In the matter of Ofgem's 2022 Consultation on the Regulatory treatment of CLASS as a balancing service in the RIIO-ED2 price control

---

OPINION

A. INTRODUCTION AND SUMMARY

1. We are asked to advise Centrica in respect of proposals set out by Ofgem in its consultation "Regulatory treatment of CLASS as a balancing service in the RIIO-ED2 price control", published on 17 March 2022 (the "**2022 Consultation**")[1]. Specifically, we are asked to advise as to the lawfulness of the Gas and Electricity Markets Authority's ("**Ofgem**") "minded-to position" that it will direct that, under the RIIO-ED2 price control, a form of balancing service known as Customer Load Active System Service ("**CLASS**") provided by Distribution Network Operators ("**DNOs**") to the Electricity System Operator (the "**ESO**") be included in the DRS8 Value Added Services category of Directly Remunerated Services ("**DRS**").

2. In summary, our view is, first, that Ofgem does not have power to make the intended direction; and secondly, that it has failed to have regard to a material consideration, namely the fact that a DNO providing CLASS would fall outside the scope of the key legislation regulating the provision of balancing services.

   2.1. The question of whether Ofgem may direct that CLASS services be remunerated as DRS under the terms of the Electricity Distribution Licence (the "**Licence**") depends on whether they are a service which is part of the *"normal activities of [the DNOs'] distribution business"*, for the purposes of special condition 5C.4 of Schedule 2A to the Licence. Pursuant to standard condition 1 this includes any business that is "ancillary" to the distribution of electricity.

   2.2. Applying ordinary principles of construction, this condition has to be interpreted consistently not only with (i) the definitions set out in the standard licence conditions applicable to DNOs, but also with (ii) the wider legislative context. Under the relevant legislative scheme, the provision of balancing services is treated

[1] The 2022 Consultation is accompanied by an Impact Assessment, together with a supporting Annex prepared for Ofgem by NERA.

as quite distinct from the provision of distribution services and it is separately regulated, falling outside the scope of the licensing regime established by ss.4-10 of the Electricity Act 1989 (the "**EA 1989**").

2.3. Having regard to the nature of CLASS services, the relevant licence conditions and the legislative scheme, we consider that the provision of CLASS by DNOs is not part of the DNOs' business of distributing electricity through the DNOs' distribution systems, nor is it ancillary to that business. It follows that Ofgem would be acting ultra vires were it to seek to direct that CLASS be included as a DRS under CRC 5C for the RIIO-ED2 price control period.

2.4. Moreover, a DNO providing CLASS would fall outside the scope of EU Regulation 2019/943 (the "**2019 Regulation**") which regulates participation in balancing markets. Ofgem does not discuss or appear to have had any regard to this material consideration in the 2022 Consultation.

3. The remainder of this Opinion is structured as follows:

3.1. Section B outlines the relevant legislative and regulatory scheme enacted by (i) the EA 1989 (against the background of EU Directive 2019/944 (the "**2019 Directive**")), (ii) the 2019 Regulation and (iii) the relevant provisions of the Licence.

3.2. Section C considers whether the provision of CLASS can be regarded as a part of or to be ancillary to the DNO's distribution business, so as to fall within special condition 5C.4 of the Licence.

3.3. Section D considers the consequences of Ofgem's failure to have regard to the terms of the 2019 Regulation.

B. THE LEGISLATIVE SCHEME

B(1) The Electricity Act 1989

4. Part I of the EA 1989, in particular ss.4-10 and s.11A, establishes a scheme for the licencing and regulation of certain activities in relation to electricity supply, including supply, generation, distribution and transmission. In its amended form, the EA 1989 has implemented a series of EU Directives into UK law, including finally the 2019 Directive,

and to that extent it is EU-derived domestic legislation falling within s.2(1) of the European Union (Withdrawal) Act 2018 ("**EUWA 2018**") and retained EU law falling within s.6 EUWA 2018.

5. The scheme of licensing in Part I EA 1989 is founded on ss.4-6, which provide that certain activities are prohibited by s.4(1) unless conducted in accordance with a licence granted under s.6.

6. In respect of electricity distribution, s.4(1)(bb) and s.4(2) together prohibit a person from distributing electricity without a licence, *"for the purpose of giving a supply to any premises or enabling a supply to be so given".* Section 6(1)(c) then empowers Ofgem to award distribution licences authorising a person to distribute electricity, again for the purpose of giving a supply to any premises or enabling a supply to be so given.

7. A definition of distribution is at s.4(4), which provides that 'distribute' means:

> *"distribute by means of a distribution system, that is to say, a system which consists (wholly or mainly) of low voltage lines and electrical plant and is used for conveying electricity to any premises or to any other distribution system." (emphasis added)*

8. Section 64 EA 1989 adopts the same definition of 'distribute', with the addition that *"cognate expressions shall be construed accordingly"*.

9. The definition of distribution for the purposes of the licensing scheme is thus tied to the purposes of giving supply to premises.

10. In our view it is plain that CLASS cannot itself constitute distribution within the definitions in s.4(4) and s.64. CLASS is not concerned with conveying electricity to a premises for the purposes of giving a supply to that premises. Indeed, Ofgem do not appear to consider that CLASS can itself constitute distribution. Rather, at ¶3.66 of the 2022 Consultation they appear to focus on whether CLASS can be ancillary to DNOs' distribution business.

11. It is important to note that balancing is not a licensable activity under ss.4-6 EA 1989. We describe below certain features of the legislative scheme applicable to balancing.

12. Pursuant to s.7(1), a licence may include "*such conditions (whether or not relating to the activities authorised by the licence)*" as appear to Ofgem to be requisite or expedient having regard to its statutory duties. However, we note that under the scheme of EA 1989, the power of licensing is fundamentally one of licensing the particular, otherwise prohibited, activities set out in s.4 EA 1989 and does not confer a free-standing power on Ofgem to price regulate other forms of activity.

B(2) The 2019 Directive

13. As noted above, the EA 1989 implemented a series of EU Directives including finally the 2019 Directive. The 2019 Directive itself is no longer part of UK law. However, pursuant to s.2(1) EUWA 2018, the provisions of UK law that implemented it immediately prior to the end of the Implementation Period (i.e. the EA 1989) continue to have effect as they had effect in domestic law immediately before 31 December 2020 (save as amended). Moreover, they constitute retained EU law for the purposes of s.6(7) EUWA 2018.

14. Article 2(28) of the 2019 Directive provides that:

> *"'distribution' means the transport of electricity on high-voltage, medium-voltage and low-voltage distribution systems with a view to its delivery to customers, but does not include supply"*

15. We note that the terms of this definition reinforce the conclusion at paragraph 10 above that the provision of balancing services or CLASS cannot fall within scope of distribution for the purposes of the EA 1989. CLASS does not consist of the transport of electricity with a view to its delivery to customers.

16. We also note that the 2019 Directive envisages that the provision of balancing services, in the form of demand response and energy storage services, should be a different function to distribution. For instance:

    16.1. Article 2(57) of the 2019 Directive lists balancing activities as being separate functions to distribution:

    > *"'electricity undertaking' means a natural or legal person who carries out at least one of the following functions: generation, transmission, distribution, aggregation, demand response, energy storage, supply or purchase of electricity…" (emphasis added)*

16.2. Article 8(2)(l) addresses *"demand response solutions and energy storage"* as alternative to the construction of new generating capacity, with no mention of distribution. The same is true of Recital 13.

16.3. Recital 61 expressly states that DNOs should be incentivised to procure services from distributed energy resources *"such as demand response and energy storage, based on market procedures"*, but does not suggest that DNOs themselves should be enabled to provide such services to the ESO.

17. The other crucial point is that while the 2019 Directive establishes an extensive regulatory scheme for distributors of electricity (see, for instance, the tasks for distribution operators set out article 31), the regulation of balancing markets was separately provided for in the 2019 Regulation.

B(3) The 2019 Regulation

18. The 2019 Regulation was incorporated into UK domestic law by virtue of s.3(1) EUWA 2018, subject to consequential amendments made by the Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020/1006. The 2019 Regulation is therefore retained EU law for the purposes of s.6(7) EUWA 2018. Article 1 of the 2019 Regulation explains that it sets out *"fundamental principles for well-functioning, integrated electricity markets"*.

19. Article 2 defines balancing in broad terms as:

> *"all actions and processes, in all timelines, through which transmission system operators ensure, in an ongoing manner, maintenance of the system frequency within a predefined stability range and compliance with the amount of reserves needed with respect to the required quality"*

20. On its face, this definition might be thought capable of including the provision of CLASS within the regulatory scheme set out by the 2019 Regulation. However, for the reasons set out below DNOs providing CLASS would clearly be excluded from the scope of the 2019 Regulation.

21. Article 2 of the 2019 Regulation defines a 'market participant' in the following terms:

> *"a natural or legal person who buys, sells or generates electricity, who is engaged in aggregation or who is an operator of demand response or energy*

storage services, including through the placing of orders to trade, in one or more electricity markets, including in balancing energy markets"

22. As further explained below other key terms in the 2019 Regulation, including the concept of "balancing services provider", depend upon this definition of market participant.

23. DNOs providing CLASS do not meet this definition of market participant. They are clearly not engaged in buying, selling or generating electricity. Nor are they engaged in aggregation, demand response or energy storage.

    23.1. "Aggregation" is defined by article 2 of the 2019 Regulation as *"the function of combining multiple customer loads or generated electricity for sale, purchase or auction in any electricity market"*. We consider that CLASS does not fall within this definition. It appears that Ofgem shares this view, since it states at ¶1.10 of the 2022 Consultation that:[2]

    "Only DNOs can provide CLASS. This is because, in addition to the assets specifically required for CLASS, it involves the operation of monopoly network assets that are essential for a DNO's business as usual operation to provide a reliable system. <u>It is therefore distinct from other forms of demand side response in which an aggregator groups together disperse distributed energy resources with the aim of enabling these small energy sources to provide services to the ESO</u>" (emphasis added)

    23.2. Importantly, DNOs providing CLASS are also not operating demand response services as that term is defined within the scheme of the 2019 Regulation. Article 2 defines demand response as:

    "the change of electricity load <u>by final customers</u> from their normal or current consumption patterns in response to market signals, including in response to time-variable electricity prices or incentive payments or in response to the acceptance of the final customer's bid to sell demand reduction or increase at a price in an organised market as defined in point

[2] We also note Ofgem has previously clarified that DNOs should not provide aggregation services. ¶1.11 of Ofgem's 2017 consultation on 'Enabling the competitive deployment of storage in a flexible energy system: changes to the electricity distribution licence' stated that: "…*we also consider that DSO involvement in commercial aggregation risks having a negative effect on that market and undermining the impartiality of the DSOs. As such, we do not believe that this is an appropriate activity for DSOs to engage in*." Similarly, ¶1.4 of Ofgem's 2020 consultation on 'Regulatory treatment of CLASS as balancing service in RIIO-ED2 network price control' stated that *"…we have made clear that DNOs cannot operate storage or act as commercial aggregators, which can both be done by third parties."*

(4) of Article 2 of Commission Implementing Regulation (EU) No 1348/2014, whether alone or through aggregation." (emphasis added)

The provision of CLASS does not involve the change of electricity load by final customers, as DNOs are not final customers.

23.3. It is also plain that CLASS is not a form of energy storage.[3]

24. A series of further defined terms in article 2 of the 2019 Regulation rely upon this concept of market participant (which excludes DNOs providing CLASS).

24.1. "Balancing service provider" is defined as a "*market participant providing either or both balancing energy and balancing capacity to transmission system operators*".

24.2. "Balance responsible party" is defined as *"a market participant or its chosen representative responsible for its imbalances in the electricity market"*.

24.3. A "bidding zone" is defined as "*the largest geographical area within which market participants are able to exchange energy without capacity allocation*". A series of further defined terms relate to this definition of bidding zones.

25. DNOs providing CLASS do not meet the definition of market participants for the purposes of the 2019 Regulation and so cannot be balancing service providers as defined in that Regulation. It therefore follows that they fall outside of the regulatory scheme, provided for by the 2019 Regulation, regulating balancing service providers.

26. Further, in consequence of the defined terms set out at paragraphs 23-24 above, DNOs providing CLASS are not subject to a number of rights and duties which are allocated by the regulatory scheme to market participants, balancing service providers and balance responsible parties. Nor would the position of DNOs be properly taken into account in the application of other provisions. We note certain of these issues below.

---

[3] Energy storage is defined by Article 2 of the 2019 Regulation as *"deferring the final use of electricity to a moment later than when it was generated, or the conversion of electrical energy into a form of energy which can be stored, the storing of such energy, and the subsequent reconversion of such energy into electrical energy or use as another energy carrier"*. In our understanding CLASS does not defer the use of electricity in this sense or relevantly involve the conversion of electrical energy into other forms

27. Article 5(1) of the 2019 Regulation provides that:

> *"All market participants shall be responsible for the imbalances they cause in the system ('balance responsibility'). To that end, market participants shall either be balance responsible parties or shall contractually delegate their responsibility to a balance responsible party of their choice. Each balance responsible party shall be financially responsible for its imbalances and shall strive to be balanced or shall help the electricity system to be balanced." (emphasis added)*

28. Article 6 then sets out a number of principles for balancing markets, in reliance upon the definition of market participants. For example:

    28.1. Article 6(1) sets out principles of non-discrimination between market participants and for market participants to have non-discriminatory access.

    28.2. Article 6(4) grants market participants the right to bid for balancing energy *"as close to real time as possible"* and prohibits the closing of balancing energy gates before the intraday cross-zonal gate closure time (see also article 8(1)).

    28.3. Article 6(8) provides that the procurement of balancing capacity by the transmission system operator shall be market based and non-discriminatory between market participants at the prequalification process.

    28.4. Article 6(6) relies upon the concept of a bidding zone, which as noted above are defined by reference to the concept of market participants

29. Articles 7 and 8 expand on these principles specifically in relation to day-ahead and intraday markets. The organisers of these markets are required to maximise the ability of all market participants to manage imbalances (article 7(2)(b) and article 8(1)), as well as maximising the opportunities for all market participants to participate in cross-zonal trade in as close to real time as possible (article 7(2)(c)). Market participants also have rights in relation to their participation in forward markets, under article 9. Articles 7-9 all also rely upon the concept of a bidding zone. Article 22(2) attributes the output of the strategic reserve to balance responsible parties.

30. The crucial point is that, by tying the definition of a balancing services provider to that of a market participant, the regulatory scheme provided for by the 2019 Regulation confers

significant rights and obligations upon balancing services providers. DNOs providing CLASS would not fall within the scope of this regulatory scheme.

31. For the avoidance of doubt, we acknowledge that as noted at ¶1.11 of the 2022 Consultation, it has been considered that CLASS meets the definition of a demand unit and reserve providing group in Commission Regulation (EU) 2017/1485, which lays down technical requirements for transmission system operators. However, that does not mean that it fits within the market-based scheme of economic regulation envisaged by the 2019 Regulation.

B(4) The Electricity Distribution Licence

32. DNO Licences are awarded by Ofgem under s.6(1)(c) EA 1989. As DNOs constitute regional monopolies in the distribution market, their activities are subject to price regulation, as determined through Ofgem's RIIO processes. Those price regulation terms are then set out in special conditions attached to the Licence. Certain services are defined to be DRS under Condition CRC 5C.

The relevant provisions of the Licence

33. Under CRC 5C.2, and the definition at CRC 1B.7, DRS are *"services that comply with the General Principle"*.

34. The General Principle is set out at CRC 5C.4:

> *"The General Principle is that a service provided by the licensee as part of the normal activities of its Distribution Business within the Distribution Services Area is to be treated as a Directly Remunerated Service if and to the extent that the service so provided is not already remunerated under any of the income categories set out in paragraph 5C.5."*

35. The term '*Distribution Business'* in CRC 5C.4 is defined in standard condition 1 as:

> *"a business of the licensee… which… comprises any of the following activities:*
>
> *(a) the distribution of electricity through the licensee's Distribution System (including any business in providing connections to that system);*
>
> *(b) the provision of Metering Services and Metering Equipment… ; and*

(c) the provision of Data Services,

and in each case includes any business that is ancillary to the business in question." (emphasis added)

36. CRC 5C.10 then provides that:

"Where the Authority (having particular regard to the General Principle) is satisfied:

(a) that any service treated by the licensee as a Directly Remunerated Service should not be so treated; or

(b) that any service not treated by the licensee as a Directly Remunerated Service should be so treated,

it may give the licensee a direction to that effect."

37. DRS 8 and DRS 9 are in the following terms.

37.1. DRS8 provides that DNOs may be remunerated for:

"Services that utilize Relevant Assets, as defined in standard condition 1… under commercial arrangements between the licensee and another person… involving:

(a) the installation of equipment for the purpose of electronic communications or data transfer;

(b) the display of any advertising or promotional material; or

(c) any service specified in a direction given by the Authority for the purposes of this condition that, in the absence of such a direction, would be included in category DRS9 (Miscellaneous)…"

37.2. Standard condition 1 provides that a Relevant Asset:

"means any asset that for the time being forms part of the licensee's Distribution System, any control centre for use in conjunction with that asset, and any legal or beneficial interest in land (whether under the law of England and Wales or under the law of Scotland) upon, under, or over which any such asset or control centre is situated."

37.3. DRS9 provides that:

> *"This category consists of the provision of any other service (including electric lines or electrical plant) that:*
>
> *(a) is for the specific benefit of any third party who requests it; and*
>
> *(b) is not remunerated under one of the charges mentioned in paragraph 5C.5 or under any other charge for a Directly Remunerated Service."*

Construing the terms of the CRC 5C

38. We note the following points regarding CRC.

39. First, the key question is whether CLASS comes within the scope of the General Principle in CRC 5C.4 and hence Ofgem's power under CRC 5C.10, rather than whether it falls within one of the existing categories DRS1-DRS9. Ofgem retains a power to direct treatment as DRS even where the service does not fall within one of those specific categories. The precise terms of DRS 8 and 9 are therefore of relevance only insofar as they cast light upon the scope of CRC 5C.4 and 5C.10.

40. Secondly, although CRC 5C.10 does not confine Ofgem to only considering the General Principle set out in CRC 5C.4 when exercising its power of direction, Ofgem is required to have "*particular regard*" to it. For the avoidance of doubt, although the terms of CRC 5C.10 only require Ofgem to have particular "*regard*" to the General Principle, we do not consider that Ofgem would have power under CRC 5C.10 to direct that a matter which was neither part or nor ancillary to the business of distributing electricity should be treated as DRS. CRC 5C.2 is explicit that "*Directly Remunerated Services are services that comply with the General Principle*". There is no scope for services which do not comply with the General Principle to be treated as DRS. Nor do we understand Ofgem to be suggesting the contrary. Moreover, and in any event, Ofgem's power under CRC 5C.10 is conditioned by the scope of its powers to grant and modify licences under ss.4, 6, 7 and 11B EA 1989, as discussed above.

41. Thirdly, as already noted at paragraph 10 above, CLASS is not itself distribution of electricity as that concept is defined in the EA 1989 or the 2019 Directive. For that reason, we consider that it cannot constitute distribution within the meaning of sub-paragraph (a) of the definition of "*Distribution Business*" in standard condition 1.[4] Nor do we understand

[4] It plainly does not fall within sub-paragraphs (b) or (c).

Ofgem to be suggesting that it is. Rather Ofgem appear at ¶3.66 of the 2022 Consultation to be taking the view that CLASS is ancillary to DNOs' distribution business. We consider this point further below.

42. Fourthly, when construing and applying 5C.4, it should be noted that the question is whether the service provided is part of the DNOs' normal activities. That is, it is not simply a matter of whether a particular activity (such as managing voltage in the network) is part of the DNO's normal activities. It is a question of whether providing a CLASS as a service to the ESO is normal part of the DNOs' activities.

43. Fifthly, we consider that in its context the term "ancillary" requires to be given a strict construction:

    43.1. There is no single legal meaning of the term "ancillary". It depends on the wider legislative context within which it is used. For instance, the business of a contractor engaged by a railway company to build, repair and paint its stations was held, for the purpose of section 4 of the Workers Compensation Act 1897, to be *"merely ancillary or incidental to"* the business of the company, whose primary business was the carriage of passengers or goods: *Pearce v London & South Western Railway* [1900] 1 QB 100. A similar meaning was given to the term in *Green v Britten* [1904] 1 KB 350, which held that work was ancillary to a business where it was *"subsidiary, subordinate or appurtenant to the business carried on*". In contrast, the term *'ancillary service'* in the 2019 Regulation is defined as (emphasis added) *"a service necessary for the operation of a transmission or distribution system…"*

    43.2. We consider that the term as used in standard condition 1, and as it bears upon CRC 5C, requires to be construed in the context of the overall legislative scheme which lies behind the licence. In *R v Secretary of State for the Environment, Transport and the Regions, Ex p Spath Holme Ltd* [2001] 2 AC 349 at 396 Lord Nicholls said: *"Statutory interpretation is an exercise which requires the court to identify the meaning borne by the words in question in the particular context*". Similarly, in *R (Westminster City Council) v National Asylum Support Service*, [2002] 4 All ER 654 Lord Steyn said at para 5 that "*The starting point is that language in all legal texts conveys meaning according to the circumstances in which it was used. It*

follows that the context must always be identified and considered before the process of construction or during it".

43.3. As noted above, the terms of s.4 and s.6 EA 1989 prohibit and correspondingly allow Ofgem to licence certain activities, which include distribution for the purposes of giving a supply to any premises. Although s.7(1) allows licence conditions imposed on those activities to relate to other matters, the scheme of the EA 1989 does not purport to confer power on Ofgem to regulate (or price regulate) matters falling outside the scope of the licensable activities.

43.4. We further note that under the terms of the 2019 Directive, which lay behind the EA 1989 prior to 31 December 2020, and under the 2019 Regulation, which continues to apply in amended form, the provision of balancing services is envisaged as something which is quite distinct from distribution. Moreover, the terms of the 2019 Regulation make clear that balancing service providers are to be "market participants" and that in such markets "*prices shall be formed on the basis of demand and supply*" (article 3).

43.5. For these reasons we consider that the phrase *"any business that is ancillary to the business in question"* in standard condition 1 as it bears upon CRC 5C.4 must be construed strictly as only encompassing a business that is sufficiently closely connected to the distribution that it is appropriate for Ofgem seek to regulate pricing for that service through the distribution licence.

C. OFGEM'S FIRST ERROR: IT WOULD BE ULTRA VIRES TO DIRECT THAT CLASS BE INCLUDED AS A DRS

C(1) Introduction

44. Having set out the regulatory scheme in some depth, our reasons for why we consider that it would be ultra vires, and hence unlawful, for Ofgem to direct that CLASS be included as a DRS can be taken shortly.

C(2) The proper construction of CRC 5C.4

45. CRC 5C.4 requires CLASS to be a service which is part of the normal activities of a DNO's Distribution Business. That Distribution Business includes any business that is ancillary to the DNO's business of the distribution of electricity through their distribution

system. We have already set out at paragraph 10 above our view that CLASS cannot itself be regarded as a form or aspect of distribution. Having regard to the points at paragraph 43 above, we consider that CLASS cannot be regarded as ancillary to that business either.

45.1. The first, practical, point is that if a DNO were to seek to provide balancing services by other means (such as, for example, by aggregation) then it would not be considered to be conducting the normal activities of its Distribution Business, even if it provided those services in part by using its local distribution network. This is because the provision of balancing services is an entirely different kind of activity to that of distribution: it does not consist in the conveyance of electricity, it is provided as a service to a different body (namely the ESO) through specific markets, and it involves different commercial risks.

45.2. Second, as set out above, balancing services are conceptualised under the legislative scheme as being fundamentally different in nature from distribution and they are subject to a different type of regulatory scheme. Balancing services are not subject to the licensing scheme in Part 1 of the EA 1989 but are instead subject to the market-based scheme provided for by the 2019 Regulations. Balancing service providers are specifically defined as market participants, and article 3(a) of the 2019 Regulation requires that prices in such markets be formed "*on the basis of demand and supply*". We do not consider that regulating CLASS, which is provided as a balancing service, can properly be regarded as an aspect of regulating distribution.

46. This means that the provision of CLASS services does not fall within the scope of the General Principle at CRC 5C.4, and so cannot constitute a DRS under CRC 5C.2. It follows that Ofgem would be acting ultra vires were it to direct that the provision of CLASS be treated as a DRS under CRC 5C.10.

C(3) DRS8 and DRS9

47. We turn briefly to consider the terms of DRS 8 and DRS 9. For the avoidance of doubt, we do not consider that the terms of DRS8 and DRS9 are themselves capable of determining whether Ofgem has power to make the intended direction.

47.1. If the provision of a service cannot fall with the scope of the General Principle at CRC 5C.4, and so cannot constitute a DRS under CRC 5C.2, then it does not matter whether it may fall within the definition of the particular wording of one or more of the categories of DRS.

47.2. Equally, if Ofgem does enjoy the power to direct that CLASS services be treated as DRS under CRC 5C.10, it does not matter whether those services fall within the existing DRS categories.

48. DRS8 and DRS9 are therefore only relevant insofar as they may help shed light on the proper interpretation of CRC 5C.4. In that regard, we note Ofgem's discussion of those categories at ¶¶3.66-3.67 of the 2022 Consultation.

49. The terms of DRS 8 are set out at paragraph 37.1 above. It refers to the services that utilise "Relevant Assets" that are defined in Standard Condition 1 to include *inter alia* land that forms part of the licensee's distribution system.

50. Clearly CLASS would utilise Relevant Assets, albeit that as noted at ¶1.11 of the 2022 Consultation, DNOs would require to invest in additional communications and control systems to provide CLASS services. However, we do not consider that the mere fact that CLASS would be provided by utilising in part, even in large part, a DNO's relevant assets necessarily means that it is ancillary to the distribution business of the DNO so as to fall within CRC 5C.4. As explained above, under the legislative schemes, the provision of balancing services is a different kind of service provision to the provision of distribution services. Providing balancing services is not a part of the normal activities of the Distribution Business. It requires the purchase and installation of additional assets, to add additional capability to the network. Although voltage management is clearly a required aspect of distribution, to provide voltage management to the ESO as a service for the purposes of balancing supply and demand on the electricity system as a whole is a very different matter.

51. Moreover, we note that CLASS is quite different in nature from the types of matters set out in sub-paragraphs (a) and (b) of DRS8.

51.1. Sub-categories (a) and (b) of DRS8 (the installation of electronic communications equipment and the display of advertising) envisage that DNOs can earn revenue

from activities, *"under commercial arrangements"* with a third party, which do not in themselves consist of distribution and which are provided through the use of Relevant Assets.

51.2. However, these two sub-categories do not appear to envisage additional investment and assets on the part of the DNO. Instead they appear to be examples of incidental revenue opportunities which arise as a direct consequences of a DNO holding land for the purpose of its distribution business. In our view, they envisage a relatively passive use of the DNO's land by third parties, which can contract with the DNO to install electronic communications equipment and/or advertising infrastructure on the DNO's land. In that sense they appear to fall within the meaning of ancillary as incidental or appurtenant as set out in the authorities cited at paragraph 43.1 above. Given that the DNO only holds that land in consequence of its regulated role of providing distribution, it can also be understood why revenues associated with that land should be included as DRS.

51.3. We disagree with the view expressed at ¶3.68 of the 2022 Consultation that sub-categories (a) and (b) *"both expressly envisage additional investment"*. Certainly sub-categories (a) and (b) do not expressly envisage investment on the part of the DNO. Rather, they appear to envisage the DNO earning revenue from commercial arrangements with third parties where that third party is providing the electronic communications equipment and/or advertising infrastructure.

51.4. In contrast to sub-categories (a) and (b), in the case of CLASS, it is not simply a matter of earning revenue by virtue of the DNOs' ownership of assets which form part of its relevant business. Providing CLASS services involves active engagement by the DNOs in both investing in and installing the communications and control equipment, and actively engaging in the relevant bidding markets to provide services to the ESO.

52. We therefore do not consider that the existence of sub-categories (a) and (b) provide any basis for regarding a wider category of services as being ancillary to the distribution business, or any support for Ofgem's proposed direction.

53. Finally, for completeness, we note that the power of direction under sub-category (c) is simply a power to reclassify the provision of services from DRS9 to DRS8, and

accordingly depends on the interpretation of DRS9. If a matter cannot fall within the scope DRS9, then it cannot be brought into the scope of DRS8 by the power of direction sub-category (c). We doubt whether the provision of balancing services such as CLASS, which the DNOs would tender to the ESO to provide, falls within the terms of DRS9 as drafted, as it does not appear to be a service *"for the specific benefit of <u>any third party</u> who requests it"* (emphasis added). However, of course, Ofgem retains the power to make a direction under CRC 5C.10 provided that the service in question falls under the terms of the General Principle in CRC 5C.4.

D. <u>OFGEM'S SECOND ERROR: OFGEM HAVE FAILED TO CONSIDER THAT CLASS FALLS OUTSIDE THE SCOPE OF THE SCHEME REGULATING BALANCING SERVICES PROVIDERS</u>

D(1) Introduction

54. As noted above, CLASS falls outside of the scheme of economic regulation established by the 2019 Regulation for governing balancing services providers. On the basis of the publicly available materials in the 2022 Consultation, together with its accompanying Impact Assessment, Ofgem do not appear to have considered this issue.

55. Our view is that this failure is unlawful. The way in which the provision of CLASS by DNOs to the ESO is to be regulated, and the rights and duties conferred on DNOs as a result, is plainly a highly material consideration that Ofgem was required to take into account.

D(2) The applicable legal principles

56. The legal principles are familiar and uncontroversial.

    56.1. A decision by a regulator such as Ofgem will be unlawful if it fails to take into account a material consideration: see the discussion in *R (Peak Gen Top Co Ltd) v The Gas and Market Authority* [2018] EWHC 1583 (Admin) at paras 124 to 135 per Lavender J; *R v Director General of Telecommunications ex p Cellcom* [1999] 11 WLUK 507 at para 27 per Lightman J.

    56.2. A material consideration in this context is one that, on the facts of the case, is 'so obviously material' that it was irrational for the decision-maker to not have taken it into account: *Re Findlay* [1985] AC 318 at p334 per Lord Scarman; *R (Samuel*

Smith Old Brewery (Tadcaster)) v North Yorkshire County Council [2020] UKSC 3 at para 32 per Lord Carnwath.

D(3) The legislative scheme regulating balancing services providers is a highly material consideration to whether DNOs should be permitted to provide CLASS

57. Ofgem have not considered or addressed how DNOs could engage with balancing markets when they are not market participants for the purposes of the 2019 Regulations and appear to fall outside the regulatory scheme of those Regulations.

58. Our view is that this point is so obviously material that it was irrational for Ofgem to not take it into account.

    58.1. Ofgem is consulting specifically on whether and how to permit CLASS's use as a balancing service.

    58.2. The result of Ofgem's minded-to position would be to allow all DNOs to engage in the market with other entities providing balancing services to the ESO, who are subject to the regulatory scheme set out by the 2019 Regulation, where those DNOs do not have the benefit of the same regulatory rights and are not subject to the same regulatory duties, as set out at paragraphs 26-29 above.

    58.3. Ofgem has given no consideration to whether it is lawful for it to permit DNOs to engage in balancing markets under articles 6 and following of the 2019 Regulation when they are not defined as "market participants". Nor has Ofgem considered whether it is lawful for it to permit DNOs to engage in balancing markets when they are not subject to symmetrical rights and duties. For example, the non-discrimination principle in article 6 of the 2019 Regulation only applies as between "market participants" and on its face would allow the ESO to discriminate in favour of or against DNOs. To take another example, DNOs would not be subject to balance responsibility.

    58.4. Nor has Ofgem given any consideration to whether any specific measures are required to mitigate any gaps in regulation that might result from this anomalous position.

59. We therefore consider that, were Ofgem to proceed to implement its proposed direction without considering these issues, it would clearly be acting unlawfully and its decision could be challenged on ordinary judicial review principles.

E. CONCLUSION

60. For the reasons set out in section C, we consider that Ofgem does not have power to make the intended direction.

61. For the reasons set out in section D, we consider that, even if Ofgem does have such a power, any such direction would be unlawful if Ofgem failed to have regard to the material consideration that DNOs are not market participants under the terms of the 2019 Regulation.

PHILIP WOOLFE
Monckton Chambers

OLIVER JACKSON
11KBW

16 May 2022