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By email only

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Shell Energy Europe response the statutory consultation on *Enabling the competitive deployment of storage in a flexible energy system: changes to the electricity distribution licence*

Dear Sir/Madam

Shell welcomes the opportunity to respond to Ofgem's statutory consultation to introduce new Licence conditions on unbundling rules for Distribution Network Operators (DNOs) necessary to enable the competitive deployment of electricity storage in Great Britain (GB).

We are concerned that the proposed regulatory framework does not go far enough in addressing the conflict of interest that DNOs may have in relation to electricity storage, and that failure to address the potential conflicts of interest will result in effective foreclosure of the competitive deployment of storage in GB. This is because the regulatory framework proposed by Ofgem:

1. does not place any restrictions on DNOs in owning electricity storage;
2. proposes a regulatory framework to address conflicts of interests in the operation of electricity storage, which in our view is likely to be too complex to be effective; and,
3. does not require DNOs to take any actions to promote the competitive deployment of storage on their networks.

We believe that the clearest framework to promote the competitive deployment of storage is full ownership unbundling – which means that a network company is prohibited from any generation or supply activities. The weight of evidence in both European and GB processes, demonstrates that addressing network companies' potential conflicts of interests is fundamental to establishing effective and efficient electricity markets.



This view is also supported by the Council of European Energy Regulators (CEER) in its recent White Paper on the Role of Distribution System Operators (DSOs) ¹. The White Paper highlights three important conditions, supported by European Energy Regulators, as necessary for DSOs to act as neutral market facilitators:

1. A prohibition on DSO ownership/operation of energy storage and electric vehicles' charging infrastructures.
2. Enhancing unbundling is seen as particularly important to ensure the energy transition is achieved to the benefit of customers as many new products and services (of which storage is an example) will have to be deployed.
3. Transparency of a medium-term forecast of network needs/service requirements, so that market participants can react and offer solutions.

As explained in the rest of this consultation response, we urge Ofgem to use this opportunity to implement the CEER recommendations and fully address all potential conflicts of interest inherent in network companies owning and operating generation.

European experience in electricity network unbundling

In relation to unbundling, the main regulatory focus in the last two decades has been on unbundling transmission system operators from generation and supply activities. There are some interesting lessons that Ofgem could draw from this experience, in considering the costs and benefits of different unbundling regimes for GB DNOs. We found that DG Competition's (2005) Energy Sector Inquiry² (the "Sector Inquiry") provides a good evidence-based overview of the challenges associated with inadequate unbundling arrangements.

One of the conclusions reached in the Sector Inquiry is that *"the experiences of full ownership unbundling [in Europe] suggest that it significantly changes the behaviour of the network undertaking: fully unbundled Transmission System Operators ('TSOs') and Distribution System Operators will no longer have the incentive to favour affiliated companies –since there are none–, but can focus on optimising the use of the networks."*

The Sector Inquiry discovered several practical challenges resulting from inadequate unbundling and the potential conflict of interest that this creates:

1. The [network company] is unlikely to have an incentive to connect potential competitors in the generation/supply business to their network.
2. Despite an obligation to [explain] refusals, the existence, location and degree of [network] congestion [on which the refusal is based] is often not transparent.

¹ <https://www.ceer.eu/documents/104400/5937686/The+Role+of+the+DSO/94563e91-008a-fc43-85fb-1f908a210c9b>

² http://ec.europa.eu/competition/sectors/energy/2005_inquiry/index_en.html

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3. It is impossible for market participants to verify whether and to what extent the congestion that was claimed to exist by the network operator is real. Particularly where the alleged congestion can not be attributed to a single generator.
4. A lack of transparency as regards network constraints combined with the obligation on applicants to contribute to network reinforcement [costs] creates considerable leeway for vertically integrated companies to raise their rivals costs for bringing new capacity online.
5. Obstacles can also stem from delays in the grid connection process caused by/attribution to the [network company].
6. Works related to building new network connections [to resolve any congestion] can only be undertaken by the network operator itself, who also chooses the best geographical location of the grid connection.
7. A vertically integrated network operator has no incentive to choose the shortest connection or to make attractive offers for building network extensions and reinforcements that will serve its competitors.

Our primary concern with Ofgem's proposals is that, while the proposals seek to address the potential conflicts of interest associated with DNOs operation of storage assets, Ofgem is not proposing to take any action to address the potential conflicts of interests with DNOs ownership of electricity storage.

We consider that there is strong evidence to suggest that failing to address such conflicts of interest will not only have a negative impact on the competitive deployment of storage, but also on the competitive deployment of other forms of flexibility that would have to compete with DNO owned storage to achieve a return. We expect that failing to address these conflicts of interest now will only require the regulator to take increasingly stronger action in the future.

However, in the case of electricity storage, it would be less disruptive and costly to put in place stricter unbundling requirements now, than in the future when DNOs may potentially have deployed significant amounts of electricity storage on their networks.

The regulatory treatment of DNO owned storage

We understand that economic grid scale electricity storage is a relatively new technology and that scope needs to be provided for network companies to gain a better understanding of the potential for storage to act as a non-wires alternative or to provide ancillary services. Developing this understanding can be achieved through time limited trials where network operators may be allowed to – under certain conditions – own and operate storage. However, we do not think that dispensations from normal unbundling rules to support such trials should be codified into, and provide the basis for, the enduring regulatory framework.

Also, one question not addressed in the consultation is the expected regulatory treatment of electricity storage owned by DNOs. We can see two broad options: firstly, the storage is part of the DNOs regulated asset base; secondly, the storage competes with other generators in the wholesale market and in the provision of ancillary services to network operators.



Our concern with storage becoming part of the DNOs regulated asset base is that this is unlikely to ensure value for money for consumers and would entirely foreclose the competitive deployment of storage. In this scenario we would expect the regulator to prohibit the DNO owned storage from participating in the wholesale market or in providing ancillary services. However, even if DNO owned storage is prohibited from participating in these markets, we would still anticipate an erosion in the potential revenue and business case for the competitive deployment of storage and other forms of flexibility.

If Ofgem is considering allowing electricity storage to become part of the DNOs regulated asset base we suggest requiring the DNOs to allow market participants to bid for the anticipated long-term revenue stream, as this may go some way to protecting consumers interests – and provide Ofgem with a benchmark against which to assess any DNO proposal.

Our concern with DNO owned storage competing in markets for revenue is that, as regulated entities DNOs are likely to have lower cost of financing than their competitors, and in seeking to maximize the value of the storage, there is a strong incentive for DNOs to use their privileged position to (even implicitly) promote their commercial interest. To enable the competitive deployment of storage, we would expect the regulatory framework to seek to address the kinds of conflicts of interest that were identified in the Sector Inquiry.

We also note that National Grid is prohibited from owning or operating storage and consider that the same level of unbundling should apply to DNOs. National Grid may even be viewed as less conflicted than DNOs, due to the greater unbundling of the system operation function. However, we are also concerned that allowing DNOs to own storage will mean that any storage will be built on the DNOs own networks, at points that maximise value for the DNOs. While it may be more economic and better value for GB consumers for storage to be located at different points on the network, including the transmission network.

Conclusion

We propose that ownership unbundling provides a regulatory framework that is both the least costly to implement and best suited to promoting Ofgem's objective of enabling the competitive deployment of storage. Ownership unbundling will remove the need for any complex derogation procedures, for detailed regulatory monitoring and enforcement, and the incentive for DNOs to use their monopoly position to their commercial advantage.

We would be interest to understand why Ofgem considers that ownership unbundling does not provide the most appropriate regulatory framework at this stage. If Ofgem is unwilling to impose ownership unbundling at this stage, we urge Ofgem to take some action to address the potential conflicts of interest that arise from network companies being allowed to deploy and own generation assets.



To achieve this, we propose that Ofgem amend the proposed Licence condition such that the three routes to exemption (A, B and C) become the relevant tests for DNOs to own storage, and to apply the proposed independent system operator requirements in all cases for asset operation.

In case Ofgem is unwilling to place any regulatory restrictions on DNO ownership of electricity storage, we would urge Ofgem to at least acknowledge the potential conflict of interest and take some action to address this within the proposed License condition. Minimum actions that we would propose are to require the DNOs to:

1. demonstrate that they have put in place measures to address the potential conflicts of interests that arise in network companies owning generation assets;
2. take action to promote the competitive deployment of storage and publish an annual report on their progress.

In addition, we would request Ofgem to closely monitor the information provided to the market by DNOs on the best sites for storage, the grid connection process, and the application of network charges, to seek to minimise the scope for preferential treatment of DNO owned storage.

Yours sincerely

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