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Sent by email to: Flexibility@ofgem.gov.uk

Dear Louise, Alex, Edwin & Freya

Position paper on Distribution System Operation (DSO): Ofgem's approach and regulatory priorities

Thank you for the opportunity to share our views on Ofgem's approach to DSO policy development, including Ofgem's priorities and forward work plan. We welcome the recognition that providers of flexible energy resources contribute to system efficiency and that the regulatory framework should encourage efficient levels of investment in flexible technologies and business models.

We support the strategic objectives in the paper. However, the regulatory measures are not sufficient to deliver these. The proposed programme of work falls short of the approach presented at the 10 June stakeholder workshop. Network companies need clearer direction on the key issues around industry structure, removing conflicts of interest, enabling flexibility markets and meeting more ambitious targets on data and other key enablers.

Distribution Network Operators (DNOs) need more oversight in the current regulatory period to ensure they are maximising the potential for market-based flexibility procurement, without overreliance on direct control mechanisms, such as active network management (ANM).

We believe Ofgem must act now to remove DNOs' ability to use their regulated network assets to provide commercial ancillary services to the Electricity System Operator (ESO), reversing the CLASS decision as soon as possible. Waiting until ED2 in 2023 will risk market investment in flexible assets being held back.

We have responded below to the consultation questions and also comment on Ofgem's underpinning philosophies and the coordination with other initiatives.

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Ofgem's underpinning philosophies

We note that the paper does not look at DSO as a single entity. Instead, the paper views DSO as a range of distinct functions delivering smart active operation of the distribution, including through coordination with the transmission system.

We believe several of the DSO functions can and should be delivered by third parties as part of a competitive market. Examples are aggregation of DERs, operation of flexibility trading platforms, dispatch of DER and supply of grid-operational services using DER assets.

Ofgem should develop the CEER decision making framework, presented at the 10 June workshop, with market participants into GB-specific guidance. CEER attempted to create a process for deciding on the areas where DNOs (known as DSOs in EU legislation) should be active and which should be solely left to the market. Centrica supports the CEER position[1] that:

- a market-centric approach for the facilitation of services should be used wherever possible
- that DNO/DSOs should not be active in areas where there is a market and
- there needs to be a clear boundary between a DNO/DSO's core activity and the provision of other services.

Some DSO functions more clearly sit within the remit of the DNO – if we assume that a separate regulated DSO entity is not created in the short term. A practical solution, that retains future optionality for institutional reform, would be to require a minimum level of functional separation of non-contestable DSO functions within the DNO. Some DNOs have started in this direction and other the other DNOs could start implementing this before RIIO-ED2.

Functional separation could help with measuring DNO performance in delivering non-contestable DSO functions and help mitigate potential conflicts of interests, such as when deciding between the procurement of flexibility services and reinforcement, or when deciding to use those flexibility services (as against using non-market-based control tools).

Distribution system operation – coordination with the price controls and other linked initiatives

Policy changes by Ofgem and BEIS need to be coordinated so that revenue opportunities are not removed from the nascent flexibility markets (including via the TCR) before the alternative revenue streams are ready to replace them.

We support Ofgem directing all network companies to include a digitisation strategy in their RIIO-2 business plans. To enable DNOs to deliver the changes needed for the start of ED2, the networks and Ofgem need to be taking steps now. We acknowledge some activities are being initiated but remain concerned that delivering on the objectives could slip well into, or even beyond, the next regulatory period.

[1] CEER (2019) New Services and DSO Involvement https://www.ceer.eu/ceer-conclusions-paper-on-new-services-and-dso-involvement

1. *Do you agree with our strategic outcomes?*

Centrica agrees with these broad strategic outcomes.

Clear boundaries and effective conflict mitigation between monopolies and markets

We agree clarity is needed up-front around DNO participation in certain services, including those Ofgem lists as DSO functions in Figure 2. We welcome Ofgem's recognition that suppliers and other market participants are increasingly able to deliver DSO functions.

We do not agree with the suggestion that DNOs should be participating in markets. The only example where we believe it is acceptable for DNOs to compete with other DNOs and other parties is in the market for connections and network provision. Ofgem has already set regulatory conditions for competition in connections and for IDNOs/AIDNOs.

We do not agree with the justification, as drafted in the position paper, around economies of scale for DNOs providing services. DNOs must not be permitted to compete in the provision of flexibility services. Given the nascent nature of the flexibility market, this could do irreparable damage to the case for private investment, as demonstrated by the impact of Project CLASS.

Electricity flexibility platforms can be and are already being provided by the market. DNOs should use "independent" platforms for procurement, meaning DNOs should not own or operate platforms. This is because of the inherent conflict of interest in a monopsony buyer (with access to free, non-commercial network management options) buying on a market platform that they operate. For reference, wholesale power markets are run by independent third parties – not by the buyers and sellers on those markets.

It is also critical that DNOs do not control end assets with which they have flexibility service contracts: this amounts to the DNOs themselves being aggregators and is contrary to the idea of market provision of services. Aggregators and other commercial service providers are best placed to optimise the flexibility of their assets. Flexibility will not come to market if subject to inappropriate control by DNOs.

We support CEER's starting position that DNOs should not be active in contestable markets. We believe Ofgem should revert to the work done with CEER on boundary setting, noting that the Clean Energy Package provisions restrict DNO participation in electricity storage and electric vehicle charging.

The DNO unbundling and associated compliance programmes should be strengthened further[2] to ensure that all commercial activities – including contestable DSO functions – are fully separated from the regulated business.

We note that the Open Networks Programme's 2019 work plan has been updated to look at conflicts of interest and mitigating actions. Whilst this is welcome, it will be difficult for the Open Networks Programme alone to deliver a solution. DNOs will still require leadership and accompanying actions from Ofgem in this area.

[2] Building on recent improvements linked to Ofgem decisions on storage and Affiliated Independent DNOs (AIDNOs)

Effective competition for balancing and ancillary services, and other markets

Flexibility providers need to be able to stack revenues between multiple markets in order to economically justify investment. The Ofgem paper recognises the importance of this for flexibility project investment cases. We agree that the DNOs, ESO and local energy markets should coordinate to enable this.

We agree flexibility providers need improved information about network and system needs, low barriers to entry and low transaction costs.

Under this principle we need to see measures to ensure DNOs do not misuse 'free' flexibility from Active Network Management (ANM) schemes, instead of procuring flexibility solutions from the competitive market. Overuse of ANM risks undermining flexibility markets. As well as offering a 'free' option to the local DNO, projects on an interruptible connection cannot participate in certain markets. We could support the establishment of a "Red Amber Green" approach to network management, where ANM is only to be used in extreme cases or where flexibility services cannot procured through the market(s).

We reiterate the point that allowing DNOs to use their regulated assets to participate directly in competitive markets for balancing and ancillary services undermines effective competition.

Neutral tendering of network management and reinforcement requirements, with a level playing field between traditional and alternative solutions

We agree with this objective. The DNOs' cost-benefit analyses should be shared with the market to demonstrate transparent decision making. However, DNOs should move away from making contracting decisions through long-term, bilateral tenders which are made through traditional procurement mechanisms. These do not reveal locational or temporal pricing signals to the market. Auction-based markets are well-accepted as promoting liquidity, price transparency, and efficiency (i.e. lowest cost to all parties). Buyers and sellers should create price/quantity pairs of flexibility needs/availability and have the market(s) clear the optimal solution. This approach can accommodate both long-term contracting (required for DNO planning purposes) and short-term procurement.

We note that the ESO historically procured through exclusive, long-term, bilateral tenders, but that it has realised the need to move to shorter-term, auction-based procurement to lower barriers to entry and drive liquidity in flexibility markets. This is the basis of the System Needs and Products Strategy and Power Responsive. If this economic reasoning holds for the ESO, it should also hold for DNOs. The DNOs must learn from the ESO's experience and should not start procuring flexibility in the way that the ESO used to.

Strongly embedded whole electricity system outcomes

We agree with this objective.

Earlier this year Centrica responded to Ofgem's consultation on licence conditions and guidance for network operators to support an efficient and coordinated Whole System. We supported the proposed changes, but, in line with this response, we called for further action to ensure full neutrality of network companies taking actions that impact the whole system. Our key asks included strengthening of the DNO unbundling regime to ensure all commercial activities were separated from the network business and to end DNOs' ability to use their regulated assets to provide ancillary services to the ESO.

We note that whole-system outcomes are a function of flexibility market design. That is, only through enabling price competition for DER flexibility between multiple buyers (e.g. DNOs and the ESO) can we say that a MW of flexibility has received a price that truly reflects its value to the whole system. Such multi-buyer markets can be managed through pay-as-clear auctions.

In terms of transmission/distribution co-ordination, we also note that market platforms are able to perform this function in a transparent way. Co-ordination must not be managed in back-office processes as sellers are unable to know why and when their assets are unable to provide services). Co-ordination can be managed through information being visible on market platforms, and through conflicting bids being resolved in auctions.

In the longer-term whole energy system outcomes should also be considered e.g. considering linkages with heat.

2. *Do you agree that our work programme will help to deliver the strategic outcomes?*

The work programme set out in the position paper is not sufficient to deliver the strategic outcomes. Industry needs Ofgem to:

- set more ambitious and specific targets for delivering the key enablers, where appropriate with penalties for not meeting them,
- set out clear economic principles for the procurement of flexibility, such as independence of market platforms, an appropriate focus on shorter-term procurement, allowing unfettered price signals and transparency of transmission-distribution co-ordination mechanisms.
- give clearer direction that regulated network/system operators cannot participate in contestable areas and
- work with BEIS to define a holistic strategy to enable the development of fully-functioning flexibility markets before the start of the next regulatory period (RIIO-ED2) in 2023.

The Ofgem and industry milestones set out in Figures 3 and 4 must be brought forwards. If Ofgem and industry just work to the dates this paper and the Open Network Project's draft 2020 work plan[3] we see the ultimate objective of a smarter more flexible system slipping beyond 2028 into the following regulatory period.

<u>DNOs and new contestable services</u>

We welcome Ofgem's decision to consult on CLASS. As the original direction can be withdrawn after consultation, we do not see a need to wait until 2023 to end DNO's ability to sell services to the ESO ancillary services market. If the 2020 consultation corroborates market participants view that the CLASS decision is ultimately harming consumers due to it undermining the market and slowing the development of GB flexibility markets, then it should be withdrawn immediately.

We believe Ofgem should consult on CLASS as soon as possible and consider if the consultation can be brought forward into 2019.

Ofgem says that it intends to decide this year if DNOs should have the ability to modulate EV chargers and links this decision to the Smart Energy Code (SEC) modification SECMP0046. We

[3] Included in ENA response to 16th July 2019 Open letter to the ENA Open Networks project from Ofgem and BEIS - https://www.ofgem.gov.uk/system/files/docs/2019/10/on-prj_-_response_to_ofgem_beis_open_letter_0_0.pdf dated 2nd October 2019.

believe Ofgem should consult separately on this issue. SECMP0046 has focussed on the technical solution that could enable DNOs to modulate EV charging through the smart meter. The SECMP0046 working group is not advising on whether DNOs should be able to do this or the governance arrangements that would need to be in place if they did.

The question of whether and how DNOs could modulate EV chargers needs to be discussed separately to the SEC modification. Any decision would need to consider the provisions of the Electricity Directive (EU) 2019/944 Article 33 and the recommendations of the EV Energy Taskforce.

Centrica believes that DNOs should not have direct access to modulate EV chargers. As with ANM connections this creates a perverse incentive for DNOs to use curtailment of household demand as a free option, instead of procuring from the competitive market. We believe that market-based solutions will be available, consumers should have the option of participating in EV-related demand response services and be rewarded for participation.

Ofgem's work programme only includes concrete plans to develop policy positions on these two specific services – EV charging and CLASS. Given that Ofgem has already carried out some work on a broader approach and input into the CEER positions, we do not see why Ofgem could not develop broader guidance on the participation of DNOs in contestable markets.

Key enablers for DSO functions

The key enablers workstream must deliver 'quick wins' in the 'least regrets' areas. Whilst we agree delivery of key enablers is the responsibility of industry, Ofgem can provide more direction and impetus. Industry needs the active participation of Ofgem employees in code change workgroups to provide prompt advice and help remove regulatory blockers.

Improved data provision is the common theme across all the key enablers identified in this section. Centrica supports the recommendations of the Energy Data Taskforce (subject to appropriate protection of personal and commercially sensitive data). We welcome Ofgem's commitment to implement the EDTF proposals, including Ofgem's direction to network companies to produce a digitisation strategy for RIIO-2.

However, industry needs to see improved data provision now. Improved provision of system data is essential for the development of a smart flexible whole energy system. Better quality data provision to market participants will enable investment in flexible and other energy assets in the right place at the right time. Data should be shared and provided in a consistent form across all networks. Network owners and operators should provide data to market participants in the most granular (detailed) form possible.

We welcome Ofgem's proposal to update the Long-Term Delivery Statements (LTDS) as a route for some improvements. Data needs to be provided in a format that meets users needs and to be up to date (reflecting the latest information available to the DNO). We agree with the data best practice list on page 27 and the data key enablers described in more detail in the tables on pages 29-31. However, Ofgem may need to set out the deliverables for DNOs in even more detail to make it crystal clear what needs to be delivered by when.

We have been asking DNOs to improve their heat maps for some time, so that flexibility providers have access to clearer more granular information on where to invest. Some DNOs are better than others. As an example of good practice, the ESO has produced a network capacity map provides good visibility of available transmission capacity for both generation and demand, which

includes an estimate of connection costs at https://www.nationalgridet.com/get-connected/network-capacity-map. The ENA should consider if a similar product could be produced for the distribution networks.

We support the inclusion of 'Network monitoring & visibility enablers' in this position paper. We have also been asking that DNOs must do more to roll out LV and MV monitoring, so that they can see how their network is operating and identify where flexibility services can contribute. Ofgem should focus on ensuring networks maximise improvements before RIIO-ED2.

Development of coordinated flexibility markets

Like Ofgem, we also want to see DNOs improve flexibility procurement and processes that help facilitate flexibility markets. We welcomed the ENA's Flexibility Commitment and Six Steps for Delivering Flexibility Services. Although these are a step on the right direction, more ambition and real action is needed from the networks. We communicated our key asks to the ENA when responding to the Open Networks Project Flexibility Consultation in August 2019.

We generally support the convergence of procurement processes, as proposed by Ofgem Section 1 (paragraphs 3.11 – 3.15). We are engaging in and support the Open Networks Product 4 in WS1A to create a set of standard commercial agreements. Where Ofgem asks DNOs to explain the choice between using ANM and procuring flexibility from the market, this should include a reasoned justification each time the competitive market solution is not used.

Although we broadly agree with the more detailed work programme for this workstream in Appendix 1 we believe further actions are needed to ensure DNOs use true markets that are open to multiple participants. Whilst there is a role for long-term reserve contracts, we believe true markets for flexibility will require:

- Auctions with no pre-published prices that match supply and demand with 'clearing'.
- Use of frequent and shorter-term procurement, providing regular price discovery and enabling 'churn'. The latter allows the market to remain open to new providers and innovative new business models to enter the market quicker. This does not necessarily mean the exclusion of all longer-term contracts. Network operators could use a mix of durations, provided enough short-term products are used and the use of long-term products does not stifle the market.
- Avoidance of price-capping. Price discovery is important for forecasting and efficient investment.
- Multi-sided markets with multiple buyers, that resolve transmission-distribution conflicts in a transparent manner
- Marketplaces that are independent of the DSO/DNO – operated by third parties or with other structural arrangements that guarantee independent operation

DNOs must not create procurement structures or procure systems that give exclusivity or preferential treatment to any single third-party aggregator.

3. *Do you have anything to add to the thinking and analysis that informs how we propose to deliver our programme of work.*

Please note our comments on Ofgem's underpinning philosophies and the linkage with other initiatives before Q1. We underline the urgent need for a more holistic strategy and clearer direction from Ofgem and BEIS to enable the development of markets for flexibility in the near term. Whist we agree with the objectives of this position paper – the proposed work programme needs to be more ambitious.

We support the comments made in Energy UK's response on the detrimental impact to the FR and FFR market from ENWL's Project CLASS participation in ESO markets and back Energy UK's request to stop this activity immediately.

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I hope you find this response useful. If you would like to discuss anything in further detail, please contact me at helen.stack@centrica.com .

Yours sincerely

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