

10/05/2022

Mike Duncan, Senior Manager
DSO and Whole Systems Team
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

flexibility@ofgem.gov.uk

Non-confidential

Dear Mike,

Regulatory treatment of CLASS as a balancing service in RIIO-ED2 price control

Drax Group plc (Drax) owns and operates a portfolio of flexible, low carbon and renewable electricity generation assets – providing enough power for the equivalent of more than 8 million homes across the UK. Drax also owns two retail businesses, Drax Energy Solutions (formerly trading as Haven Power) and Opus Energy, which together supply renewable electricity and gas to over 300,000 business premises.

We believe CLASS should be prohibited as a balancing service, as per option 3 in the consultation. We acknowledge the Impact Assessment (IA) indicates the other options convey an overall positive impact on consumers, industry participants and environmental issues, relative to option 3 (the counterfactual). However, the IA fails to fully consider the longer-term detriment caused to the emerging flexibility market. We also reiterate our view given in response to past consultations on the topic, that this proposal is inconsistent with Ofgem's statutory duty to promote competition and undermines the principles and objectives set out by the ESO in its Balancing Services Roadmap.

Our main concerns and views on the Impact Assessment and Ofgem's minded-to position are given below:

- Allowing regulated monopolies to offer the provision of CLASS services to the ESO risks distorting the level-playing field and competitive price discovery in the market.
- Allowing the provision of CLASS as a service to the ESO sets a precedent for network-based solutions in the balancing market. This may lead to increased dominance of regulated assets in competitive balancing markets and have a detrimental impact on future investments in flexible and low-carbon commercial projects.
- We acknowledge that Ofgem has not identified any instances, to date, of anti-competitive behaviour by DNOs in the provision of CLASS as a balancing service, and that Ofgem's competition assessment indicates that a DNO would be unlikely to secure significant market power. However, we would highlight that many balancing service needs are becoming more locationally granular. For instance, the Reactive Power Market Design Project is considering a move to a nodal approach to needs-assessment and pricing. This means that in certain locations DNOs are increasingly likely to gain significant market power. This has not been considered adequately in Ofgem's assessment. As a minimum, we would expect Ofgem's

assessment and decision to clarify how these proposals will align with future changes to the balancing services market design.

- We believe the IA gives undue weighting to the immediate and short-term benefits of the minded-to option and little to no consideration of the longer-term implications, specifically the liquidity of the market and availability of solutions beyond the ED2 period. Allowing CLASS provision in RIIO-ED 2 is likely to lead to reduced investment into flexible assets over the period and a lack of alternatives to DNO / regulated asset solutions in the medium to long term. This could result in a scarcity of providers and consequently higher balancing costs.
- The next 5 years will be critical for attracting investment into new flexible and low-carbon capacity in order to achieve the UK's Net Zero ambitions and the ESO's vision of operating a zero-carbon grid by 2025. Provision of CLASS by DNOs risks undermining investor confidence and reduces the number of revenue stacking opportunities for commercial participants. This is particularly important in the context of nascent or emerging technologies, such as the use of hydrogen or DSR in the provision of balancing services, as envisaged by the ESO in its Balancing Services Roadmap.
- It is essential Ofgem fully considers the knock-on effects on costs in other services and areas of the market. As part of the historical analysis of ENWL's participation, data showed that bid prices and availability fees were on average lower across services such as Secondary FFR and Firm FR once ENWL began participating in a service. This was driven in part by other providers lowering their prices in response to DNO participation. Whilst this shows an instant reduction in costs to consumers, it does not necessarily factor in the wider implications of these lower prices being offered by commercial providers. Artificially suppressing the price by allowing DNO participation may lead to inefficient price discovery distorting the true value of the service, with prospective investors in flexible technologies having to recover their costs through other revenue streams consequently putting upward pressure on those prices. We're concerned that these considerations have not been fully explored in the IA.
- We recognise that there may be circumstances when alternative solutions, such as regulated assets, may need to be used in balancing markets in the interest of consumers. This requirement is likely to arise when there are insufficient commercial solutions. We do not believe this is the case for balancing services in GB.
- The costs and benefits modelled in the IA are subject to significant uncertainty and variation, with many indirect impacts being hard to account for. Therefore, we are not convinced the expected net benefit to consumers and market participants is sufficiently large to justify an arrangement which may detrimentally impact the UK's net zero ambitions, Energy Security Strategy and wider market frameworks.

If you would like to discuss the points above, please do not hesitate to contact us.

Yours sincerely,

Matt Young

Group Head of Regulation
Drax Group plc