

RE Ofgem Consultation – Regulatory treatment of Customer Load Active System Services (CLASS) as a balancing service in the RIIO-ED2 price control

18th May 2022

Context

Sembcorp Energy UK (SEUK), a wholly owned subsidiary of Sembcorp Industries, is a leading provider of sustainable solutions supporting the UK's transition to Net Zero. With an energy generation and battery storage portfolio of nearly 1GW in operation, our expertise helps major energy users and suppliers improve their efficiency, profitability, and sustainability, while supporting the growth of renewables and strengthening the UK's electricity system.

Our Wilton International site on Teesside sits within a hub of decarbonisation innovation. At the site, we provide energy-intensive industrial businesses with combined heat and power (CHP) via our private wires network, which supplies electricity generated by gas and biomass. These services are complemented by our fleet of fast-acting, decentralised power stations and battery storage sites situated throughout England and Wales. Monitored and controlled from our central operations facility in Solihull, these flexible assets deliver electricity to the national grid, helping to balance the UK energy system and ensure reliable power for homes and businesses.

SEUK Response

SEUK is pleased to respond to the Ofgem consultation regarding the Regulatory treatment of Customer Load Active System Services (CLASS) as a balancing service in the RIIO-ED2 price control dated 17th March 2022. Our response is not confidential.

General comments

Having reviewed the Consultation and Impact Assessment documents that form part of this consultation, our view of Ofgem's 'minded to' position remains unchanged from our original response to the previous consultation, in that we still do not agree with or support the view that CLASS services meet the criteria for inclusion in DSR8.

In support of our position, we provide the following views, which we hope Ofgem will fully consider before making a final decision:

SEUK still does not believe that the case has been made that CLASS meets the General Principle of Special Condition CRC 5C. By allowing DNOs to introduce CLASS as a competitive service in the balancing market, Ofgem has moved away from the obligations on DNOs to remain neutral in the facilitation of the market. Furthermore, the service itself has been clearly identified as an aggregation activity and decisions have already been made with regard to other aggregation-based services (such as batteries) that these are not eligible for inclusion under DRS8. We therefore still do not understand why CLASS has been assessed differently or conversely why Ofgem will not allow DNOs to employ other

forms of aggregation activities under these arrangements. Further clarification on these aspects would therefore help greatly in our understanding of Ofgem's current thinking.

We are concerned that the capacity used for aggregation by CLASS is not owned by the DNO and customers are not aware that the capacity they are paying for is being used for this purpose, with DNOs ultimately being able to profit from the service. In addition, we urge Ofgem to undertake further assessments to consider the potential interaction between the CLASS service and the increasing amount of domestic demand-side response and any other whole system delivery, such as battery operation, during periods of import. We believe that these aspects should be included within the IA to obtain a holistic view as to the impacts and costs of CLASS and provide for informed decision making. This is of particular importance if other DNOs are encouraged to provide such a service in the near future, as has been indicated and which will be the message that Ofgem sends if they decide to extend ENWL's CLASS product into RIIO-ED2. If the decision is made for CLASS to continue, then these aspects must be considered and addressed where appropriate.

CLASS provides response and reserve services which can be (and are currently) being provided by commercial providers via flexible assets. Therefore, these services are not uniquely deliverable by DNOs, but the solution is, which seems anti-competitive. Other service providers that currently operate in this market provide value for money as the competitive market allows for good price discovery and maintains effective competition. This will be eroded over a relatively short period of time if CLASS is to be allowed to continue to operate under the current arrangements. Furthermore, we understand that the CLASS service was used to provide frequency response but is no longer employed for this purpose - it would therefore be helpful to understand why this decision was made.

CLASS is not a 'simple solution' and will carry a potentially significant and as yet unquantifiable future cost that could easily undermine the merchant and competitive response and reserve markets. Although currently difficult to quantify it is clear that CLASS introduces a monopoly 'guaranteed revenue' player into a competitive market with an extremely low risk profile (when compared to its competitors) and who has access to privileged information (as legitimately required to maintain its 'business as usual' activities) that will be used to optimise the CLASS service. The current position for DNOs is that the rate of return for installed assets is already guaranteed (via DUoS) and that long-run marginal costs are also covered. We therefore remain to be convinced as to how such a market can remain truly competitive and how this will not introduce distortions.

The Ofgem argument that CLASS will benefit customers by reducing their overall costs is a moot point. Ofgem's IA shows that the current approach to benefit sharing between customers and the DNO, although altruistic at face value, will clearly benefit the DNO more than the individual customer who stands to gain between £0.30 and £2.27 per annum. We would argue that, although positive for customers, this benefit may be seen as negligible given the current increases in energy bills that they are having to manage. Again, this distortion will only increase if other DNOs are incentivised to develop their own CLASS products. Further, the introduction of the CLASS balancing service on a larger scale is

likely to discourage some customers from entering into any DSR agreement themselves where they could potentially save more money.

To further clarify the findings of Ofgem's IA, we would welcome an explanation as to why a 30-year period has been used for the cost-benefit analysis when the extension of CLASS into RIIO-ED2 is only a five-year period, as this approach does not provide for a clear understanding of the true costs and benefits for the continued employment of the CLASS service. Where longer assessment periods cater for a more flexible approach to understanding potential future use-cases of the CLASS solution, these must also be balanced by a similarly critical review of the potential long-term impacts of eroding balancing services. For completeness it would be helpful to understand the cost-benefits that would accrue over the RIIO-ED2 period.

We continue to support competition and the importance of driving down costs for customers, but if this is achieved because of market distortions it is highly unlikely that such a position will endure over the longer term. A healthy and openly competitive capacity market will provide the correct investment and incentive signals for those essential supporting services that are required if GB is to successfully transition to a net zero position by 2050 and meet all targets at optimum cost. Our current view is that the continued provision (and likely increase) of the CLASS balancing service will severely undermine investor confidence and so the provision of alternative balancing services that cater for other markets that CLASS does not participate in.

SEUK responses to specific consultation questions

Question 1: Do you agree that the approach taken in our Impact Assessment is proportionate and balances the trade-offs between the scale of expected impacts and the cost of doing further analysis relative to the benefits such analysis may yield?

We appreciate that impacts that are difficult to quantify are challenging to analyse and assess. However, further assumptions and assessments as to future impacts of ENWL's current market share, cost-base, price structure and benefits together with the likelihood of increases in this service from other DNOs must be considered if clear, balanced and informed decisions are to be made.

Part of this modelling difficulty may be resolved by assessing CLASS under a tighter definition as we have noticed that the definition used for the IA is much wider than that originally provided by ENWL in support of their application for funding under Ofgem's Innovation Project.

Genuine concerns have been expressed on several occasions as to the potential medium- and longer-term effects that increasing use of the CLASS service could introduce into the balancing market. These include:

- The regulatory uncertainties that an Ofgem 'minded to' decision would introduce that could reduce investment in existing and new flexibility technologies and services;
- A reduction in the overall competition in the balancing services markets;



- The potential use of CLASS for other potentially more beneficial services for end customers; and
- The increased costs to customers over the longer term.

We would ask that these aspects are further assessed before any final decision is made.

As previously highlighted in our response, we would also ask that further explanation and clarification is provided as to why this consultation is considering Ofgem's 'minded-to' position of extending ENWL's CLASS service into the next 5-year Price Control period R110-ED2 but providing assumptions and arguments in support of this based on a 30-year Impact Assessment.

We note that the impact assessment suggests that a large proportion (50%) of the stated benefits of the CLASS service come from its use under (and so reduced costs of) the new Dynamic Containment (DC) services. The DC service has been in operation since October 2020, but as ENWL have not employed CLASS here it would be useful to understand why and how Ofgem are claiming this as a benefit under the current IA drafting. Further, it would be helpful to understand why ENWL made the decision to withdraw from the original and equivalent FFR market that it had previously participated in.

Question 2: Do you agree that our sensitivity analysis captures a reasonable range of uncertainty over the likely costs and benefits of deploying CLASS as a balancing service?

We understand the sensitivity analysis that has been conducted and why such an approach has been employed. However, this only covers the DNO perspective and as we have identified earlier in our response, we believe that there are other aspects that must also be considered as part of the impact assessment that could easily introduce market distortions, additional costs and investment uncertainties who's impacts could be greater than those benefits already assessed, but which are not currently clearly understood.

Question 3: Do you agree that it would not be proportionate for Elexon to work with industry to develop a solution to adjusting supplier imbalance positions via the Modification process in response to CLASS activations at this stage?

Given that currently only one DNO has employed CLASS the impacts on supplier imbalance positions do not seem to be causing a problem at present. However, the impacts of other DNOs developing their own CLASS arrangements are not yet understood and as such this potential problem needs to be carefully assessed before decisions are made.

If potential impacts of allowing CLASS to participate in the balancing market at a larger scale are identified these will need to be assessed at the earliest opportunity and mitigating solutions may need to be developed to protect other parties who may be adversely affected by no fault of their own, if decisions are made to proceed. In order to answer this question in full it would be helpful if Ofgem were to establish exactly what Elexon would require in order to manage imbalances of this nature, only then would it be possible to begin to understand what is proportionate.

We already acknowledge the increasing pressures on Suppliers, and the wider implications for the energy industry when these organisations exit the market. This should not be further compounded by the actions of other parties if this can be avoided.

Question 4: Do you agree with our assessment that there is no evidence that competition is currently being distorted or impeded by the participation of CLASS?

Whilst we agree that there is currently no definitive evidence that there are any substantial market distortions from the single CLASS service provided by ENWL, it is the impacts of future large-scale deployment, within potentially different future market conditions, that should be the subject of this question. We would like to see further analysis as to the impacts of market saturation, should the provision of the CLASS service increase that would inevitably follow an Ofgem minded to decision. Such potential increases in CLASS would come at a time when the ESO volume requirements are likely to decrease (due to improved efficiencies) that could also introduce a downward pressure on market size.

In order to provide a more complete assessment of any potential market distortions that the introduction of the CLASS service may, or may not, have introduced we believe that it would be helpful to better understand how the CLASS service is currently being priced within the market. For example, given the different cost structure that underpins the CLASS service we would expect to see CLASS services running at a lower, relatively flat-rate, when compared to other competing services.

ENWL currently hold a relatively large portion of the market share. If this is scaled up to account for 3 or 6 DNOs providing a CLASS service, it becomes clear that this would dominate the balancing market and so would distort competition. As we have previously noted, if Ofgem decides to allow ENWL to continue to provide CLASS services under DSR8 for the RII0-ED2 period this will encourage other DNOs to follow suit, particularly if profit is to be made. Large-scale rollout of CLASS nation-wide will put other providers of these services, albeit not using the same methodology, under increasing pressure with some of these balancing service providers being unable to compete. These existing balancing service providers may also have been providing additional services that cannot be fulfilled by CLASS arrangements alone, which suggests that these wider implications also need to be assessed before any final decision is made. Furthermore, operators of developing technologies such as batteries (identified as a key service in the transition to net zero) may be dissuaded from entering the market or providing such services if CLASS introduces market distortion or leads to the removal of clear investment signals. Open competition is the best way to ensure that this does not happen, and we believe that Ofgem's current 'minded to' approach will inevitably lead to such a distortion.

Question 5: 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?

There do not seem to be clear procedures in place for DNOs to prove that they are not leveraging their monopoly position. Industry and investors need confidence that these are effective and can be accessible so that industry can verify the DNOs claims and keep them accountable. Consideration for additional monitoring and reporting should therefore be given as part of the assessment for both extending and increasing the CLASS service.

It does not appear that sufficient safeguards are in place given the current decision to ignore decisions previously made with regard to other aggregation style services and the fact that such a service has been allowed to unfairly compete in a market whilst not meeting the general principles contained within the related party's Licence Conditions.

Further consideration needs to be given to a potential conflict of interest that may emerge for the ESO who will be caught between purchasing the balancing services under current arrangements, that favour CLASS services (the ESO must accept the lowest bids) and their responsibility for maintaining diversity in the market. The ESO should be able to send clear signals to encourage new and innovative services and engaging with these parties on an equal footing. The potential expansion of the CLASS service could seriously undermine this ability and so should be considered further.

Question 6: What additional measures do you think would be effective and proportionate to address actual or perceived conflicts of interest with respect to CLASS?

Should DNOs be allowed to continue to provide CLASS in RIIO-ED2, they should be required to seek explicit consent from all customers of whom they intend to use capacity for CLASS provision. This obligation should apply retrospectively to include those customers already being utilised for CLASS. This contractual agreement should spell out that the customer is agreeing to be exposed to losses in the form of higher tariffs as well as gains in the form of lower tariffs and that within a certain range, their voltage will be affected. Customers should also be made aware of any potential impacts to their DSR capability should they already be contracted with a commercial aggregator.

Other measures could be considered but it is clear that these would take time to develop and implement rendering them sub-optimal over the RIIO-ED2 period, for example, introduction of a cap or threshold for CLASS services to limit market share. A rebalancing of the revenue share between service providers and customers should also be considered.

In addition, Ofgem could consider the deployment of the CLASS service for other, less contentious purposes. For example, for 'peak reduction', network management and other DNO regulated activities.

Question 7: Do you agree that our minded-to position provides the most efficient incentive for CLASS's participation in balancing services?

Whilst SEUK agrees that Ofgem's minded-to position to proceed with Option 1a provides DNOs in general and ENWL in particular, with the best financial incentives to continue to provide (or further develop) CLASS's services to the balancing market, this question

presupposes that this approach is the most beneficial for the market overall. We are arguing here that this is not necessarily true, and that further assessment is first required to unambiguously determine that this is the case.

We again, refer to our previous comments that one of the core principles, as developed by Ofgem as the regulator, is that regulated parties such as DNOs should not provide commercial services such as CLASS as part of their role as a regulated monopoly, that such a decision will undermine this principle, will create regulatory uncertainty and damage investor confidence.

Given this position we do not believe that this is the most balanced question to ask as part of this consultation, but that it is better to seek views as to the potential outcomes that such a decision could lead to, in order to reach a fully informed view.

Network operators are already obligated and incentivised to manage their networks effectively and efficiently we do not see why there is a need to further fund/ reward activities via a profit-sharing, competitive market route in which they hold a monopoly position and are already funded for these activities via their price control and RIIO.

Question 8: Do you agree that requiring CLASS in the price control would not promote efficient investment signals in CLASS and could distort competitive outcomes?

Yes, we agree with Ofgem that requiring CLASS in the price control would undermine competition as it would effectively be a free service for the ESO (but not free to the consumer). This would damage the response and reserve markets. In addition, such an approach would remove the correct investment signals, impact market liquidity and lead to higher prices overall.

Question 9: What additional reporting or monitoring in RIIO-ED2 could be valuable to assess the ongoing impact of CLASS? Please explain how Ofgem, the DNOs or any other party would be required to support the proposed measure.

This question assumes that CLASS services will automatically be included in RIIO-ED2, and we have still to see the conclusive evidence that this approach meets all the necessary requirements and obligations currently placed on DNOs or that it provides an overall, long-term positive impact for either customers, the balancing market or balancing service providers. As we have suggested earlier in our response, areas that may be helpful to better understand the impact of the CLASS service on the balancing market would be to review market prices, trends and shares to clarify how these have changed over time and particularly during system stress events. If the CLASS service is to endure then this form of monitoring should also remain in place in order to consistently assess any trends or market distortions that may emerge.

Please let me know should you require any further information or clarification on any aspect.



Regards,

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