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Contact / Extension:
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Dear Edwin,

Ofgem Consultation: Regulatory treatment of CLASS as a balancing service in the RIIO-ED2 network price control (10 February 2020)

SP Energy Networks owns and operates the electricity distribution networks in central and south Scotland (SP Distribution), and Merseyside and North Wales (SP Manweb). We serve 3.5million distribution customers. We also own and maintain the electricity transmission network in central and south Scotland (SP Transmission). We are the only DNO group to operate across all three GB political administrations.

Given the magnitude of the changes that will be needed to deliver Net Zero, we agree that network companies providing services to other network companies is an important part of a safe, efficient, reliable and decarbonised whole energy system. We therefore welcome Ofgem's consultation on how CLASS should be treated in RIIO-ED2.

Our analysis

We believe that Ofgem's analysis of the options was comprehensive and considered. We agree with the analysis and the conclusion that model 1a provides the widest benefit.

The below summarises the key points which we consider are critical to the decision. We've also included three additional points which the consultation paper did not cover (the potential reduction in transmission network use of system (TNUoS) charges, the potential reduction in network charge volatility, and the specific benefit to vulnerable and fuel poor customers).

- **Distribution customers** would get the greatest benefit from reduced distribution use of system (DUoS) charges under model 1a. There may also be reduced DUoS charges under models 1b and 2, but not to the same extent. There would be no DUoS charge benefit under model 3. We think that it is good for distribution customers to benefit from assets they have already funded (and from knowledge share from customer funded innovation projects). We also support model 1a as vulnerable and fuel poor customers, who are typically less likely or less able to actively participate in the energy system, still get to benefit from the DSO transition.

- **All electricity system customers** would benefit from reduced BSUoS charges (and reduced BSUoS volatility¹) under model 2. There would likely also be reduced BSUoS charges and volatility under models 1a and 1b, but not to the same extent. There would be no such benefit under model 3. In addition, where the CLASS services enable the ESO to rely on lower cost services instead of transmission network investment, then customers would also receive reduced TNUoS charges.² The lack of any BSUoS or TNUoS charge benefit means we do not support model 3.
- **System security.** The transition to Net Zero is giving rise to the need for more system flexibility, and greater consideration of whole system solutions. CLASS services fulfil both these requirements. As with any solution, it is important to understand its cost and value compared to other potential solutions, so that the most efficient solution can be identified. Competitive participation in a market (models 1a and 1b) provides this transparency of value. Given the range of technical challenges that the transition to Net Zero presents, it does not feel sensible to prevent the use of any tool which can be deployed to increase system security – we therefore do not support model 3.

In summary, we support model 1a as we consider that it provides the greatest benefit to customers (from whom all costs are ultimately recovered). It is also beneficial from a whole system and system security perspective.

For model 1a to be successfully implemented, it is important that there continues to be a clear and transparent way to differentiate between 'CLASS assets' (which the DNO would pay for) and business as usual assets (which are price controlled and funded by customers). We support the continuation of using the definition that CLASS enabling costs are "costs that are solely attributable to providing CLASS". We support this principle-based approach as it is simple, clear and transparent. With time, we expect that the amount of equipment captured as "CLASS enabling costs" will reduce, as equipment which is currently only needed for CLASS becomes necessary for business as usual network management as networks become smarter and more flexible.

Conflict of interest management

We appreciate that there may be a perceived conflict of interest with models 1a and 1b. It is important to address these perceived conflicts of interest, to ensure that third party service providers have confidence in the market and continue to participate. We have therefore set out a number of proposed mitigating measures in response to questions 7-12. Chief amongst these is that, by the start of ED2, a comprehensive and holistic regime to manage conflicts of interest will be in place. This conflict management regime is a key enabler for a number of DSO activities, and for enabling the network-to-network services that will be required to provide customers with a safe, efficient, reliable and decarbonised energy system. These proposed measures should be considered in addition to the mitigating factors set out in your consultation document.

¹ Having a market with more providers (i.e. increased liquidity) not only has the potential to reduce prices, but also to reduce price volatility. Reduced price volatility is beneficial as less volatile, more predictable system charges makes for a more stable investment case for non-network parties wishing to invest in the system (e.g. building new generators or storage). This benefit applies to models 1a, 1b and 2. We have not done any assessment to quantify the magnitude of this benefit.

² Whilst these charges are directly applied only to transmission entry capacity (TEC) holders and suppliers, they are often ultimately recovered via consumer electricity bills, meaning that distribution customers could also benefit from a reduction in TNUoS charges.

Next steps

Given the magnitude of the challenges that will arise in delivering Net Zero, we welcome the recognition of the role of network-to-network services in ensuring a safe, efficient, reliable and decarbonised energy system for customers. We support your intent to publish a decision on CLASS in RIIO-ED2 by this summer. A decision is needed within this timeframe to ensure that it can be accommodated within DNOs' RIIO-ED2 submissions.

We are currently undertaking work to develop a CLASS service across a number of substations across our SPD and SPM licence areas. The aim (excepting potential disruption from Covid-19) is to have a pilot substation operational by the end of this year, and for the service to be business as usual from a number of sites from next year. Given the impact on this investment that model 3 would have, whilst we will continue with the pilot site, we will pause any significant investment developing CLASS more widely dependant on your decision on CLASS in RIIO-ED2.

Please do not hesitate to contact me if you have any questions about any part of our response. We look forward to continuing to engage with you and delivering the DSO transformation.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'G Campbell', written in a cursive style.

Graham Campbell
Head of Distribution System Operation and Whole Systems
SP Energy Networks

1. Are there any other options we should have considered?

We think that the consultation document considers all the main options; we do not think that there are any other options that should be considered.

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

Yes, we agree that a market-based mechanism encourages the efficient use of CLASS. This is because the ESO has a range of solutions and balancing service providers to choose between; the ESO must identify which solution/provider is the most efficient. To do this they need to understand their relative costs and values. Competitive participation in a market (models 1a and 1b) provides this transparency of value between solutions, and so enables the most efficient solution to be identified.

3. 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 consider that it is appropriate for customers to share any profits that DNOs make from CLASS services. This is for two reasons:

1. The CLASS services rely on using some distribution network assets that have been funded by customers.
2. The CLASS service makes use of knowledge that was developed by a customer funded innovation project.

For these two reasons, we think it is right that customers should get to share in the profits.

Under model 1a, there is no incentive for DNOs to invest in CLASS where this is a material risk of losses; the incentive is on the DNO to make sensible investment decisions and to make a profit. This, combined with the alignment of DNOs interests with their customers' interests, protects customers and means the risk of customers incurring losses is low. CLASS participation to-date supports this view.

We do not feel that the profit share would materially affect a DNO's competitive behaviour in the provision of balancing services. This is because DNOs will still aim to be competitive as they still need to recover their costs of CLASS enabling works (like a third party commercial provider needs to recover its costs), and there is no cap on their potential profits (like a third party commercial provider).

Model 1a contains the risk that the sharing factor will change every price control, and is not known more than a year in advance of the start of the price control. This creates significant investment uncertainty. This investment uncertainty risks creating a barrier to the creation of valuable CLASS services, which would be to the detriment of the system and all customers. This effect is more acute as we move from an eight year price control to a five year price control. To address this risk, we consider that revenue from CLASS capability developed in

ED1 should be subject to the ED1 sharing factor on an enduring basis. This would provide much needed investment certainty.

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

We agree with Ofgem that the balancing service market is sufficiently competitive and liquid such that a revenue cap would add increased complexity and cost to the provision of CLASS services for no material benefit. A cap would create the risk of the DNO not being able to act in a truly competitive manner in the balancing services market, which would reduce the benefits of competition.

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

This depends on the CLASS price control mechanism. A price control regime that only funded the DNO to **enable** a certain volume of CLASS services, rather than being funded or rewarded based on whether that CLASS service is used by the ESO, has the potential to result in inefficient outcomes for customers. However, if the price control included an incentive regime or output measures which were linked to the utilisation rate of CLASS services, then there would be a clear incentive on DNOs to only develop CLASS where it was useful (and valuable) to the ESO.

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

From a transmission system reliability perspective: having more balancing services available will increase transmission system reliability, because the ESO will have more tools at its disposal. Therefore CLASS promotes transmission system security.

From a distribution system reliability perspective: we assume that CML/CI and related RIIO-ED1 incentives will be carried forward in some form to ED2. The reliability incentive is likely to be a much stronger financial incentive than the CLASS incentive. Given this, the DNO will not offer CLASS if it risks the reliability of the distribution system.

7. 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 have no evidence that competition is being distorted by CLASS services.

In addition to the analysis presented in the consultation document, we do not consider it likely that DNOs will have market power in the future for two further reasons:

1. Project TERRE and efforts by the ESO are encouraging more non-network parties to participate in the balancing services market.³
2. Most balancing services are non-locational. This means that DNOs are in competition with each other. So even if multiple DNOs developed CLASS services, they would be in competition with each other and so erode each other's market share.

8. 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?

We are not aware of any privileged information that DNOs receive that would provide us with an advantage. We would note two relevant points:

- ESO balancing markets are moving closer to real-time and with shorter contracts. Assuming that the ESO continues its practice of making bid pricing public, this means that there will be a steady stream of up-to-date pricing information that is publicly available. This is likely to be far more useful to providers in analysing market trends and developing bidding strategies than the information DNOs receive (e.g. week 42 data, which relates to fault infeed and is only received once/year).
- We are firmly on the path to making data visible and accessible where this provides benefits to customers. As per the EDTF recommendations, we expect this data provision to be in place by the start of ED2. The resulting transparency will help mitigate the concern that different market bidders may have access to different levels of information.

9. 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 understand that the question refers to the perception of DNOs having privileged information about:

1. Balancing service providers seeking to connect to the distribution network; their connection could erode the DNO's CLASS market share.
2. Balancing service providers who also provide flexibility services to the DNO; the DNO could have privileged information about their bidding strategies.

Currently, we have a separate DSO function within SP Energy Networks, with an independent Head of DSO. This means that the part of the business that would be making decisions about CLASS is separate to the parts of the business which process and progress connection applications. These two parts of the business are separated on different office floors, and under normal arrangements have no sight of each other's work.

³ ENW has been successful in securing contracts for Fast Reserve. The ESO has also contracted with pumped storage, gas stations, batteries and demand response sites for this service, implying that a number of different technology types can provide balancing services in a competitive and diverse market.

Looking to the future, our work developing and procuring flexibility services has driven forward our conflict management thinking and processes. We are looking to use the Internal Audit team from the wider Scottish Power Corporate business to carry out a review of the transparency and independent decision making within our flexibility tender process by the end of this year. The findings and recommendations of this audit will be made public and used to refine our governance and decision making processes. The learnings from this are likely to be highly relevant to CLASS, and to how SP Energy Networks can develop a “holistic regime to manage conflicts of interest”, as opposed to a range of “bespoke conflict management approaches for different activities”.

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

None.

11. 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?

The standard distribution licence conditions and the Electricity Act 1989 (**1989 Act**) contain two overriding principles that are relevant here:

1. Section 16(1) of the 1989 Act and Standard Licence Condition (SLC) 12 requires DNOs to make a connection to parties who request one. Therefore if competing balancing service providers sought connection to a distribution network, and the DNO inhibited that, then that DNO risks breaching this condition.
2. SLC 4 requires DNOs to manage and operate their business in a way that is calculated to ensure that it does not restrict, prevent or distort competition in, amongst other things, the supply or generation of electricity. Therefore if competing balancing service providers were already connected to a DNO's network, and that DNO were to inhibit them by treating them differently to their other customers, that DNO risks breaching this condition.

A breach of the Distribution Licence and/or the 1989 Act is a significant matter. We would face potential enforcement action and, in a worst-case scenario, the revocation of our licence or a significant financial penalty. These penalties are orders of magnitude in excess of any minor benefit we may derive from breaching these conditions, and so are a strong safeguard against DNOs not abusing their position.

Competition Law contains two overriding principles that are relevant here:

1. Section 19 of the Competition Act 1998 prevents parties from abusing a dominant market position. DNOs arguably have a dominant position in the provision of new connections in their licence areas. Therefore, if competing balancing service providers sought connection to a distribution network, and that DNO inhibited that, then that DNO risks breaching this condition.
2. Section 2 of the Competition Act 1998 prevents parties from entering into an anti-competitive agreement. If DNOs really were to receive information from the ESO which

gave a commercial advantage, and used that to enter into a balancing services agreement with the ESO that was detrimental to market competition, then that DNO risks breaching this provision.

Ofgem have concurrent powers with the Competition and Markets Authority to enforce this competition law. Breach of competition law is a serious issue and could, for example, result in DNOs receiving a significant fine. This penalty is significantly in excess of any minor benefit we may derive from breaching these conditions, and so is a strong safeguard against DNOs not abusing their position.

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

Given that these measures are needed to provide third party providers with confidence in the market, we consider it more appropriate for these third parties to respond to these questions. In consideration of the information they provide, we would ask Ofgem to consider the mitigating factors we have set out within this response.

We are committed to developing a holistic regime to manage conflicts of interest. This is because this conflict management regime is needed for a range of DSO activities we would like to provide. This regime will be built on being transparent and making information visible, accessible and interoperable.

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

We consider that having more balancing services for the ESO to choose from, and having these compete on a level playing field with third party providers (model 1a), will increase competition and market liquidity. This is good for customers as it:

- improves competition, creating a downward pressure on prices, which customers will realise through reduced use of system charges.
- improves liquidity, reducing the volatility of charges. Reduced price volatility is beneficial as less volatile, more predictable system charges makes for a more stable investment case for non-network parties wishing to invest in the system (e.g. building new generators or storage).