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Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control
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Dear Edwin,

Thank you for the opportunity to respond on the above issue. Uniper does not support the use of CLASS as a balancing service and believes that Ofgem could be setting a precedent which will damage investor confidence and competition, and result in higher costs for customers. This response make the following key observations:

- Preventing monopoly network companies from competing in competitive markets has been a key principle that previous regulators, including OFFER and the Monopolies and Mergers Commission, worked to prevent through measures such as breaking up companies with associated networks and competitive businesses. Ofgem's current position seems to contradict and reverse that stance.
- Regulators have previously been concerned that monopoly network companies should be seen to be neutral market facilitators, as a failure to do so could be expected to reduce the effectiveness of competition. CLASS removes this neutrality by making the DNO an active participant in the competitive market.
- CLASS effectively creates a cross subsidy whereby assets paid for by customers through the price control are used to operate unfairly in competitive markets. Furthermore, the risk of operating the service and the cost of capital associated with doing so is effectively underwritten by network customers, resulting in an additional cross subsidy.
- DNOs have access to technical performance information of parties connected to their networks which gives them an additional unfair advantage when competing with them. They also have superior information on localised network conditions which may affect the provision and demand for balancing services. Electricity North West has recently raised a modification proposal to provide greater sharing of information between TSO and DSOs.
- There appears to be no proposed adjustment to supplier imbalance positions as a result of the use of CLASS. This is different to the position which would

occur if competitive aggregators provided demand control services. This is another potential source of distortion to the competitive market.

- DNOs provide connections to those who they would be competing with. If CLASS was used as a balancing service, we believe additional reporting measures should be put in place so Ofgem can assure itself that the provision of the CLASS service is not interfering with the DNO's obligation to provide this service in a non-discriminatory manner. This should include the DNO being required to demonstrate that CLASS is not a contributing factor to any delays to new connections or restrictions placed on parties connected to its network.
- If a DNO, who is also providing a balancing service, fails to meet its Grid Code obligations, how will Ofgem decide the extent to which this is a result of the balancing service provision? What additional remedies will be in place in the event that the provision of balancing services was indeed a contributing factor?
- We believe that CLASS can be effective, but as an enhanced method to provide existing Grid Code requirements, not as a competitive balancing service.

Our detailed responses to each question are as follows:

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

Yes. We believe that the best option is not to treat CLASS as a balancing service. Monopoly service providers should be facilitating competitive markets, not competing in them. This contradicts the position that the regulator has taken for at least over 20 years and has also promoted within the EU.

In 1998 when the Office of Electricity Regulation (OFFER) was considering the physical separation of the distribution and metering businesses of the Public Electricity Suppliers (PESs) from their supply businesses, it concluded that *"it is important to ensure that the monopoly distribution system is neutral and is seen to be neutral, with respect to competing suppliers. The accumulating experience in gas and electricity discussed in this chapter, and the views of the MMC cited here, suggest that this would be furthered if electricity distribution businesses, like other monopoly businesses such as electricity transmission and gas transportation, were fully separated from trading activities such as electricity supply and generation and gas supply, which are potentially competitive."*¹ It is this consultative process which ultimately resulted in the legal separation of distribution businesses from the PESs.

The views of the MMC referred to in the above extract from OFFER related to the Monopolies and Mergers Commission's (MMC) conclusions on the need to separate British Gas's Transportation and Supply businesses. OFFER clearly saw a read across from that situation to that of the PESs. For instance, OFFER noted that the MMC stated *"this dual role gives rise to an inherent conflict of interest which makes it impossible to provide the necessary conditions for self-sustaining competition"*² and that

¹ Reviews of public electricity suppliers 1998 to 2000 separation of businesses - consultation paper (Office of Electricity Regulation - 30th May 1998) - paragraph 2.31

² Ibid – paragraph 2.16

“failure to provide for neutrality as between its trading and transportation interests, may be expected to reduce the effectiveness of competition and to operate against the public interest by inhibiting choice, restricting innovation, and leading to higher levels of gas prices than would otherwise be the case”³.

Furthermore, in the PES consultation document OFFER looked at why National Grid was established as a business separate from the competitive markets it played a role in facilitating, concluding that *“The neutrality of the transmission system operator in England and Wales has been an important component in the development of competition in generation, for example, through ensuring no discrimination in the provision of connections and the publication of assessments of the likely requirements for new generation. The fact that the transmission system has been operated independently of incumbent generation interests has given confidence to entrants. In addition, the separation of transmission and generation interests has meant that there have been more informed and open debates about the role and efficiency of transmission and the conduct of generators. This has assisted the regulatory process in these sectors and led to improvements in operating practices and procedures.”*

So in summary, the arguments for the separation of DNOs from competitive markets were that it assisted the regulatory process by ensuring no discrimination in the provision of connections and the publication of information to the competitive market, which provided confidence to new entrants. In contrast, the failure to separate the monopoly businesses would be expected to work against competition, inhibit choice, restrict innovation and work against the public interest.

Another key principle which OFFER, and subsequently Ofgem, has long held important is that of avoiding cross subsidies. It appears to us that there must be an inherent amount of headroom or overcapacity in a DNO's network if it is able to provide CLASS as a balancing service, as well as a last resort Demand Control action in times of system stress under the Grid Code. That headroom is presumably due to historic over investment in the network which has been paid for by the DNO's customers under the terms of its price control. Therefore, there is the real likelihood of price controlled assets being used to fund a non-price controlled competitive business. Unless the competitive business fully compensates the price controlled part of the business for this, a cross subsidy between the customers of the DNO and its shareholders is created. This is because any profit for the competitive business is overstated as the costs are not fully accounted for.

Additionally, the DNO will have an existing duty to facilitate new network connections for parties who may seek to compete with it in the provision of balancing services. If the connection of a party, such as a generation or storage facility, were to undermine the DNO's ability to provide CLASS due to its impact on the network, how would the connecting party be sure that its application would be assessed in a fair manner? For instance, the DNO could specify a greater amount of reinforcement to be undertaken, or for greater restrictions to be placed on the connection, compared with those that would apply if meeting the balancing obligations under CLASS was not a consideration.

Clearly, CLASS could be useful in enhancing a DNO's ability to meet its Grid Code obligations to provide demand control as a last resort measure at times of system stress. Therefore, consideration could be given to funding this through the price control if it is deemed to be cost effective. However, it should not be used to allow a monopoly network provider to compete in the competitive market in a subsidised manner.

³ Ibid – paragraph 2.17

Our experience of the debate around the CLASS project is that our concerns are shared by the vast majority of parties who compete in the market, including transmission and distribution connected generators, storage providers and demand side response providers. Parties are keen that a competitive market is in place so that the best performing technologies and participants succeed to the benefit of customers, but do not believe that CLASS allows for fair competition. We note that Ofgem has appeared to have dismissed these concerns over competition on the basis that DNOs are the only ones who can provide CLASS. We agree that DNOs are the only ones who can provide voltage control by adjusting the settings on DNO substations, but they are not the only parties who can provide balancing services and indeed are not the only companies who can provide demand control services.

The issue is that CLASS enables DNOs to compete unfairly in markets which up to now they have been prevented from competing in and which therefore could have significant detrimental effects on competition and ultimately on customers. Indeed, any cross subsidies will mean that the perceived benefits in terms of lower cost for customers will to some extent be illusory. That is, perceived cost savings will simply be paid for through higher levels of price controlled revenue.

The consultation document seems to suggest that the market share of balancing services that could be captured by CLASS would not be significant. However, this seems to contradict the evidence provided in support of CLASS. For instance, Baringa in its assessment of the impact of CLASS on the GB Electricity Market concluded, *"Assuming that NGET is willing to have CLASS provide 100% of the Frequency Response service, all other providers could be displaced, including Pumped Storage, DSR, batteries and diesel engines"*⁴.

Therefore, this is an important decision for the Authority to make, which could have a profound impact on the market and customers for years to come.

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

We do not believe that CLASS should participate in balancing services. Market based mechanisms described in the consultation would be least damaging of the options discussed, but would still significantly distort competition.

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)?

Any sharing of profits would simply be reducing the amount of cross subsidy that would result from allowing CLASS to participate in this manner. It would be better to prevent the cross subsidy in the first place. CLASS should be a last resort network action taken to provide Demand Control at times of system stress under the Grid Code.

⁴ Assessing the impact of CLASS on the GB Electricity Market (Baringa – 31 May 2016) – paragraph 6.3.3.1

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

We believe that CLASS should be dealt with as a network cost in order to provide last resort demand control at times of system stress when other providers have been exhausted, but prior to the actual disconnection of customers. This would mean that it would be unnecessary to treat it as part of DRS9.

If Ofgem decides to allow a monopoly network company to compete in the competitive market, then the DRS9 route would be the less distortive. However, this still puts the DNO in a privileged position compared with other competitive providers of services. For instance, we note that certain costs such as the shorter life of network assets associated with CLASS will be reflected in the prices used to bid into the relevant balancing services. If another provider gets its cost assessment and therefore its bidding wrong, then its shareholders will fully pick up the losses associated with this. Under these arrangements the CLASS shareholders will be insulated to a large extent as the DNO's customers will underwrite some of the loss. This provides another effective form of cross subsidy between unregulated and regulated parts of the business.

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

Either option would distort competitive outcomes. Requiring CLASS in the price control would just make this worse. However, as we mention in our response to question 4, it might be appropriate to treat CLASS as a network cost, under the DNO's price control, if it were to only be used as a last resort service at times of system stress in accordance with Grid Code obligations.

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

Our assumption is that DNOs would be wary of allowing CLASS to prevent them from being able to meet their Grid Code obligations. However, it is bound to limit a DNO's ability to provide Demand Control through voltage reduction compared with the full potential in its system, if it is already using voltage reduction as a balancing service. This would therefore increase the chances that, should such an event occur, that actual customer disconnections would occur on top of voltage reductions.

Should a DNO fail to meet its Grid Code requirements at a time when it is providing balancing services, then Ofgem would need to consider how it could be established whether this was as a result of using CLASS. How would Ofgem measure this? If it was found that CLASS contributed to the failure, consideration would have to be given to the additional enforcement measures Ofgem would take compared with a DNO in a similar position where the provision of balancing services was not a factor. Would this be set out anywhere or would it be the subject of enforcement action resulting in fines?

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

We note that CLASS assets have been relatively successful in that one DNO network managed to capture 13% to 21% of the Fast Reserve market in 2019. We accept that

these percentages alone do not represent market power in themselves at this moment, but if cross subsidised assets are used in a wider number of DNO areas, then this could quickly become a serious issue whereby truly competitive providers are forced out of the market. This would correspond with the Baringa analysis which suggests that DNOs could displace all competitive providers as mentioned in our response to question 1.

ESO licence conditions simply require the purchase of services on economic grounds. If these are cross subsidised, having effectively been funded by over investment in network assets, then they may appear to be the cheapest solutions even though the total effect on customers may not be the most economic in reality. Therefore, we are not certain that they would provide effective protection in these circumstances.

We accept that DNO licence conditions requiring them not to discriminate in the provision of connections should in principle provide some protection if effectively policed by Ofgem. We note that these sorts of provisions already existed in PES licences prior to OFFER deciding to instigate full separation instead. Indeed, we note that DNOs have offered to put in place enhanced separation of teams undertaking different functions.

OFFER had considered this very issue in its 1998 consultation and mentioned the MMC's assessment of BG's proposal to separate its business into different units. OFFER quoted the MMC's conclusions that *"as long as BG remains an integrated business, even if its units are run separately as BG has proposed, these decisions are likely to be influenced by the interests of BG Trading. There may be no overt or intentional discrimination. Such a situation is likely to involve constant appeals to the regulator, and lack of confidence on the part of both shipper and the regulator that decisions are being taken on an objective basis"*.⁵ Therefore, OFFER clearly did not believe that licence conditions would be sufficient in themselves. Ofgem will presumably have to be assured that the present situation of DNOs is sufficiently different from that described above so that such concerns are no longer warranted. We are not convinced, however, that this is indeed the case.

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

A DNO will have privileged information on conditions on its network, often close to real time which competitors will not have. Additionally, any competitors connected to the DNO's system will have to provide information to the DNO on the technical characteristics of their plant including operating parameters. Therefore, there will definitely be an asymmetry of information between competitive balancing service providers and monopoly network companies. We note that ENW has proposed a modification to the Grid Code to provide a greater degree of information sharing between the GB ESO and DNOs, so presumably this asymmetry will increase in time too.

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?

⁵ Reviews of public electricity suppliers 1998 to 2000 separation of businesses - consultation paper (Office of Electricity Regulation - 30th May 1998) – paragraph 2.27

We do not know how this could be done in practise other than the full operational ring fencing of the CLASS team. This would mean the CLASS function could not share personnel with the ordinary distribution system operating team and would only be able to operate the CLASS systems. This would mean for instance that ordinary operation and switching of the network could not be carried out by personnel employed by CLASS and should they wish to transfer to a “non-CLASS” part of the DNO, they would have to follow the same procedures that National Grid operates when someone moves between the ESO and another part of the company, such as enforcing a period of gardening leave.

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?

A DNO will have a lower risk profile than a competitive provider of services as it is a regulated business with its downside risk being underwritten through the DRS9 process. We accept this limits the upside benefit too, but the general approach means that the DNO should have a lower cost of capital and therefore lower hurdle rate for its service. This results in another unfair advantage compared with other service providers who are truly exposed to the risk of competing in the competitive market.

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?

As we mention in our response to question 7, we do not believe that existing safeguards would be fully sufficient to provide protection and comfort to true competitive service providers and that appears to be a view that OFFER agreed with in 1998, which is why it decided the PESs should legally separate their distribution businesses from their competitive ones.

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

If Ofgem is unable to reconsider its minded to position to allow monopoly network providers to participate in competitive markets, then at the very least information provision from the DNOs concerned needs to be enhanced. For instance, whenever such a DNO provides a connection offer to a generator, customer or storage user, it should have to explicitly demonstrate, to Ofgem and that user, that the potential impact of the connection on its ability to provide balancing services was not a factor on any restrictions, timings or costs that such a connection is subject to. We would not anticipate these additional requirements being necessary for any DNO which did not have associated businesses competing in competitive markets.

However, as we mention above, the best solution would be for Ofgem to adhere to OFFER's original rationale for introducing full business separation. Therefore, we believe CLASS should be an enhanced method of providing last resort demand control at times of system stress.



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

The main specific effect is the undermining of flexibility markets, particularly at a time when they are being developed to provide greater competitiveness between historically traditional providers of the services and new technologies.

We also note that if aggregators were providing demand control in this manner, it would be expected that the volumes of the affected Supplier BM Units would be adjusted to prevent a distortion of the imbalance arrangements. We are not aware of any such adjustment taking place for CLASS, even though Baringa noted this would be necessary in its report on CLASS.⁶ Failure to address this issue will result in another effective cross subsidy which prevents the true cost of the CLASS process to be reflected in the market.

I hope the above comments prove helpful to your considerations. Please contact me in the first instance should you wish to discuss this further.

Yours sincerely

Paul Jones
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⁶ Assessing the impact of CLASS on the GB Electricity Market (Baringa – 31 May 2016) – section 8.5