

06 June 2022

Dear Sir/Madam,

Please see below for SMS Plc's response to Ofgem's consultation "*Future of Local Energy Institutions and Governance*".

1. Are the three energy system functions we outline (energy system planning, market facilitation of flexible resources and real time operation of local energy networks) the ones we should be focusing on to address the energy system changes we outline?

Yes. We agree that these are a good set of challenges to be focusing on.

However, we note that both wholesale market operations (forward trading, spot market, and peer-to-peer trading) and network charging will also be important drivers in how local networks function. The consumer behaviour that these two sources of price signals – dynamic and static signals respectively – will drive should not be overlooked in assessing how the market will operate as more flexibility comes onto the system.

2. Do you agree with the criteria we have set out for assessing the effectiveness of institutional and governance arrangements?

We agree with the set of five criteria that you will apply: accountability; credibility; competence; coordination; and simplicity.

We believe, also, that, given the nature of the consultation and its focus on greater challenges ahead with system management, **openness** and **transparency** ought to form central parts of your assessment criteria as well.

Paragraph 2.18 speaks about how at the distribution level there will be a greater need for more active management at the household level. Paragraph 2.19 sets out the case that effective digitisation and sharing of data across common platforms and formats is a cornerstone of the transition towards net zero.

Your description for the 'coordination' criteria speaks about how "the extent to which information exchange is enabled or hindered" is a good starting point but this is not a strong-enough criteria to ensure that information is provided in the first place to be exchanged. Local system information should be widely available to all current and potential parties, and the provision of it should be a central charge of those running markets.

Decision-making should also be transparent. This covers the results of markets and the data used to arrive at market outcomes.

Local markets will potentially be the focus of many more participants than national balancing services markets, so the provision of useful data to all participants should be a requisite, enforced by Ofgem.

3. Do you agree with our assessment of how far the current institutional arrangements are, or are not, well suited to deliver the three key energy system functions?

We agree with Ofgem's assessment of the current structure of the institutional arrangements governing DNOs. They are not well suited to the task of delivering Net Zero.

The incentives around planning and the development and use of flexibility markets are misaligned at the distribution level and we agree that they should be better aligned, with governance and oversight.

Furthermore, we support Ofgem's assessment of the risks to be addressed via the observations that there are no existing separations of DNO/DSO functions at licence and code levels as there are at the transmission level, and that cost control processes must be developed for these functions.

4. Overall, what do you consider the biggest blocker to the realisation of effective energy system planning and operation at sub-national level?

The two biggest blockers we see at the distribution level are: (1) the lack of operational planning for service dispatch at the transmission level and the distribution level, and; (2) the assessment of the kind of services DNOs/DSOs say they require of local assets compared to the actual mix of asset types and capabilities available locally.

Firstly, there currently exists an operational disconnect between the dispatching of transmission level flexibility – balancing services, BM, wholesale, etc. – and distribution network management such as Active Network Management and non-firm connections. It is difficult to commit to the provision of flexibility at one market level only to be curtailed or restricted at another level. Operational procedures between the ESO and whichever body or bodies are governing local or distributional services must be put in place so that flexibility resources can participate in all markets with certainty. There is a well-known phrase which says that “all politics is local”. The same can be said about flexibility in that “all flexibility is local” in that it must be dispatched from somewhere. There should not be an unaccountable DNO/DSO veto on flexibility provision, so this issue ought to be addressed.

Secondly, the bodies responsible for distribution level flexibility provision should be tasked with looking closely at the potential volumes and types of flexibility available to them in all locations. It may not be possible to deliver hours-long responses at the MW level to a signal. Distribution level services ought to be assessed in terms of second-by-second, minute-by-minute, and hour-by-hour requirements, both in terms of physical system needs and also by the asset base available locally. National Grid's assessments of the growth of heat networks, heat pumps, EVs, domestic level storage, amongst other technologies, should feed in to the assessments of what distribution level flexibility services should – and could – look like.

5. Do you agree with the opportunities of change we outline and the potential benefits they may create?

Yes, we agree with the opportunities for change and with the potential benefits.

6. Are there additional opportunities for change and benefits that we have not set out?

No comment.

7. We set out a number of risks associated with change. Do you agree with these risks and the potential costs they create? Are there additional risks of change and costs that have not been set out?

We agree with the risks and their potential costs which Ofgem has set out. However, we do not think that institutional inertia on the part of the existing DNOs should be a barrier to change.

All parties involved will be aware that there will be costs and risks involved with this necessary change. We will not achieve our Net Zero targets without addressing these risks and meeting these costs.

8. For each model, we have set out the key assumptions which need to be true for the model to offer the right solution. Which of these assumptions do you agree with?

We agree with the assumptions as set out for each model.

9. Out of the framework models we have developed which, if any, offer the most advantages compared to the status quo? If you believe there is another, better model please propose it.

We support the development of Framework Model 3. This model offers the most complete package of operation and regulatory support for the development of system-wide flexibility.

Framework Model 3 also offers the greatest potential for responding flexibly to evolving system needs. The Framework Model 3-proposed separate entity responsible for the set of planning and operation functions can be created with the ability to adapt and change its procedures, markets, and goals as needs change. This would be easier to achieve than continuously requiring multiple modifications across multiple codes as is currently the case.

We support the independence of the proposed Regional System Planner and Operator from the traditional role of the DNO, as well as the connections with the FSO and the GNDs. The coordination role linkages with Local Government are also welcome.

The chief benefit we see is the combination of both network developments and flexibility inputs into the planning process for regional energy. In this way, the value of flexibility will be taken into consideration more fully against network upgrade costs.

10. What do you consider to be the biggest implementation challenges we should focus on mitigating?

Ofgem should focus on reducing the regulatory barriers to the separation of DNO/DSO roles where these roles are currently combined and should simplify the creation of new regulations and cost controls where these do not yet exist.

Ofgem should work with BEIS to create the necessary primary legislation to enable the transfers of responsibility.

If these tasks are assessed to require the timescales of a Significant Code Review, then Ofgem should set out a programme of work and begin immediately. The industry cannot achieve local scale flexibility volumes and markets at the levels required for net zero without these changes, and the UK cannot afford to drift towards the net zero targets under the current unfocused regime.

11. Taking into account the varying degrees of separation of DSO roles from DNOs under framework model 1, do you consider there are additional measures we should consider implementing, in particular in the short term (e.g. changes in accountability etc)?

We suggest that Ofgem places a requirement on all DNOs above any voluntary steps they may plan to make to go as far as UKPN in separating the DNO & DSO roles.

Ofgem should disallow DNOs from participating in flexibility markets directly, in particular where their participation is aided by asymmetrical market information, use of monopoly-controlled assets, and where their participation hinders the capability of other parties to participate.

The roles managed by a DSO, or Regional System Planner and Operator should be separated as early as possible from the roles of the DNO entities which manage the physical infrastructure.

These are goals which we believe Ofgem would be able to achieve early and which would make the transition to full regulatory separation much more natural in the medium to long term .

12. Are there other key changes taking place in the energy sector which we have not identified and should take account of?

The opening of the Wholesale market to smaller participants via the BSC Mod P415 will contribute to the development of local markets, and the rollout of mandatory Half Hourly Settlement by 2025 will have a similar impact.

These changes will make it possible for smaller providers of flexibility to be more active in the market, and when smaller parties become more active this inevitably happens at the distribution level, and at lower connection voltages.

We recommend taking in to account the shape of markets as they are predicted to be affected by these twin changes when assessing local energy governance issues.

13. What do you consider to be the most important interactions which should drive our project timelines?

We believe that the most important interactions are the alignment of market signals with market structures and the development of a regulatory framework flexible enough to respond to evolving systems needs.

Wholesale market signals will drive EV and domestic battery owners as well as domestic space and water heating actions as gas boilers are phased out. The ability to participate in the Balancing Mechanism and in the various Balancing Services markets will help to fund the transition to a more flexible pool of distribution connected assets.

Participation in these markets – in which value is found by responding to a market signal – must be balanced with the safe operation of regional and local networks. This requires the development of DSO-like bodies who can create and manage markets and services which allow flexible assets to interact successfully with the Wholesale markets, the BM, the Balancing Services markets, the Capacity Market, and any other grid services which are developed in the coming years whilst at the same time not overloading distribution networks.

Erecting a structure around which the various required bodies can be created, and can evolve as market conditions evolve, will be the most important guiding principle for Ofgem.

