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Your reference :

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Our reference: CLASSRIIO2

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23rd March 2020

Dear Edwin & Freya

Consultation in the regulatory treatment of CLASS as a balancing service in the RIIO-ED2 network price control.

Thank you for providing Innogy renewables the opportunity to comment on the above consultation. We are very concerned with the “minded to” position Ofgem has set out in the consultation. We have concerns both with the process associated with this decision, as well as the decision itself. We are very concerned that “minded to” position to allow the continuation of CLASS as a Directly Remunerate Service 8 (Value add) service will continue to distort the competitive market for balancing services and risk future investment in assets and process that can deliver increased and improved flexibility for the UK. We fully support and endorse the consultation response submitted on behalf of the Energy UK member organisations.

The approach outlined by Ofgem to allow the continuation of CLASS as a DRS 8 service in the next price control period (RIIO-ED2) seems to directly contradict with the avowed position of Ofgem and BEIS to build upon the Smart Systems Flexibility Plan, adjust the capacity market to better reflect the needs of Demand Side Response and seems entirely counterproductive at this precise moment when Ofgem and BEIS are re-engaging with industry and wider stakeholders as to how more flexibility can be procured and provided within a competitive market. The planned suite of workshops (COVID-19 notwithstanding) over the next few weeks to seek stakeholder views and comments on proposals for measures to monitor and deliver more flexibility (to help support the delivery of the wider net zero decarbonisation ambitious) will be severely undermined by this “minded to” decision.

We have long argued; most recently in our submission in October 2019 to Ofgem’s proposed DSO position paper, that there is an inherent contradiction in the role of the DNO / DSO role to provide the role of a neutral market facilitator whilst allowing that same (regulated entity) to participate in commercial market based balancing services. The risk of actual or perceived conflicts of interest between the system operator role and the regulated network owner and operator is significant and will continue to undermine the development and investment in new flexibility assets that will be required to deliver the decarbonisation targets at least cost to consumers.

We also believe that as well as providing commercial distortions in the market, allowing CLASS to be used for commercial balancing services will undermine its more valuable role of providing voltage control and a last resort to help NG ETO in the event of future catastrophic frequency events (such as those experienced in both 2012 and more recently during the de-loading experienced during the 9th August 2019 event). Enabling and funding CLASS solutions to enhance distribution networks through price control to better activate and manage voltage control in the event of any future security of supply situations should be the goal, where there are identified needs and opportunities to upgrade existing network assets which no other organisation can do, instead of enabling the funding of a future roll out of CLASS technologies to bid into commercial balancing services markets.

As well as the content of the consultation, we are very concerned with the process that has been undertaken regarding the consideration of this issue. This consultation does not at any point ask or invite comments on the minded to position that Ofgem have taken. Furthermore, no impact assessment has been undertaken and / or published in respect to this decision which is expected; (but nowhere proven), that the minded to approach of allowing CLASS to continue to be funded via DRS8 will be in consumers' best interests as the risk of losses (leading to higher Distribution Use of System charge) is assumed to be lower than the likelihood of an increase in shared revenues (which would lead to a reduction in DUOS charges). There is no calculation of the impact of allowing the use of CLASS in the current price control period, and we and industry have raised the issue of CLASS offering commercial services for several years, noting that the ENA Open Networks project included this issue on their risk register in 2018 (relating to the ED1 price control period) and this is not considered as part of the consultation at all.

We would welcome the publication of any independent technical advice which would confirm whether there are any associated operational issues with an increased roll out of CLASS (including but not limited to additional wear and tear of monopoly network assets, the impact of any customers connected to a CLASS controlled substation who are themselves contracted to provide frequency services to NG ESO) and whether an increased use of CLASS has an impact on the level of losses within those associate network areas.

Please find attached our response to the questions as set out in the consultation.

If you have any queries regarding our response, please do not hesitate to contact me.

Yours sincerely

Kate Garth
Innogy Renewables

Q1) Are there other options we should have considered? Please provide the reasons for your suggestion.

Whilst the three options for the treatment of CLASS superficially seem reasonable, the lack of any impact assessment (which would apply equally to all the options) makes the consideration of these options much more problematic and harder to assess whether other options should be considered. Furthermore – we are very concerned that nowhere in this consultation does Ofgem ask whether stakeholders agree with the minded to position set out by Ofgem. For the avoidance of all doubt, we do not.

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

It is unclear from the question what is being sought here. On a principles-based approach, we would agree that market-based mechanisms should always be the preferred option for the procurement of future services (whether these are wholesale energy, ancillary services or capacity market). However, the question is specifically about CLASS and its participation in balancing services. As balancing services required by ESO can [and are] currently provided by third party commercial organisations, we do not believe CLASS should participate in these markets, given that CLASS (as confirmed in paragraph 1.7 of the consultation) can only be provided by DNOs, who have very different financial structures, commercial drivers, access to operational information from their role as a regulated network operator compared to other commercial providers of alternative balancing services.

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)?

As per our response to question 2, we believe the issue of profit sharing and exposure to losses is a clear reason why CLASS should not be available to participate in market-based mechanisms given the commercial advantages that this confers. Whilst DNOs would have some (limited) exposure to any losses through the totex sharing factor, they are not exposed to all, unlike commercial providers. We note also that unlike other commercial providers of balancing services to NG ESO (which are delivered through DSR), there must be an explicit agreement with the customer agreeing to a share of the losses or revenues. This is patently missing in the use of CLASS, and nowhere in the consultation has the impact on the wider settlement arrangements been considered. There are additional risks associated with the creation of imbalances for market participants which will affect the integrity of the settlement arrangements and creates risks that cannot be hedged; which may also increase costs for consumers.

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

Again, for the avoidance of doubt, we do not believe allowing DNOs to offer CLASS as balancing services funded through DRS9 is appropriate. We believe it is likely that placing a limit on the prices allowed to be offered to the ESO would impact investment given that the prices would be limited to reasonable costs and a reasonable margin – but neither we nor Ofgem can say whether the impact would be negative or positive given the lack of a comprehensive impact assessment. We are concerned that part of the justifi-

cation expressed in paragraph 3.15 of the consultation as to why Option 1B is seen as less desirable by Ofgem appears to be based on the *“the complexity associated with identifying and demonstrating compliance with such a limit may disincentivise investment due to potentially lower revenues and any administrative burden associated with ensuring compliance”*.

We believe this approach is problematic and further increases our concerns outlined in our response to question 1 – i.e. how will the price control framework and compliance reporting ensure that any costs associated (resulting from) the increased frequency and scale of voltage control used on the substation transformers results in faster equipment replacement, additional maintenance than would otherwise be the case (resulting in additional costs borne by the DNOs customers) for the provision of a commercial service versus using the assets solely to enhance and protect the DNOs own networks and where explicitly will these costs be monitored and resulting adjustments to consumers Use of System Charges be adequately quantified and verified.

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

We agree that requiring CLASS in the price control would not promote efficient investment signals in CLASS because CLASS should be excluded from participating in commercial, market-based products for all the reasons previously set out. We are concerned with the framing of this question, as it could be argued that by agreeing with the statement that requiring CLASS in the price control would not promote efficient investment signals is in fact a tacit agreement that a responder would support its inclusion in the DRS8 or DRS9 category, which we do not.

Allowing CLASS to participate within the ESO’s commercial procurement of FR, FFR or [in future other balancing services] would we believe, be more far more likely to distort competitive outcomes, and given the lack of evidence provided to date, we do not believe a decision can or should be taken to allow the continuation of CLASS in the current ED1 price control period (let alone in ED2) until this has been provided and assessed by independent experts.

There is a wider question as to whether the provision of CLASS within the price control would be a better outcome if it enabled better voltage control and management of DNO’s network assets to manage local constraints and in the event of emergency instructions from NG ESO. We do not object to the funding of CLASS assets through the price control, where those assets contribute to an identified network need and will enable more efficient and resilient networks and provide greater security of supply. We object when that funding is used to provide commercial services, which can and are being provided by commercial providers.

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

No, we do not have evidence that it could affect the likelihood of system reliability issues, but we maintain that the case hasn’t been proven that it wouldn’t. We note the existing requirement within the Grid Code within OC6 (6.5) which requires DNOs to respond to a National Electricity Transmission System Warning – Demand Control Imminent within 30 minutes. Given that this response (under section 6.5.3) could require 2 voltage reductions, between 2 – 4%, each expected to deliver a 1.5% demand reduction

would suggest that providing commercial incentives on DNOs to utilise their voltage reduction capabilities to provide FR and or FFR would increase the likelihood of system reliability issues.

We also note that in the original CLASS closedown report issued in September 2015 stated that:

*“When the CLASS Method is applied across all primary substations in the Project, Electricity North West could gain up to 12.8MVA of network capacity and defer the reinforcement of five primary substations with an associated expenditure of £2.8 million for up to three years. The CLASS Method can be implemented at one primary substation 57 times faster and 12 times cheaper than traditional reinforcement. It takes one week to retrofit into a primary substation at a cost of £44 000 compared with the typical average time to reinforce a primary substation of 57 weeks at a cost of £560 000. **These are the minimum benefits available by reducing the voltage by 1.5% (i.e. one tap position) at the primary substation. If the voltage is reduced by 5% Electricity North West could gain up to 250MW of network capacity and defer the reinforcement of 28 primary substations with an associated cost of £15.9 million for up to three years. When applied at GB scale, it is possible to gain up to 3.1GW of network capacity (the equivalent of 135 new primary substations) and defer £78 million in reinforcement costs. The Grid Code obliges a DNO to provide a demand response to NETSO for the management of frequency, delivered by the 3% or 6% voltage reduction at DNO substations; but this is generally called upon when other generation and demand management options such as STOR have been exhausted. There is no base case for the commercial provision of demand response for frequency reserve or reactive power for voltage control from a DNO to NETSO. This is because the current regulatory model disincentivises such activities.**”*

We would ask whether the regulatory costs and impacts of a failure by the DNO to deliver the necessary voltage reduction because the equipment had already provided balancing services to ESO through a commercial offering. In the light of the events of 9th August 2019 and previously in 2012, we would request this be undertaken before any final decisions are taken.

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?

As we are not currently providers of FR or FFR we cannot at this time present evidence that the market has been distorted or impeded due to the participation of CLASS, that said we are aware of increasing concerns and reluctance on behalf of customers to consider installing new battery storage systems. However, we do not agree with Ofgem’s assessment that it is unlikely DNOs have or would have market power in future.

The 3 factors that Ofgem have considered (included in Appendix 2 are)

- 1) A DNOs ability to have or to gain market power
- 2) A DNOs ability to discriminate against its competitors in its monopoly role to artificially restrict competition
- 3) Indirect impact on other markets which would outweigh consumer benefits of CLASS

With regards to the evidence provided to support Ofgem’s position that DNOs do not have or would not an ability to gain market power. We are not convinced by the argument set out in the first paragraph that:

“we are of the view that the evidence provided by this analysis does not indicate it would be proportionate to undertake a more comprehensive assessment at this stage”.

We disagree. Given that this consultation is considering the continuation of the current regulatory framework for the next electricity distribution price control period (RIIO-ED2 2023 – 2025) we believe there is an absolute requirement for a full and comprehensive assessment before any decisions are taken. We would also note that this issue has been raised previously by ourselves and many other stakeholders (including EUK and ADE).

We welcomed the output of the Open Network Workstream 3, Product 7 (Conflicts of Interest) and note that the issue of the use of TO / DNO funded assets, the treatment of CLASS has been included in the Conflicts of interest / Unintended Consequences risk register since December 18 as a conflict of interest within ED1. It is therefore disappointing that as part of this consultation, the impact of the existing decision to allow CLASS to be allowed under DRS 8 within the ED1 price control period is not being considered, given industry’s concerns, and the acceptance by ENA (back in 2018) that this issue is live and is continuing to cause concern (which could hamper the development of wider provision of flexibility).

More broadly, we are very concerned that the evidence provided on ENWL’s use of CLASS within FFR and FR markets is minimal (i.e. whilst the report contains some details on the level and prices achieved by ENWL’s average availability prices for accepted FFR bids was higher during the daytime compared to the market and lower overnight) there is no such corresponding information provided re FR (other than ENWL provided 21% of all accepted firm FR capacity between April and December 19 – which at first glance appears to be a fairly high proportion of the firm FR capacity).

There is no information provided as to whether these volumes are growing and whether the prices submitted by ENWL have changed over that period. More seriously, we are concerned that only considering a backwards view of the markets accessed by CLASS to date doesn’t fully account for the rapid changes within the balancing services markets (including the current hiatus on procuring STOR and FR) and the proposals for the replacement reserve services (Dynamic Containment) expected to be launched by NG ESO over the summer.

Given that the assets are already in situ, being managed and maintained – this may provide the DNO with a significant advantage in terms of the bidding into future markets, as the assets are (transformers) are accounted for within the regulated revenues, whilst the additional equipment (control and communications equipment has already been bought and installed).

With regards to the rationale set out regarding factors affecting the ability for DNOs to have or gain market power in future – aside from our concerns regarding the backwards looking assessment of DNO involvement with CLASS (and the comparisons made with the Baringa report from 2016), we note that to date only ENWL has used CLASS to provide balancing services to NG ESO – however, there is no assessment of the impact on the wider balancing services market were other DNOs also to enter their assets. Whilst it may be likely that no single DNO would be able to achieve market power but as a sector, it would seem likely that DNOs would in future provide a greater proportion of the market to the detriment of third party commercial providers and the future investment in additional flexible assets.

There is no discussion of a sectoral approach within the information contained within Appendix 2 nor the wider document. We believe this is a fundamental oversight and makes any proper assessment of the options and decisions very difficult. We note paragraph 2.12 states:

“The ESO is incentivised to procure CLASS where it is efficient, so we expect it would do so when it would reduce the overall amount it would spend on balancing services”. This appears to be a very different expectation than the justification (against DNOs being able to have market power in the future), which is quoted the Ofgem guidance issued to NGENSO with regards to striking an *“appropriate balance between short term reductions in balancing costs and the longer term development of balancing services markets”* – however it is unclear whether the increased participation by other DNOs would be viewed as a positive outcome in terms of developing balancing services markets, given it would mean new participants entering the market and providing services – especially as the main benefit which has been provided as justification for allowing CLASS to continue as a DRS 8 service is (as stated in para 1.7) that *it involves the operation of monopoly network assets that are essential to the DNOs business as usual operation to provide a reliable system*.

We note and welcome the increased action Ofgem and BEIS are taking with respect to DNOs taking or addressing actual or perceived conflicts of interest. However, we are less convinced that in this specific area, this has both been adequately addressed and as importantly is seen to be addressed. We fully support the drive by Ofgem and BEIS to increase the opportunities for flexibility services, however we are concerned that providing a *“mindset to position to continue to allow CLASS to bid into commercial services”* – rather; than at the very least, maintaining a neutral stance during the consultation period, serves to undermine investor confidence in future flexibility provision, not least given the uncertainty on size, type, speed and duration of future ancillary services.

Furthermore – whilst Appendix 2 considers the likelihood or perceived risk that DNOs (or in future DSOs) would undermine their role as a neutral market facilitator – there is no mention of any assessment of how a DNO may be able to better access finance (at more competitive rates), be able to pass on losses to consumers if they are unsuccessful in the future provision of balancing services. These, we believe are more likely areas that DNOs can benefit from their separate monopoly role – and we would urge Ofgem to ensure these are fully explored, documented and published before a final decision is taken.

With regards on the evidence suggested regarding indirect impacts on other markets, we are unclear as to the basis of the assessment used and do not believe this is a legitimate approach to be taken, given that this consultation is considering the future price control period (2023 – 2028). Within Appendix 2 – Ofgem confirm they have assessed the risk as to whether *“reductions in customer bills associated with lower balancing costs from CLASS would be offset by consequential effects in other markets through:*

- 1) flexibility providers are displaced by CLASS in a balancing services market*
- 2) a displaced flexibility provider is not able to recover this lost revenue by participating in a different market or raising prices in a different market*
- 3) without that revenue, the flexibility provider is loss making and exits all markets and*
- 4) the other markets from which the flexibility provider has exited now have fewer participants, which allows some remaining participants to exert market power to raise prices.*

The document simply states that [Ofgem’s] *“view is that the probability of negative outcomes from this issue is low.”*

There is absolutely no justification or assessment for this statement provided – other than the statement DNOs currently offer a small proportion of balancing services (and thus displacement of current providers is small).

A key issue here is the use of the term “currently”. Yes, we agree that currently, only one of six DNOs is offering this service (specifically for FR & FFR) – however, as this consultation is considering the future price control period – there is no way to know whether that assumption is likely to be correct, either for the remainder of the ED1 price control, let alone over the ED2 period.

Ofgem states that they “*don’t have evidence that DNO participation will increase substantially, either in volume or in the number of products delivered*”. We would agree it is unlikely that Ofgem would have evidence for the future uptake of these services at this stage, but that does not mean it won’t happen and we do not believe this is a sufficiently robust criterion upon which to take a decision will could impact the provision of and future take up of flexibility services over the next 8 years.

Furthermore, we note that there are already other innovation funded projects which aim to demonstrate the capability of DNOs to provide essential services to system operator beyond CLASS aProject Phoenix developed by SPEN is looking to showcase the competitiveness of synchronous compensators in provision of wider system services such as inertia and voltage stability.

We do not think that Ofgem’s assessment affectively captures the risks of increased DNO market power in the future as these are not limited to the regulatory treatment of CLASS as a service. We would reiterate that network operators should always seek (and if required support the development of), competitive solutions, while investing in capabilities that ensure that the security and capacity of the network is maintained. Those investments must not be treated in future as services that can remunerated by their provision to the ESO.

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 co-ordinate?

The CLASS service involves the dispatch of network assets and the DNO has privileged access to information on such assets which is not available to other commercial providers of balancing services. If in future DNOs and ESO increasing coordinate activities, this will increase the risk of foresight of potential future ESO demand and procurement opportunities.

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 believe the question itself is symptomatic of the issues associated with allowing a DNOs / DSO who have a critical role in acting as a neutral market facilitator (which includes / will include the procurement of flexibility services, connection offer process etc) to offer commercial services. The key focus should not be the **inappropriate** use of privileged information to benefit the commercial performance of CLASS, there should be **no opportunity** for this information to be utilised (appropriately or inappropriately for the

purposes of deploying CLASS in a commercial manner – as this is information that is not available to any other market participant.

Any remedial actions (such as separate teams, ringfenced systems etc) will not and cannot mitigate the underlying issue.

We were supportive of the decision Ofgem took regarding the prohibition of DNOs operating storage and we are disappointed that this decision appears to be a retrospective step. We are also concerned that this decision will set a precedent for other (yet unknown) circumstances where DNOs / DSOs could in future seek to provide alternative commercial services to ESO (please also note our response to question 7 with regards to the potential future use of synchronous compensators by SPEN through project Phoenix).

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 are very concerned that DNOs would in future be able to bid CLASS into their own DNO flexibility procurement and how this will impact on the pricing / bid management for increases or decreases in energy demand for local flexibility markets. The current CLASS direction does not require any separation of activities / ring fencing of information and or systems – precisely because the economic argument is that by using existing DNO network assets, balancing services can be provided more cheaply than other providers.

We would also ask whether any calculation of the potential costs of imbalance borne by suppliers has been factored in, given that the DNO will not be exposed to these, whereas suppliers' final notified position may be adjusted (resulting in imbalance charges) which would fall on suppliers (and ultimately their customers). We are also unsure as to whether the provision of CLASS would interfere with or reduce the effectiveness of any other flexibility activities being undertaken through DSR by customers connected to those substations where CLASS has been enabled. We would ask whether any impacts have been considered in terms of sites continuing to be able to meet their contracted frequency response services.

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 do not believe the existing safeguards (including licence obligations and competition law) are sufficient to prevent DNOs from taking advantage of their DNO role in the context of using CLASS to provide balancing services, simply on the basis that where there is a perception of a potential conflict of interest / unintended consequences, then the risk remains that investors in alternative providers of flexibility will not come forward or will seek higher returns to cover the risk of reduced access in future, which becomes a self-fulfilling prophecy.

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

Our preference would be for the Distribution System Operator role to be ringfenced and separated from the traditional DNO role - any way, not just because of CLASS although this brings the issues to the fore – we would support a similar unbundling to the legal separation delivered between NG ESO and NGETO

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

We are concerned about the impact of the provision of balancing services by DNOs on market participant imbalance. The dispatch of the network assets would have a distortive effect on supplier imbalances and increase costs for customers. It creates risks for suppliers that cannot be effectively managed. In effect the DNO is using the electricity supplied by suppliers to customers to provide the service without any compensation and permission from the suppliers.

DNOs should focus on ensuring the security and capacity of their networks are maintained through appropriate and timely investment through Regional Development Plans and Infrastructure Development Plans, not the continuation and or development of new commercial services.