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Your ref

Our Ref

Date

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Contact / Extension

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Dear DSO & Whole Systems Team

Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control (2022 consultation)

This response is from SP Energy Networks (SPEN). SPEN owns and operates the electricity distribution networks in the Central Belt and South of Scotland (SP Distribution plc) which serves two million customers, and North Wales, Merseyside, Cheshire and North Shropshire (SP Manweb plc) which serves one and a half million customers.

We welcome the opportunity to respond to Ofgem's consultation on CLASS. The transition to Net Zero is giving rise to the need for more system flexibility, and greater consideration of whole system solutions. The deployment of CLASS fulfils both these requirements whilst also reducing customer bills; ensuring everyone can benefit economically from the transition.

As with any solution, it is important to understand its cost and value compared to other potential solutions, so that the most efficient solution can be identified. Competitive participation in a market provides this transparency of value. Aligned to Ofgem's minded-to position, we therefore support model 1a. We agree with Ofgem that this option, which is symmetric in nature, provides the greatest potential benefit to customers by lowering DUoS when DNOs earn a profit through provision of competitive services to the ESO, whilst incentivising DNOs to only invest in CLASS where it is economical and efficient to do so. We believe that this position is completely aligned to Ofgem's responsibility to enable *"innovation which drives down prices and results in new products and services for consumers"*.

For model 1a to be successfully implemented, it is important that there continues to be a clear and transparent way to differentiate between 'CLASS assets' and business as usual assets. We support the continuation of using the definition that CLASS enabling costs are "costs that are solely attributable to providing CLASS". We support this principle-based approach as it is simple, clear and transparent.

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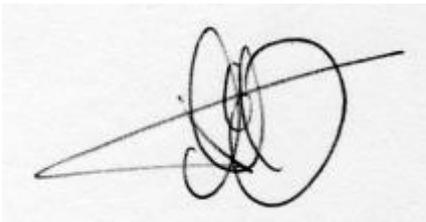
www.spenergynetworks.co.uk

Conflict of interest management

We acknowledge that there may be a perceived conflict of interest with model 1a. It is important to address these perceived conflicts of interest, to ensure that third party service providers have confidence in the market and continue to participate.

We have therefore set out a number of proposed mitigating measures in response to questions 4-9. Importantly, as detailed in question 6, by the start of ED2, we will deliver a new DSO directorate within SPEN which will be discrete from our traditional DNO business. As part of this, a Conflict-of-Interest Management Plan will be in place. This Plan is a key enabler for a number of DSO activities, and for enabling the network-to-network services that will be required to provide customers with a safe, efficient, reliable and decarbonised energy system. These proposed measures are in addition to the mitigating factors set out in Ofgem's consultation document.

Yours sincerely



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Appendix 1- 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?

Yes, we agree that the approach taken in the Impact Assessment was proportionate. We were encouraged that Ofgem included both quantitative and qualitative analysis in their assessment to draw the conclusion that the deployment of CLASS is in the best interest for customers. Given this, we agree with Ofgem that further analysis is not needed.

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 agree that there is some uncertainty over the costs and benefits of deploying CLASS at this stage, given that only ENWL have deployed CLASS, and the technology is still relatively in infancy. We therefore welcome the sensitivity analysis that has been carried out as part of the Impact Assessment. We believe that the three scenarios that Ofgem have used adequately capture the relative uncertainties with CLASS. For example, we believe the downside scenario, by increasing direct costs of CLASS by 50% and including additional indirect costs on asset health and reliability, which we don't believe would ever come to fruition, constitutes an absolute worst-case scenario. We are encouraged that even under this scenario, CLASS continues to offer value to consumers. We also believe that the investment incentive that exists under model 1a offers sufficient protection to consumers from DNOs investing where it isn't efficient to do so.

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?

We agree that there is no evidence that competition is being distorted by CLASS services. We believe that Ofgem's preferred model, 1a, will indeed promote competition in the market balancing services, putting downward pressure on prices and encouraging innovation. In addition to the analysis presented in the consultation document, we do not consider it likely that DNOs will have market power in the future for two further reasons:

1. Project TERRE and efforts by the ESO are encouraging more non-network parties to participate in the balancing services market¹.
2. Most balancing services are non-locational. This means that DNOs are in competition with each other. So even if multiple DNOs developed CLASS services, they would be in competition with each other and so erode each other's market share.

¹ ENWL has been successful in securing contracts for Fast Reserve. The ESO has also contracted with pumped storage, gas stations, batteries and demand response sites for this service, implying that a number of different technology types can provide balancing services in a competitive and diverse market.

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?

The standard distribution licence conditions and the Electricity Act 1989 (**1989 Act**) contain two overriding principles that are relevant here:

1. Section 16(1) of the 1989 Act and Standard Licence Condition (SLC) 12 requires DNOs to make a connection to parties who request one. Therefore, DNOs are obliged to provide connection to any party who requests one.
2. SLC 4 requires DNOs to manage and operate their business in a way that is calculated to ensure that it does not restrict, prevent or distort competition in, amongst other things, the supply or generation of electricity. Therefore, if competing balancing service providers were already connected to a DNO's network, the DNO must treat them equally so as to not risk breaching this condition.

A breach of the Distribution Licence and/or the 1989 Act is a significant matter in which we would face potential enforcement action and, in a worst-case scenario, the revocation of our licence or a significant financial penalty. At up to 10% of annual turnover per licence, these penalties are orders of magnitude in excess of any minor benefit potentially derived from breaching these conditions, and so are a strong safeguard against DNOs not abusing their position.

The Competition Act 1998 also contains two relevant overriding principles:

1. Section 18 prevents parties from abusing a dominant market position. DNOs arguably have a dominant position in the provision of new connections in their licence areas. Therefore, if competing balancing service providers sought connection to a distribution network, DNOs are obliged to provide connection to any party who requests one.
2. Section 2 prevents parties from entering into an anti-competitive agreement. If DNOs were to receive information from the ESO which gave a commercial advantage and used that to enter into a balancing services agreement with the ESO that was detrimental to market competition, then that DNO risks breaching this provision.

Ofgem have concurrent powers with the Competition and Markets Authority to enforce this competition law.

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?

Currently, we have a separate DSO function within SP Energy Networks, with an independent Head of DSO. As per our DSO Strategy², for RIIO-ED2, we will deliver a new DSO directorate within SPEN, discrete from our traditional DNO business. This will fulfil the DSO responsibilities for our two distribution licence areas (SPD and SPM). There are four key attributes of this new DSO directorate:

² [Annex 4A.3 - DSO Strategy .pdf \(spenergynetworks.co.uk\)](#)

1. **A dedicated DSO director.** The DSO directorate will have its own dedicated Director who will report to the SP Energy Networks CEO. The director's sole responsibility will be DSO – they will not job-share across DNO parts of the business. This means there is a single named executive who is accountable for DSO in RIIO-ED2, and it ensures visibility and representation of DSO at board level.
2. **A DSO expert stakeholder panel.** We will create an independent panel of expert stakeholders to guide and inform our delivery of DSO through RIIO-ED2. We will seek representatives from energy suppliers, flexibility market participants, other network companies, academia, technology providers, government / local authorities, and customer representatives. This panel is in addition to direct engagement with stakeholders. The panel's remit will be to:
 - I. Challenge and advise us on the transparency and openness of our Decision Making Framework.
 - II. Monitor our progress against the DSO outputs, listed in Appendix B of Annex 4A.3 (DSO Strategy) of our RIIO-ED2 Business Plan submission.
 - III. Provide oversight and input to investment appraisal and data sharing processes.
3. **Transparency of intervention decisions.** Our new dedicated DSO directorate will increase transparency through:
 - I. Publishing a range of information on all network constraints, initially for the 33kV and 132kV network, so that customers and stakeholders can follow each constraint from initial constraint identification through to how they are managed or resolved. This includes publishing our options assessment and intervention decision rationale.
 - II. All load-related intervention decisions over £2m will be externally assured and the results made public within 10 working days of assurance completion. We will publish supporting information (including our assessment of solutions), so our decisions are transparent.
 - III. Data share across all voltage levels, our Network Development Plan, and publishing flexibility tender results all increase network investment transparency.
4. We will maintain and comply with a **Conflict-of-Interest Management Plan**. This will be developed with stakeholder input and will specifically address CLASS.

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

We agree that option 1a, as a market-based mechanism, encourages the efficient use of CLASS. This is because the ESO has a range of solutions and balancing service providers to choose between; the ESO must identify which solution/provider is the most efficient. To do this they need to understand their relative costs and values. Competitive participation in a market provides this

transparency of value between solutions, and so enables the most efficient solution to be identified.

We believe that Model 1a is the best approach to protect customers' best interests. Under model 1a, there is no incentive for DNOs to invest in CLASS where this is a material risk of losses; the incentive is on the DNO to make sensible and profitable investment decisions. This, combined with the alignment of DNOs interests with their customers' interests, protects customers and means the risk of customers incurring losses is low. CLASS participation to-date supports this view.

We do not feel that the profit share would materially affect a DNO's competitive behaviour in the provision of balancing services. This is because DNOs will still aim to be competitive as they still need to recover their costs of CLASS enabling works (like a third party commercial provider needs to recover its costs), and there is no cap on their potential profits (like a third party commercial provider).

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?

This depends on the CLASS price control mechanism. A price control regime that only funded the DNO to **enable** a certain volume of CLASS services, rather than being funded or rewarded based on whether that CLASS service is used by the ESO, has the potential to result in inefficient outcomes for customers. However, if the price control included an incentive regime or output measures which were linked to the utilisation rate of CLASS services, then there would be a clear incentive on DNOs to only develop CLASS where it was useful (and valuable) to the ESO. We do, however, believe that option 1a creates a more efficient incentive for the use of CLASS.

Question 9: What additional reporting or monitoring in RII0-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.

We believe that other stakeholders may be better placed to answer this question. However, as part of our DSO Strategy, and as detailed in our response to question 6, as part of our new DSO Directorate for ED2 we will put in place a DSO expert stakeholder panel. This independent panel of expert stakeholders will guide and inform our delivery of DSO and it's remit will be to (i) challenge and advise us on the transparency and openness of our Decision Making Framework; (ii) monitor our progress against the DSO outputs listed in Appendix B; and (iii) provide oversight and input to investment appraisal and data sharing processes. Again, as detailed in question 6, we will also increase the transparency of our intervention decisions through multiple channels. In relation to CLASS, we would welcome working with Ofgem to decide on what form this would best take. For example, an annual statement on the use of CLASS from all DNOs.