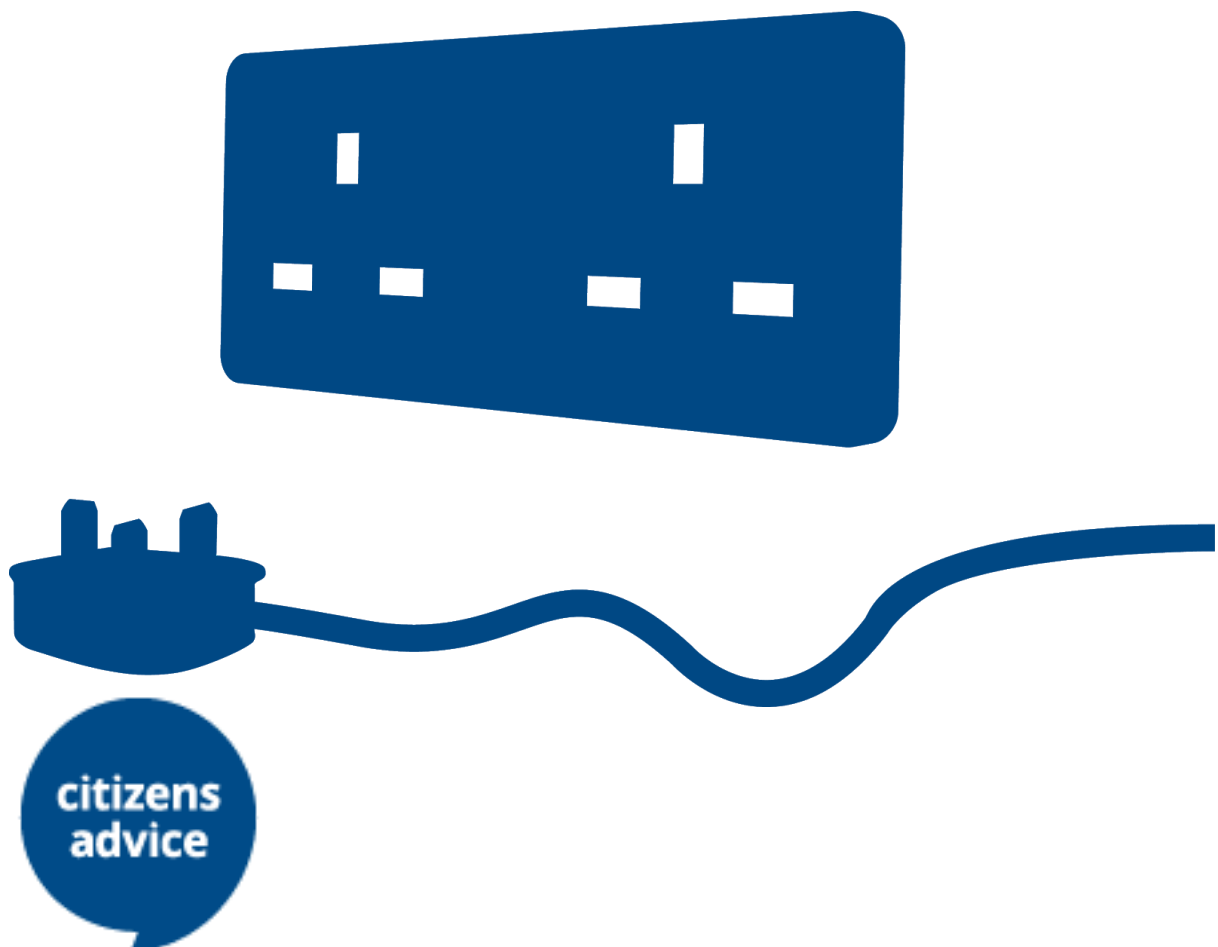


Ofgem Regulatory treatment of CLASS as a balancing service in RII0-ED2 network price control consultation

Citizens Advice submission
March 2020



Citizens Advice welcomes the opportunity to respond to this consultation as part of its statutory role to represent domestic and small business energy consumers in Great Britain (GB). Our response is not confidential and may be freely published.

We understand that this consultation is important as it will lay down the principles to inform Ofgem's position in considering the role of Distribution Network Operators (DNOs) in delivering Distribution System Operation (DSO) functions, including the DNOs' role in flexibility markets and provision¹.

As with Ofgem, we agree with the principle that the DNOs should not undertake activities that can be done by third parties so as to enable wide and effective competition for consumer benefit. Permitting the DNOs to sell CLASS (Customer Load Active System Services) to the Electricity System Operator (ESO) potentially impacts upon this principle. It was allowed under the current price control period (RIIO-ED1) as it is understood that only DNOs could provide this balancing service to the ESO, and that the risks to competition were not material.

Currently the CLASS service is remunerated via charges to the ESO which fall outside the RIIO-ED1 price control allowed revenue mechanism. The DNO is permitted to make these charges under the separate DRS8 (directly remunerated services) mechanism where profits or losses (i.e. after the costs of running the CLASS system) are shared with consumers under the DNOs' RIIO-ED1 totex efficiency incentive rates. Consumer costs would be increased (if there are losses) or decreased (if there are profits) via the Distribution Use of System charging mechanism. The ESO charges consumers for the costs of CLASS via the Balancing Services Use of System charges mechanism. The CLASS service has to compete with other balancing services for an ESO contract.

At present under RIIO-ED1, DNOs' totex efficiency incentive rates range from 53% to 70%. Electricity North West Limited (ENWL) as the only provider of the CLASS service to date has an incentive rate of 58% (i.e. ENWL will retain 58% of any profit or loss, and consumers will receive 42%). By this mechanism, the aim is that CLASS services will only operate if it is in the interests of the company (and therefore consumers) if it is profitable. Loss risk is also mitigated by the company absorbing the higher share of any losses.

¹ [Ofgem, 'Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control' consultation, March 2020, page 30](#)

There are a number of concerns raised in the consultation relating to the continued operation of CLASS as a service operated and charged for by DNOs. These issues include the potential risk of excluding competitors from participating in flexibility provision to the ESO and the risk that DNOs could abuse their position of knowledge to impede connected customers on their network from adequately competing with flexibility services to the ESO.

Citizens Advice has contributed to the ongoing conversation regarding how best to establish effective DSO functions and to facilitate an effective flexibility market. Issues relating to potential and actual conflicts of interest between DNOs and other market participants have been discussed by Citizens Advice in a number of forums and documents. In particular, we participate in the Energy Networks Association Open Networks Project Advisory Group which aims to address potential conflict issues. Citizens Advice also responds to relevant consultations on the topic:

- Citizens Advice response to Energy Networks Association (ENA) Open Networks project Future Worlds consultation, May 2019²
- Citizens Advice response to Energy Networks Association (ENA) Open Networks project consultation on Flexibility, August 2019³
- Citizens Advice response to Ofgem Open Letter consultation on approach to setting the next electricity distribution price control, October 2019⁴
- Citizens Advice response to the Ofgem RIIO-2 Sector Specific consultation, March 2019⁵

² [Citizens Advice response to Energy Networks Association \(ENA\) Open Networks project Future Worlds consultation, May 2019,](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20ONP%20-%20Future%20Worlds%20Impact%20Assessment%20-%20CA%20response.pdf)
<https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20ONP%20-%20Future%20Worlds%20Impact%20Assessment%20-%20CA%20response.pdf>

³ [Citizens Advice response to Energy Networks Association Open Networks project consultation on Flexibility, August 2019,](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20(1).pdf)
[https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20(1).pdf)

⁴ [Citizens Advice response to Ofgem Open Letter consultation on approach to setting the next electricity distribution price control, October 2019,](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20(1).pdf)
[https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20Open%20Networks%20Project%20-%20Flexibility%20Consultation%202019%20-%20CA%20response%20%20(1).pdf)

⁵ [Citizens Advice response to the Ofgem RIIO-2 Sector Specific consultation, March 2019,](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/2Citizens%20Advice%20-%20RIIO2%20sector%20specific%20response%20-%20March%202019.pdf)
<https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/2Citizens%20Advice%20-%20RIIO2%20sector%20specific%20response%20-%20March%202019.pdf>

- Citizens Advice response to Ofgem Key enablers for DSO programme of work and the Long Term Development Statement consultation, February 2020⁶

On the issue of CLASS, we understand the reasoning behind the minded-to position of Ofgem in continuing to permit the provision of CLASS services to the ESO within RIIO-ED2 on the same basis as it is currently under RIIO-ED1. We also appreciate that it appears reasonable to make the best use of DNOs' assets in the interests of balancing the electricity system. However, we would note the following points:

- Ofgem should continue to actively monitor the competitive and market power position of the DNOs providing the CLASS service and take action to address these issues if there is perceived distortion in the market for flexibility services to the ESO.
- Stakeholder feedback should be periodically sought to monitor any potential detrimental behaviour by DNOs in their operation of CLASS services including whether they are perceived to be abusing their knowledge position.
- At present, only ENWL among the DNOs is offering CLASS to the ESO as a service. ENWL is intending to further increase the roll-out of CLASS on its network (from 55% of primary substations to 59%). Reconsideration of the CLASS service may need to occur if the market position changes due to high take-up, including by other DNOs, which could lead to potential distortion in market operation and power.
- Transparency of the CLASS service operation should be made available by ESO to the maximum extent possible, including bid and contract information.
- The current sharing factor between the DNOs and consumers under RIIO-ED1 is in the range from 53% to 70% to DNOs with 30% to 47% to the consumer. Under the proposed continuation of the DRS8 mechanism, DNOs would continue to share profits with consumers at their respective sharing rate under RIIO-ED2. There are implications for consumers if the sharing rate moves from the current levels, which may increase the risks to consumers, with potential changes to both gains or loss profiles. At this stage, it is difficult to evaluate the full risk to the consumer as the sharing factors are still to be determined for RIIO-ED2.

⁶ [Citizens Advice response to Ofgem Key enablers for DSO programme of work and the Long Term Development Statement consultation, February 2020, https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/CA%20response%20-%20Ofgem%20Key%20enablers%20for%20DSO%20programme%20of%20work%20and%20the%20Long%20Term%20Development%20Statement.pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/CA%20response%20-%20Ofgem%20Key%20enablers%20for%20DSO%20programme%20of%20work%20and%20the%20Long%20Term%20Development%20Statement.pdf)

- Consideration should be given to the merit of separating DSO functions, including the operation of the CLASS service, from the DNOs' business as usual activities. This separation may serve to mitigate some of the perceived or actual conflicts of interest that may arise from operating DSO functions within a DNO structure, including CLASS services. We acknowledge that Ofgem is continuing to investigate routes to mitigation of conflicts and that this is an ongoing area of work. We agree with Ofgem's view that a "more holistic, consistent, and principled regulatory approach to managing conflicts and transparency across DNOs' operations is appropriate, rather than introducing several bespoke mitigations"⁷.
- We would welcome further analysis of the differing funding mechanisms for this activity. Specifically, we would welcome modeling of the cost/income profiles utilising both the DRS8 and DRS9 mechanisms to assess the extent of difference between them and how this might serve to incentivise or dis-incentivise a DNO. The DRS9 mechanism offers potentially valuable protections for consumers in removing the risk of losses.

Consultation questions

Question 1: Are there other options that we should have considered? Please provide the reasons for your suggestion.

The consultation has looked at the various options for offering CLASS within the DNO structure as it currently stands. There has been ongoing discussion surrounding the operation of DSO functions within the current DNO structures and whether other solutions could mitigate the risks of perceived or actual conflicts of interest. For example, the ENA Open Networks Future Worlds consultation considered a range of possibilities including separation of DSO functions to a third party body such as the ESO or to a new independent body.⁸ Consideration could have been given to the separation of CLASS operations within a separate body within the DNO entity, or for the operation of CLASS to be undertaken by an independent body with access to DNO CLASS assets. This

⁷ [Ofgem, Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control, March 2020, page 26, https://www.ofgem.gov.uk/ofgem-publications/161255](https://www.ofgem.gov.uk/ofgem-publications/161255)

⁸ [Citizens Advice response to Energy Networks Association \(ENA\) Open Networks project Future Worlds consultation, May 2019, https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20ONP%20-%20Future%20Worlds%20Impact%20Assessment%20-%20CA%20response.pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/ENA%20ONP%20-%20Future%20Worlds%20Impact%20Assessment%20-%20CA%20response.pdf)

separation could serve to mitigate the potential conflicts of interest noted within the Ofgem consultation.

It is stated that CLASS “can only be provided by DNOs”⁹ at page 6 of the Ofgem consultation paper. The consultation also notes at page 9 that the DNOs are required to operate their networks within voltage boundaries set by the Electricity Safety, Quality and Continuity Regulations and therefore DNOs are the only bodies able to operate CLASS. However, it would have been useful to see an exploration as to whether an independent body could have undertaken the CLASS service utilising DNO assets. It is not inconceivable that a trusted third party could potentially operate the CLASS service without impacting the DNOs’ regulatory obligations if appropriate licencing, regulations or safeguards were put in place with the third party body. The ESO, for instance, is permitted to have control over some electricity transmission operations for effective balancing of the electricity system.

Q2. Do you agree that market based mechanisms can provide the most efficient incentive for CLASS participation in balancing services?

Of the options outlined within the consultation for the treatment of CLASS in RIIO-ED2, we would agree that the option to prohibit CLASS is unlikely to be in consumers’ interests. The effective use of existing assets to better balance the electricity system, offer lower charges, and aid in the goal to net zero is important.

Of the remaining options presented, namely a price control remuneration mechanism or the market based mechanism, there are advantages and drawbacks to each option. The price control mechanism has the advantage of scrutiny by Ofgem to assess the efficient costs of installing CLASS, however, it may impede the effective operation of the market for balancing services, as the ESO would be required by Ofgem to take CLASS services. A market based mechanism appears to offer a reasonable compromise in incentivising companies to offer CLASS while permitting the effective operation of the balancing services market.

⁹ [Ofgem, Regulatory treatment of CLASS as a balancing service in RIIO-ED2 network price control, March 2020, page 26, https://www.ofgem.gov.uk/ofgem-publications/161255](https://www.ofgem.gov.uk/ofgem-publications/161255)

Q3. What is your view on DNOs' sharing profits with consumers, even if this means consumers are also exposed to DNOs' losses (including how this might affect DNOs' competitive behaviour noting this is different to other providers of balancing services)?

See also our answer to Question 4 below. We also recommend that DNOs offering CLASS or considering offering CLASS should ensure that they have undertaken appropriate stakeholder engagement including appreciation of the potential risks and rewards to consumers and connections' customers.

Q4. How might limits on charges to the ESO in DRS9 affect investment and utilisation signals for CLASS?

The use of DRS9 appears to offer some advantages over DRS8. DRS9 permits the DNO to recover only its reasonable costs and a reasonable margin for operating the CLASS service. Consumers would not run the risk of losses on CLASS under DRS9 although they also would not gain any potential revenue uplift under this mechanism. Under DRS8, the company is incentivised to offer CLASS where it is profitable as the profits are shared (using the relevant DNO sharing factor) between the DNO and the consumer. However, there are risks to the consumer if there are losses on the CLASS service as the consumer would take a share of these losses. There is also a potential risk that a currently profitable service could become loss-making in the future, if other flexibility providers undercut the CLASS service. Consumers could potentially then be paying for losses on CLASS costs added to the Regulated Asset Value (RAV) for many years or decades to come.

Ofgem notes on page 27 of its consultation that the lower level of potential reward under DRS9 and the need to undertake the administration of complying with the price limit would dis-incentivise a DNO from offering CLASS. There is little explanation or examples given within the consultation on how the cost/income profile would be different between the two options (DRS8 and DRS9) to be able to evaluate whether the DNO would be dis-incentivised under the DRS9 option. It would appear reasonable that DNOs should be able to calculate the costs of the CLASS system from its capital and operating expenditure accounting systems, and demonstrate that these are reasonable, to be able to efficiently operate under a DRS9 mechanism.

We would therefore welcome further analysis and modeling on the likely impact of using DRS9 over DRS8 and whether the collation and demonstration of reasonable costs and a reasonable margin would truly be so complex as to present a disincentive to offering CLASS. The protection to the consumer in not being exposed to losses under DRS9 is a valuable one that should be given full opportunity to be explored.

Q5. Do you agree that requiring CLASS in the price control would not promote efficient investment signals in CLASS and could distort competitive outcomes?

See our response to question 2.

Q6. Do you have evidence CLASS could affect the likelihood of system reliability issues?

No response provided

Q7. Do you have evidence competition is currently being distorted or impeded by the participation of CLASS? Do you agree with our assessment that it is unlikely DNOs have or would have market power in future, and the reasons we have provided in Appendix 2?

We note Ofgem's analysis on the market power position of the DNO currently using CLASS and how there does not appear to be evidence to point to ENWL having market power or distorting competition. We understand, from the low participation in CLASS to date by the DNOs, that there is a low likelihood of current market distortion.

We would welcome further analysis of the likelihood of potential market power positioning and market distortion if a large number of DNOs, or all DNOs, started to offer the CLASS service.

Q8. What information could the DNO have privileged access to that could offer it an unfair advantage in balancing services provision? How might this change in future if the DNO and ESO increasingly coordinate?

DNOs are in a position to potentially disadvantage competitors in their licence areas by refusing, delaying or otherwise interfering with connections to their networks. There are regulatory protections for customers which act to dis-incentivise DNOs from any such unfair practices, including via licence conditions. However, the perception of conflict may continue even in the absence of any evidence of unfair practices.

To alleviate the risks of apparent or real conflicts, we have advocated for the separation of DSO functions from the business as usual DNO activities¹⁰. This could be achieved in a number of possible ways including separation within the DNO entity, by a split of the legal entity (as occurred with the ESO), or provision

¹⁰ [Citizens Advice response to Ofgem Key enablers for DSO programme of work and the Long Term Development statement consultation, February 2020, page 9.](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/CA%20response%20-%20Ofgem%20Key%20enablers%20for%20DSO%20programme%20of%20work%20and%20the%20Long%20Term%20Development%20Statement.pdf)
<https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/CA%20response%20-%20Ofgem%20Key%20enablers%20for%20DSO%20programme%20of%20work%20and%20the%20Long%20Term%20Development%20Statement.pdf>

of DSO services by a third party. We note that Ofgem are continuing to investigate conflict mitigants such as the possible separation of in-house teams or auditing of decisions. It may be that such mitigants are not sufficient to alleviate the continuing perception of conflict risk. We would like Ofgem to also consider more formal separation arrangements as outlined above to achieve a solution to any apparent or real conflict position.

Q9. What measures would you consider effective and proportionate to ensure that privileged information the DNO has access to is not used inappropriately to benefit the commercial performance of CLASS?

Please see the response to Question 8 on separation of DSO functions. We also support reporting on tenders and contracts by the ESO, including CLASS services. We welcome transparency of such flexibility services to bolster confidence in the market.

Q10. In what other ways do you think DNOs could take advantage of their DNO role in the context of providing balancing services with CLASS?

No response provided

Q11. How far 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?

See our response to Question 8

Q12. What additional measures would be effective and proportionate to address actual or perceived risks of DNOs taking advantage of their DNO role?

See our response to Question 8. We would welcome continued review of the market position of DNOs offering CLASS as a service including reaching out to potential impacted stakeholders for their views.

Q13. Are there other specific effects to competition that are relevant to our decision? What effects would these have on consumers?

No response provided

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