of the price control option would result in Ofgem pre-determining the efficient level of market share for CLASS services, removing any ability for the ESO to make its own decisions about efficient procurement. Ofgem accepts as much:

> *We … do not think that requiring DNOs to provide CLASS services to the ESO and covering the costs of CLASS in the distribution price control would be efficient. Provision of balancing services is contestable, so covering the costs of CLASS in the price control*

[32] Consultation Paper p 5.
[33] Consultation Paper para 3.18.
[34] Ofgem, DSO Position Paper; Consultation Paper para 3.4.

would not lower costs for consumers if it isn't cheaper than what could be offered by other providers.[35]

77. Ofgem has not provided in the Consultation Paper any analysis of the actual costs associated with CLASS services to reach any conclusion about efficiency or how they compare to competitors' costs in all plausible scenarios. Such an analysis would be essential for Ofgem to proceed with this option and to conclude that closing off part of the market to competition would be in the interests of consumers.

78. But even if it had conducted such an analysis, in proceeding with the price control option Ofgem would also have to conclude that there is insufficient prospect for development and technological innovation in the market for balancing services, such that Ofgem can disregard the damage that would be done to long-term investment and innovation, including the prospect of new services emerging with lower cost bases than any existing services.

79. This damage to innovation and investment would be significant: market players have already made investments on the basis of an understanding of the regulatory treatment of balancing services. Faith in that regulatory regime will be fundamentally undermined by any Ofgem decision to foreclose parts of the market to non-DNO investors. This can only be expected to have a chilling effect on future investment and innovation. It would also ignore the long-standing recognition by Ofgem that future innovation offers significant benefits to consumers,[36] and the legal need for Ofgem to take into account principles of proportionality and consistency.[37]

80. Accordingly, we agree with Ofgem that including CLASS services within the DNO price control is inappropriate. Indeed, it is likely to be inconsistent with the Electricity Directive and there would likely be serious damaging consequences for consumers and competition in the long run, through undermining regulatory certainty and discouraging long-term investment. Given this, we do not consider that precluding or limiting effective competition could be rational or consistent with Ofgem's duties under EA89.

Towerhouse LLP
30 March 2020

[35] Consultation Paper p 5.
[36] Ofgem, *Future Insight Series: Flexibility platforms in electricity markets*.
[37] EA89 s 3A(5A).