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Date

7 June 2022

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Dear Victoria,

### Call for Input (CFI): Future of local energy institutions and governance

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 focus and effort that Ofgem is putting on DSO and stand ready to work with Ofgem to deliver a fully functional DSO that benefits our customers. However, we believe that the CFI, and the framework models presented within the document, hugely underestimate the work that has still to be done to fully define the roles, responsibilities, and capabilities of the DSO.

Our track record shows our DSO ambitions are high; we have the desire to deliver change that benefits our customers, the detailed knowledge of our distribution network and stakeholders essential to any DSO transformation.

For example, we have gone from tendering no flexibility before 2019 to tendering for 1.5GW across over 1,550 sites in 2021; we delivered the first reactive power flexibility tender; we delivered the first site-specific pricing signals; we delivered the first fully functioning Universal Smart Energy Framework (USEF) flexibility market in GB; we initiated and contributed over £500,000 per year<sup>1</sup> to the Open Networks project; and we developed the largest DNO innovation portfolio (many of which are Totex funded). Furthermore, to progress development of flexibility markets, we are currently working with Oxera to undertake independent research to understand the barriers currently faced by flexibility service providers and plan to implement their recommendations post- Summer 2022.

In the context of the CFI, Framework Model 1 '*Internal separation of DSO roles within DNOs*' is low-regret and will allow industry to move forward with their plans without distraction, whilst retaining the benefits of the current incentive regime under the RIIO framework<sup>2</sup>. We are now entering a critical period in delivering the interventions needed to meet interim and final Net Zero targets. Significant institutional change, without adequate supporting evidence quantifying the benefits case, will put this at risk by

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<sup>1</sup> There were no allowances for this under RIIO-ED1.

<sup>2</sup> The totex incentive mechanism (TIM) encourages DNOs to make a least-cost trade-off between all categories of their opex and capex within the price control period, so that an operating expense (like payments to a DER) is treated in the same way as a capital expense. The TIM shares savings or increased costs, relative to any under or overspend, with consumers, and provides a strong incentive for DNOs to operate efficiently, including procurement of flexibility to replace or postpone capital investments.

diverting focus and resource away from delivery, placing barriers between DSO planning staff and DNO delivery staff, and exacerbating the existing skill shortage by duplicating roles.

Our proposed approach for RIIO-ED2<sup>3</sup> not only meets the ambitions within Model 1; but delivers more. For example, our stakeholder-endorsed RIIO-ED2 proposals for working with Local Authorities<sup>4</sup> will go significant ways to ensure better alignment with sub-national energy planning and represent a relatively easy solution, rather than significant institutional change, whilst allowing for regional policy distinctions.

A great deal of uncertainty remains around future pathways and it is natural to look at the Electricity System Operator (ESO) arrangements and compare. However, it took approximately 15 years from the inception of a separate ESO function from Transmission Operator (TO) for the ESO to become a legally separate entity (2019). It will take a further 5 years to transition to a Future System Operator (FSO) model in 2024, i.e. approximately 20 years in total. Given the additional complexities at distribution level, Ofgem must be mindful of the need to allow the necessary time and development work to properly implement DSO in a safe and efficient way.

We recognise that there may be some point in the future where it is in customers benefit to move towards a different DSO governance model. However, in the short term, there is fundamental work needed to ensure the DSO model is fully defined, with legal responsibilities and liabilities fully explored. In order to establish this, Ofgem should consider the following in the short term:

**1. An Industry-Wide Transformation Programme must be established to adequately consider fundamental DSO roles and responsibilities in detail before considering any future governance models (akin to BETTA).**

Some practical examples of the fundamental, unanswered issues that must be considered and worked through as part of the Transformational Programme include the following:

- o How will generation and storage connected to the grid be optimised where it can maximise benefit to the end consumer? Flexibility may have a role in ameliorating constraint costs at times of high renewables output, at the cost of increasing demand on distribution systems. DNOs will need to incentivise consumers to increase or move their demand at those points in time. Ofgem and industry must consider how this would be remunerated.

We are currently working with Octopus Energy to seek response from domestic customers to move their demand following an instruction delivered less than 24 hours in advance. We believe this will provide valuable learnings on what is achievable, the level of response we can expect and the impact on our network.

- o The residual demand curve for intermittent generation will have periods of shortfall where storage, for example, will need to be incentivised. This raises fundamental questions on how the system will be optimised across the transmission and distribution networks, in the best interests of consumers, through the charging arrangements. This is likely to become an even bigger challenge in light of the SCR which will reduce connection costs and stimulate a higher volume of activity in already congested sections of network.

**2. The Transformation Programme should work to join up the interacting workstreams within Ofgem and BEIS**

We welcome the wide-ranging workstreams of Ofgem and BEIS and continue to engage with both parties closely. However, we do have concerns over Ofgem's seeming lack of coordination and somewhat opaque policy development process. For example, Ofgem defined DSO baseline

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<sup>3</sup> [Annex 4A.3 - DSO Strategy.pdf \(spenergynetworks.co.uk\)](#)

<sup>4</sup> [Annex 4A.27 - Strategic DNO.pdf \(spenergynetworks.co.uk\)](#)

expectations for 2023-28 in September 2021, which DNOs used to develop detailed DSO strategies as part of their RIIO-ED2 submissions. Ofgem then issued a Request for Information (RFI) in December 2021 seeking information on different DSO organisational arrangements. Ofgem then issued a further RFI in March 2021, seeking information on activities which could be seen to conflict with the principles within the Business Plan Guidance. Finally, Ofgem have published this Call for Input (CFI), which makes little to no reference to the previous documents and proposes yet new governance models.

Related issues, such as the Access and Forward-Looking Charging SCR and distribution flexibility markets, aren't currently being considered together even though they interact: both are about sending pricing signals to distribution customers to operate in ways which benefit the network. The establishment of the FSO, the Access and Forward-Looking Charging SCR, REMA and the DSO are all interdependent. Considering them separately risks inefficient, suboptimal outcomes which could result in customers paying more and whole system conflicts.

### 3. The cost benefit analysis (CBA) methodology and impact assessment (IA) approach used by Ofgem to ensure customer benefits are maximised is critical.

Defining the roles, responsibilities, and capabilities of the DSO as part of the Transformational Programme will be fundamental in allowing for CBA and IA to be undertaken, and we welcome working closely with Ofgem to facilitate this.

The importance of undertaking such analysis was highlighted by Oxera in their recent 'Review of Ofgem's regulation of the energy supply market'<sup>5</sup>, commissioned by the Ofgem Board. They found that no impact analysis had been undertaken to inform policy choices at the time of significant regime changes to test the extent to which the intended outcomes had been achieved without raising negative consequences. Such lack of evidence, if not obtained by Ofgem, in the context of the DSO transformation, would risk the implementation of new framework models being driven by ideology and perceived conflicts of interest, which could compromise genuine consumer value and the timely delivery of Net Zero. Furthermore, this evidence would ensure that any model taken forward is consistent with Ofgem's principal statutory objective under Section 3A of the Electricity Act 1989 (the 1989 Act) to "*protect the interests of existing and future consumers in relation to electricity conveyed by distribution or transmission systems.*" At a high level, such analysis should include consideration of the following:

- Impact on safety: our 3.5m customers depend on SPEN to deliver a safe and secure electricity supply; it is our fundamental role. Integral to this is clear responsibilities and accountabilities, which are aligned to legislation, regulation, codes of practice, and industry guidance. The introduction of new institutions could risk overlapping, inconsistent and/or conflicting responsibilities for operational safety – for customers, staff, and the public. Aside from increased coordination costs, there will be no single party/licence ultimately in control and accountable for safety. With the continuing increase in usage of low carbon technologies, DNO responsibility to manage the safety of distribution assets in customer homes has never been more prominent. We would encourage Ofgem to engage directly with the Health & Safety Executive, and DNOs, to assess safety implications as part of their assessment.
- Impact on reliability (including during storms): having multiple new institutions could inhibit the coordination required between DNO field staff and DSO operational staff to respond to outages.
- Impact on Net Zero delivery: this is an unprecedented time for DNOs to deliver infrastructure critical to the Net Zero transition, in which any disruption that could hinder or defer investment should be considered an opportunity cost to the GB consumer. Delivering interventions in this decade is critical

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<sup>5</sup> [Review of Ofgem's regulation of the energy supply market | Ofgem](#)

to meeting interim and final Net Zero targets. Significant changes risk this delivery by diverting focus and resource away from delivery, placing barriers between DSO planning staff and DNO delivery staff, and exacerbating the existing skill shortage by duplicating roles.

- o Impact on customer bills: our analysis for the December RFI showed some alternative DSO arrangements would result in a net reduction of financial benefits for customers, with the costs of legal separation being approximately four times greater than functional separation. NERA also recently found that, regardless of the degree of DNO-DSO separation, the costs of separation would be substantial, and could be up to around £2.8 billion at the GB level, equating to around £41 (20/21 prices) per customer<sup>6</sup>. Given the current state of the energy market, we would question whether this is necessary when the benefits case has not been proven

Given the significance of these potential risks, the CBAs and IAs need to be thorough and evidence-based<sup>7</sup>. There is currently no real-world experience-based DSO evidence as there is no fully functioning DSO anywhere in the world. For these reasons, we consider it is better to use RIIO-ED2 to gather real evidence and use this as the basis to make informed decisions in the future.

#### 4. Local Energy Planning is vital to successful Net Zero delivery and local institutions must be supported by the industry.

We are the only DNO who operates in Scotland, England and Wales and therefore have unique experience working within different planning and consenting regimes, as well working to meet different ambitions and targets. Through our Strategic Partnerships<sup>89</sup> with the Scottish Government and SEN, we have, and continue to, directly input into the development of guidance on Local Heat and Energy Efficiency Strategies (LHEES), which is now a statutory requirement in Scotland for Local Authorities to have in place by the end of 2023<sup>10</sup>. We also continue to work with the Welsh Government through the Energy Networks in Wales group to contribute to their efforts in ensuring every local authority in Wales has a Local Area Energy Plan (LAEP) in place by the end of 2023/24.

As part of our RIIO-ED2 Business Plan, we have proposed a team of 'Strategic Optimisers'<sup>11</sup> who will provide proactive, upfront, detailed advice through engagement at the conception stage of Local Authorities' Net Zero plans. This includes LHEES in Scotland, LAEPs and general local decarbonisation plans and initiatives. This will allow adequate consideration of the electricity network at the very early stages of planning, whilst allowing SPEN to build Local Authority plans into our Distribution Future Energy Scenarios (DFES) and subsequently our own investment plans. This will help accelerate Net Zero delivery. This approach will provide a good first step to becoming more coordinated with sub-national planning and can be used as a testbed for future arrangements.

We believe the activities explained above should be carried out so well-informed, evidence-based decisions can be made in the future. However, the UK Government has clearly highlighted the need to act urgently in all aspects within the energy industry<sup>12</sup>, meaning low regret decisions should be made now. We have the capability, knowledge, desire, track record, and strong customer links to be at the centre of the DSO transformation and deliver the best outcomes for all customers.

Ofgem's DSO RIIO-ED2 baseline expectations are comprehensive, meet the challenges of this decade, and retain optionality for future DSO arrangements. However, as Ofgem and industry continue to develop and expand DSO roles and responsibilities beyond these baseline requirements, Ofgem must ensure that

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<sup>6</sup> [2022.03.21 NERA Report DSO Strategy for publication.pdf](#)

<sup>7</sup> *This should include analysis of whether transmission separation has delivered net customer benefits.*

<sup>8</sup> [Launch of industry-first trial to decarbonise heat - SP Energy Networks](#)

<sup>9</sup> [New strategic EV Partnership marks important step towards clean energy for transport - SP Energy Networks](#)

<sup>10</sup> [The Local Heat and Energy Efficiency Strategies \(Scotland\) Order 2022 \(legislation.gov.uk\)](#)

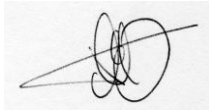
<sup>11</sup> [Annex 4A.27 - Strategic DNO.pdf \(spenergynetworks.co.uk\)](#)

<sup>12</sup> [British energy security strategy - GOV.UK \(www.gov.uk\)](#)

adequate mechanisms are in place for adequate allowances in RIIO-ED2 so as to not defer timely and necessary DSO investment.

Our full response to all the questions included in the CFI can be found in the attached Annex. Please don't hesitate to contact me if you wish to discuss any of these issues further.

**Yours faithfully**



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