

# Decision

## Decision on the proposal to review competition in the electricity distribution connections market for RIIO-ED2

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This document sets out our decision on the scope of our proposal to review the level of competition in the electricity distribution connections market ahead of RIIO-ED2. Our decision is to proceed with the review and invite DNOs to provide completed data submissions for relevant market segments that did not pass, or apply, for the Distribution Price Control Review 5 Competition Test.

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## 1. Executive Summary

1.1. This document sets out our decision on the scope of our proposal to review the level of competition in the electricity distribution connections market ahead of RIIO-ED2.<sup>1</sup>

Our decision is:

- To proceed with the review of competition without making any changes to the current classification of the Relevant Market Segments ('RMS')<sup>2</sup>
- To not consider the level of effective competition in the Excluded Market Segments ('EMS')<sup>3</sup>
- To not consider the level of effective competition in the RMS that previously passed the Distribution Price Control Review 5 Competition Test (the 'Competition Test')<sup>4</sup>
- To undertake the analysis by considering the key and supplementary indicators for competition, as set out in the consultation document, with the inclusion of data from the 2020/21 regulatory year, and
- To collect the relevant data using the data template, which would act as the DNO's final data submission.

1.2. The outcome of this review will inform the extent to which we apply financial incentives on DNO performance<sup>5</sup> and the market segments in which we allow the DNO to apply a regulated or unregulated margin.<sup>6</sup>

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<sup>1</sup> For a link to the consultation document, see [here](#).

<sup>2</sup> Relevant Market Segments refer to the defined market segments where we consider competition is viable.

<sup>3</sup> Excluded Market Segments for this review are LVSSA and LVSSB. LVSSA connections are LV connection activities relating to no more than four domestic premises or one-off industrial and commercial work (i.e., one to four houses). LVSSB connections are connections activities in respect of a connection involving three-phase whole current metering at premises other than Domestic Premises. (i.e., one off LV connections).

<sup>4</sup> Distribution Price Control Review 5 was a price control that ran from 1 April 2010 until 31 March 2015. Between 2012-2014 we ran the Competition Test to assess levels of effective competition in each RMS in each licensee region. Where we saw evidence of effective competition – the DNO passed – and we permitted the DNO to charge an unregulated margin for contestable works.

<sup>5</sup> For all RMS, there are measures in place to ensure DNOs deliver specified standards of performance to consumers, like the Complaints Metric and Guaranteed Standards of Performance ('GSoPs'). See Table 1 in Section 4 for an overview of the performance measures that apply to all RMS.

<sup>6</sup> As part of Distribution Price Control Review 5 ('DPCR5'), we introduced a regulated margin of 4% that DNOs were

1.3. Where an RMS does not pass the competition review, but we consider there to be a prospect of competition developing:

- We have decided to apply financial incentives on performance in the form of the Strategy Delivery ODI and this will apply on a penalty-only basis. For non-contestable services, we will continue to explore the potential application of financial incentives on a reward-and-penalty basis
- We have decided to maintain the 4% regulated margin.

1.4. Where an RMS does not pass the competition review and we consider there to be no prospect of competition developing:

- We have decided to apply financial incentives on performance in the form of the Strategy Delivery ODI and this will apply on a reward-and-penalty basis.
- At this time our minded-to position is to remove the 4% regulated margin. We will consult on this minded-to position for each RMS that we consider falls into this category.<sup>7</sup>

1.5. Lastly, where an RMS passes the competition review:

- We have decided to remove all financial incentives on performance for contestable activities. For non-contestable services, we will continue to explore the potential application of upside financial incentives or rewards
- We have decided to remove the 4% regulated margin and permit DNOs to charge an unregulated margin.

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required to charge connections customers for contestable works in each RMS in their licence areas. This was to create headroom for new entrants to compete.

<sup>7</sup> See paragraph 2.10 for more detail

## 2. Introduction

### Section summary

In this section, we provide a brief overview of the consultation, the reasons we are undertaking this review as well as next steps.

## Background

- 2.1. We set price controls on the companies that operate the electricity networks in Great Britain ('GB') to ensure that current and future consumers receive the network services they require at a fair price.<sup>8</sup>
- 2.2. The next round of price controls for the electricity Distribution Network Operators ('DNOs') will start in April 2023 and will run until March 2028 (RIIO-ED2).<sup>9</sup> As part of this process, we will set outputs and incentives on the service that DNOs provide. These include the service provided to customers requiring a new connection to the electricity networks.
- 2.3. Although most DNO activities reflect their monopoly position, the provision of new connections is an area where competition has the potential to exist.
- 2.4. In making a connection there are some activities that must be undertaken by a DNO. These are referred to as 'non-contestable' activities. However, there are some connection activities that can be undertaken by parties other than the DNO, such as Independent Connection Providers ('ICPs')<sup>10</sup> and licensed Independent Distribution Network Operators ('IDNOs')<sup>11</sup>. The activities where these parties can compete against the DNO are referred to as 'contestable' activities.

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<sup>8</sup> References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work.

<sup>9</sup> RIIO stands for Revenue = Incentives + Innovation + Outputs. The current RIIO-ED1 price control runs from 1 April 2015 to 31 March 2023.

<sup>10</sup> Independent Connections Providers complete and develop local electricity distribution networks but cannot operate or maintain them

<sup>11</sup> Independent Distribution Network Operators (IDNOs) complete, develop, operate, and maintain local electricity

- 2.5. In June 2021, we published a consultation on our proposal to review competition in the electricity distribution connections market. We indicated that we wanted to review the level of effective competition in certain parts of the market to determine if there have been any changes since the completion of the Competition Test, as:
- There could be RMS that did not previously pass the Competition Test in which we see no prospect of competition developing, and
  - There could be RMS that did not previously pass the Competition Test, but where there is now effective competition.
- 2.6. Where competition exists, we limit the application of direct regulation, in the form of price control incentives on service provision. This is because we consider that competition can be a more effective way of delivering improvements in customer service and efficiency than direct regulation, and we do not want price control arrangements that only apply to DNOs and not their competitors to distort competition in the market.
- 2.7. However, in the absence of effective competition, price control incentives are intended to drive DNOs to meet their connections customers' expectations by exposing them to financial consequences depending on their level of performance.
- 2.8. We received 14 responses to this consultation, with 6 from DNOs and 8 from non-DNOs. The non-confidential consultation responses are published on our website alongside this document.

## Next steps

- 2.9. We now invite DNOs to complete the updated data template by 12 November 2021 and send completed submissions to [RIIOED2@ofgem.gov.uk](mailto:RIIOED2@ofgem.gov.uk). For further explanation of the data template, please refer to Section 5 of the consultation document and for guidance, please refer to the 'Guidance' sheet within the data template for instructions on how to complete it.



2.10. Following our assessment of the completed data submissions, we will publish our minded-to positions which will detail which RMS we consider have passed or did not pass this review and what regulatory arrangements we propose to apply. Stakeholders will have an opportunity to share their views on our minded-to positions, and we will consider these, along with data provided in the template when publishing our final decision

## 3. Decision on the scope of the consultation

### Section summary

This section discusses our decision in relation to the scope we will employ for this competition review.

### Introduction

3.1. This section discusses our consultation positions, the responses received and our decisions in relation to the overall scope of this review, namely on:

- The classification of the RMS
- The RMS that passed the previous Competition Test, and
- The key and supplementary indicators for assessing the level of competition.

### Classification of RMS

#### Our consultation positions

3.2. On the current classification of the RMS; our consultation position was that this review would focus on the nine RMS that were established in 2010, where we considered competition in connections was viable.<sup>12</sup> We considered that, for the purpose of evaluating the level of effective competition in the market, the RMS remained appropriate as a means of distinguishing between different types of connections work and customer type in a manner that could be relevant for the purpose of assessing competition.

3.3. On the EMS; our consultation position indicated that this review would not consider the level of effective competition in these market segments, as we have not seen any evidence that competitors are likely to be attracted to work in these segments, and as

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<sup>12</sup> In this document we use the terms 'market' and 'markets' to refer to different segments of the energy sector. For the avoidance of doubt, these terms are not intended to describe or otherwise suggest the approach that may be taken by us for the purposes of market definition, for example in competition law investigations.

such, do not consider that consumers in these segments would be likely to benefit from changes to the current arrangements.

### **Response summary**

- 3.4. The vast majority of respondents that commented on the current RMS classification, indicated that they remained appropriate for the purposes of this review in distinguishing between the different types of connections works and customer type. One DNO disagreed.
- 3.5. A DNO respondent who supported retaining the current RMS classification highlighted how making holistic changes at this stage, could have a significant impact on the DNO's planning for RIIO-ED2, as well as for their ongoing reporting requirements.
- 3.6. A DNO respondent who agreed that the market classification remained appropriate, nevertheless highlighted that some RMS may not necessarily reflect a strong correlation between customer type and the RMS, particularly for Low Voltage ('LV') demand and High Voltage ('HV') demand connections, where there is a broad range of customer types.
- 3.7. The DNO that disagreed with our consultation position stated the current classification does not capture all the distinctions within the market segments and suggested that the existing RMS needed to be broken down on a more granular basis. The necessity of the Unmetered Private Finance Initiative ('PFI') RMS was also questioned, and this DNO respondent stated that a national market study in this area would be appropriate.
- 3.8. Additionally, the small size of some RMS was flagged by a DNO (predicated on the low numbers of activity based on volume), potentially making it difficult to make an informed decision using the key market indicators. In such instances, it was suggested that it might be appropriate to merge these RMS with another adjacent segment and consider the combined segment.
- 3.9. Lastly, with regards to the EMS; respondents that provided views on this topic agreed with our consultation position. Some DNO respondents highlighted that while they may see some competition in these segments, third party activity still remains relatively low, and there presently is not enough competition to consider it appropriate to be reviewed.

3.10. It was also highlighted that any proposal to review the level of competition in the EMS could impact on DNOs' RIIO-ED2 plans.

### **Decisions**

3.11. In relation to the current RMS classification, we have decided that it remains appropriate for the purposes of this review.

3.12. In relation to the EMS, we have decided that we will not review the level of effective competition in the EMS.

### **Reasons for the decision**

3.13. We recognise that alternative RMS definitions may exist. However, we have not received sufficient definitions of these alternative segments, or evidence to demonstrate that these better reflect customer or competitor types. Without the associated historical and current market data associated with an alternative segment, it will be very challenging to establish if this would be a more appropriate categorisation for the benefit of assessing competition. As such, we do not think there is sufficient justification to either merge or further break down / re-classify the RMS for the purposes of this review.

3.14. In coming to our decision, we have also noted the impact that a change to the current classifications could have on DNOs' planning for RIIO-ED2.

3.15. Lastly, in relation to the EMS; we did not receive sufficient evidence to contradict our consultation position.

## **RMS that passed the Competition Test**

### **Our consultation position**

3.16. Since the Competition Test concluded, we have put in place several arrangements to address barriers to competition that might otherwise exist, e.g. the Competition in Connections Code of Practice ('CiCCOP') and Standard Licence Condition ('SLC') 52, that requires DNOs to comply with and report their compliance against the CiCCOP.

3.17. Therefore, in those RMS that previously passed the Competition Test, and where there has been no evidence of non-compliance with the CiCCOP, we consider that

conditions for effective competition exist. In these RMS, we have previously seen evidence of effective competition, and assume that this is likely to have been maintained, or if the level of third-party activity has subsequently declined, we consider that there are no barriers that would prevent it from subsequently returning to previous levels.

### **Response summary**

3.18. There was broad agreement across respondents on our consultation position, with one non-DNO respondent disagreeing.

3.19. Some non-DNO respondents (although in broad agreement with our consultation position), questioned whether there exists a mechanism or reporting to ensure competition has not or does not worsen in these RMS. The non-DNO respondent that disagreed with our consultation position stated that we should put in place reporting arrangements to track whether conditions for competition are worsening in the RMS that have passed the Competition Test (or in which, through this review, we now consider there is effective competition).

3.20. In contrast, other respondents highlighted the requirements of Special Licence Condition Charge Restriction Condition 2K ('CRC 2K'), which stipulates DNOs currently submit their Competition Notice Annual Update, each year, for the RMS which passed the Competition Test. These annual reports provide key market data and information on the improvements and initiatives implemented in these RMS.

3.21. These respondents considered that these reports provide sufficient information to demonstrate how competition has changed, whether positive or negative, without the need to revisit these RMS for the purposes of this review.

### **Decision**

3.22. In relation to the RMS that passed the previous Competition Test, we have decided not to consider the level of effective competition in these RMS.

### **Reasons for the decision**

3.23. We believe that the current DNO requirements of CRC 2K, together with no instances of non-compliance with the CiCCOP and the lack of evidence provided to suggest that competitive conditions may have materially changed in these RMS, all provides us

confidence in our decision not to consider the level of effective competition in RMS that previously passed the Competition Test.

3.24. For clarification, CRC 2K, where DNOs have to submit their Competition Notice Annual Update, will continue to be in place for all RMS that pass this competition review as well as those that passed the previous Competition Test.

3.25. We will also continue to monitor each DNO's compliance with competition law and will take seriously any potential breaches of competition law and anti-competitive practices or behaviour by DNOs. Non-DNOs should report any instances of non-compliance, if they consider there has been a breach, providing all relevant evidence, to our enforcement team.<sup>13</sup>

## **Key and supplementary indicators for assessing the level of effective competition**

### **Our consultation position**

3.26. We proposed to gather data on the following key indicators to assess the level of effective competition in each RMS:

- Market share in terms of the number of offers, accepted offers and the capacity of the connections in MW
- The total number of offers
- Number of third parties operating in a RMS, and
- The value of acceptances.

3.27. Additionally, in cases where key market indicators are not sufficient or do not allow us to draw robust conclusions, and to complement the insight drawn from the key market indicators, we proposed to assess:

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<sup>13</sup> For more details on our enforcement powers, see [here](#).

- Patterns from the Competition Test
- DNO’s qualitative explanation, and
- Supplementary questions.

3.28. In the consultation, we also stated that we would not be considering factors such as DNO behaviour / current processes or customer awareness of competition, as we have put in place arrangements to address barriers to competition that might otherwise exist, e.g., CiCCOP and SLC 52, following the Competition Test.

3.29. Additionally, we stated that we may choose to consider the effectiveness of these remedies, however, at present, this is not the focus of the review. Through this review, we are looking for evidence that effective competition exists to inform the design of RIIO-ED2, as opposed to establishing an understanding of the factors that may be restricting the development of competition.

3.30. Lastly, we proposed considering data on these key market indicators for the regulatory years between 2017/18 and 2019/20. We proposed not to include data from the 2020/21 regulatory year due to the impact of Covid-19 potentially making data from this period unrepresentative of underlying trends.

### **Response summary**

3.31. There was agreement amongst respondents on the specific key market indicators that we proposed. It was flagged that, these key market indicators, when considered in the round, do enable an assessment of the level of market penetration of third parties in a RMS.

3.32. However, despite there being broad agreement in relation to the list of key market indicators, some respondents (primarily non-DNOs) disagreed with the key market indicators being the only data we should consider, and mentioned that DNO behaviour should be taken into account, as it can be a key enabler or obstacle to competition.

3.33. A non-DNO respondent also flagged that, not including DNO behaviour in this assessment, may mask the barriers to entry experienced by some third parties in certain market segments. As such, a qualitative assessment of each RMS, based on feedback from third parties, should be used to supplement the key indicators. This

was reinforced by a DNO respondent suggesting that stakeholder feedback, both positive and negative, of DNOs attempting to facilitate competition, should be considered.

3.34. A DNO respondent requested more detail in relation to how we would use the key market indicators to determine whether there is, or is not effective competition in each market segment.

3.35. A DNO highlighted that DNOs are not the main factor impacting the number of third parties accepting schemes and that this is more influenced by the competition between third parties. This respondent suggested that we apply weightings to different indicators, with more weight placed on overall share than on the number of market participants.

3.36. Providing feedback on the key indicators itself, it was flagged that the value of acceptances is not comparable between those accepted by the DNO and those accepted by third parties; as the DNO's accepted connection offers will include both the contestable and non-contestable work, whereas the third party acceptances will only include the non-contestable work, leading third party acceptances to appear lower in value.

3.37. Additionally, some DNO respondents highlighted concerns with convertible quotations and how it could impact the total number of offers issued by the DNO. One DNO stated that some third parties may occasionally request convertible quotations, which includes both contestable and non-contestable work. These are usually issued to end customers allowing them to choose whether to use the DNO for the full connection, or use a third party for the contestable work. It was suggested that some third parties request this, with no intention of actually accepting the quote. As a result, this DNO respondent believes that this could give a misleading impression on the total number of offers issued by DNOs. A further DNO respondent stated that the convertible quote can be used by third parties, to provide further quotations to end-customers, and DNOs will not know how many such quotes have been provided, impacting the total number of offers issued figures

3.38. One respondent disagreed with our consultation position and indicated that our key indicators, and as a result, our assessment criteria, will not allow us to effectively review whether competition is protecting energy consumers. It was stated that any review of competition should be able to test whether the overall market is effective



and that we should consider more than whether third party presence has increased or decreased over time. To do so, indicators like the Herfindahl-Hirschman Index ('HHI') and more holistic data like the construction of connection assets and adoption of the resulting network should be considered.

3.39. In relation to whether we should consider data from the 2020/21 regulatory year, some respondents indicated that they agreed with our consultation position to not consider data from this year. However, other respondents supported the inclusion of data from 2020/21, with one stating that extra commentary could be provided to highlight any perceived anomalies, and we could make an informed decision on how to use it.

### **Decisions**

3.40. In relation to the key and supplementary indicators, we have decided that they remain appropriate for the purposes of this review.

3.41. In relation to data from the 2020/21 regulatory year, we have decided to incorporate data from this regulatory year into the scope of this consultation.

### **Reasons for the decision**

3.42. We have noted the concerns raised over the disparity in DNO behaviour and how it should be considered as a part of this review. We assessed DNO behaviour in the previous Competition Test in order to identify any barriers to competition that existed and potential ways of remedying these. This analysis led to the development of remedies like the CiCCOP and SLC52.

3.43. Our reason for undertaking this review is different from the previous Competition Test. We are seeking to use the information gathered to establish where to apply price control incentives in RIIO-ED2, so that they do not interfere with the operation of an RMS where there is effective competition. As such, we consider that assessing DNO behaviour and whether it is obstructing competition from developing or not, is not necessarily relevant for the purposes of this review. In addition to this point, we have not seen sufficient evidence of anti-competitive behaviour to suggest that the

effectiveness of existing mechanisms to address barriers to competition, such as the CiCCOP and SLC 52, should be incorporated within this review.<sup>14</sup>

3.44. Additionally, for us to deem that there is effective competition in an RMS, the DNO will first need to pass the Legal Requirements Test. Failure to do so will mean that we will not consider the key and supplementary market indicators. A DNO's RMS passes the Legal Requirements test if it had no enforced breaches of the relevant connections related licence conditions and the Competition Act 1998 in the relevant regulatory year, and is required to satisfy the Legal Requirements Test for all of its Distribution Service Areas ('DSAs'). We ask the DNOs to provide this information, through the data template, by indicating whether it complies with all conditions of the Legal Requirements Test.<sup>15</sup>

3.45. We will continue to take the points raised on DNO behaviour into account in our monitoring and policy developments of the connections market. We have also taken the points raised into account in our decision to further explore the application of upside financial incentives on performance in relation to non-contestable services (discussed further in Section 4); our intention is to incentivise better DNO behaviour and a higher quality of service in a manner that will benefit both end customers and third parties.

3.46. Furthermore, we feel it is important to clarify some aspects of the assessment criteria, in response to the comments raised in responses:

- In assessing the level of competition in each RMS we will be cognisant of levels of competition that exist in the same RMS across other DNO regions. However, we will also take into account any additional information that the DNO provides to inform our understanding of the data provided.
- In relation to considering stakeholder feedback (i.e. non-DNO feedback), as previously stated in paragraph 2.10, following our assessment of the completed

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<sup>14</sup> See Section 6, where general comments on DNO behaviour and calls for a wider review are addressed in more detail.

<sup>15</sup> The Legal Requirements Test means an assessment of the licensee's compliance, in respect of the making of connections to its Distribution System, with: paragraph 12.6 (c) of standard condition 12 (Requirement to offer terms for connection within 65 working days), standard condition 15 (Standards for the provision of Non-Contestable Connection Services – Guaranteed Standards), standard condition 15A (Connections policy and connection performance, e.g. quotation accuracy), standard condition 19 (Prohibition of discrimination under Section 4 and 5), and the Competition Act 1998

data submissions, we will consult on our minded-to decisions. This will provide stakeholders with an opportunity to share their views, and we will consider them in the round with the completed data submissions, when publishing our final decision.

- We are not setting out at this stage exactly how these key market indicators will be used by us to arrive at a decision for each RMS. Our decisions will be made in the round, taking into account all relevant information provided. In relation to key indicators, we consider that there is no single indicator that can be solely relied upon to evaluate whether effective competition exists. All indicators have limitations in this regard, however collectively they can be combined to provide a sufficient insight into the level and nature of competition that exists.
- We note the concerns raised in relation to convertible quotations, however, without evidence of the extent of this issue we are not in a position to make methodological changes to our assessment. In RMS where DNOs consider that the volume of convertible quotations issued may give a misleading impression on the level of competition, we request that the DNO highlight this within the qualitative description box in the data template.
- For clarification, we will not be applying weightings to any of our indicators. Our assessment will be in the round, taking into account all relevant information. We have not seen sufficient evidence to justify placing greater weight on certain indicators over others.
- We will not include additional indicators like HHI, the construction of connection assets and the adoption of the resulting network within the assessment criteria. While these may be a useful indicators to consider in a full market study of competition in the connections market, this is not the scope of this review. The purpose of this review is to understand whether effective competition now exists, or has the potential to exist, in RMS that previously failed the Competition Test. We believe that the data we will gather through the key market indicators is suitable for this purpose, is consistent with the type of data used for the previous Competition Test and we have not seen evidence that this approach has negatively impacted either consumers or third parties. Nor have we seen compelling evidence that an alternative approach is likely to lead to a more effective outcome for the purpose of this review.

3.47. Lastly, in relation to the use of the 2020/21 data, we have decided to change our consultation position. We agree with the respondents that, if the most recent regulatory data is available, it would be appropriate to consider it. Even though we recognise that trends from the 2020/21 year may not be reflective of previous years, it may be a useful to take into account in assessing likely conditions in the market today, and in the near future.

3.48. Alongside this consultation we have provided an updated data template, which allows for the inclusion of 2020/21 data.

## 4. Decision on the application of price control incentives and margin arrangements

### Section summary

This section describes how we would apply financial incentives on performance and whether we will either alter, maintain or remove the 4% regulated margin.

### Introduction

4.1. In our consultation, we described the three potential outcomes following our assessment of data submissions. These are:

- An RMS does not pass the competition review, but we consider there to be a prospect of competition developing,
- An RMS does not pass the competition review, and we consider there to be no prospect of competition developing and,
- An RMS passes the competition review.

4.2. For each outcome, we need to then consider what would be the appropriate regulatory arrangements, in relation to the application of margins and financial incentives, given the extent to which effective competition exists, or has the potential to exist.<sup>16</sup>

### **RMS does not pass the competition review, but we consider there to be a prospect of competition developing**

#### **Our consultation positions**

4.3. In market segments where we do not currently see compelling evidence of effective competition, but where there does appear to be a realistic prospect of this occurring,

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<sup>16</sup> For all RMS, there are measures in place to ensure DNOs deliver specified standards of performance to consumers, like the Complaints Metric and Guaranteed Standards of Performance (GSoPs). See Table 1 later in this Section for a breakdown of the performance measures that apply to all RMS.

we stated that we would need to consider the extent to which financial incentives on performance in these RMS could potentially distort the development of competition. Ensuring consumers receive an appropriate service from DNOs may require exposing DNOs to the threat of a penalty if they are unable to meet expected standards of service. However, rewarding DNOs that exceed these levels (for contestable services) may distort competition in the market, as their competitors would not receive similar financial rewards.

- 4.4. In relation to the application of a regulated margin, we stated that we may choose to retain it. The regulated margin is intended to provide headroom in the price charged by the DNO, to enable third parties a realistic opportunity to compete against them on price. Where there is a prospect of competition developing, removing this margin might stifle potential competition, which may not be in the best interests of the consumer.

### **Response summary**

- 4.5. There was general agreement amongst respondents that financial incentives on performance (i.e. reward-and-penalty, penalty-only etc.) should apply, with one DNO disagreeing.
- 4.6. Non-DNO respondents broadly supported the notion of penalties on poor performances and “bonuses” on good quality service, with the rationale that it would serve to improve competition. A non-DNO respondent stated that a reward-and-penalty approach should be set at appropriate levels, and balanced by stricter penalties, so that the rewards do not significantly outweigh the penalties imposed.
- 4.7. Some DNO and non-DNO respondents highlighted that price control incentives should apply in a penalty-only capacity, given that rewards could offer the DNO a financial advantage over third parties that could inhibit competition by developing. For this same reason, it was highlighted that if rewards were permitted, these should be limited to non-contestable services. Additionally, a DNO also flagged that permitting a reward in these RMS would be “unfair” to the DNOs that have supported competition to the extent that they passed the previous Competition Test, as DNOs

would be better off in RIIO-ED2 by having not passed the Competition Test when it was previously run.<sup>17</sup>

- 4.8. Some DNOs expressed support for a reward-and-penalty approach with one suggesting that the reward be awarded only through a Consumer Value Proposition ('CVP') that demonstrates the additional value the DNOs plan will generate for customers. It was also stated that, while the concerns of distorting competition with the rewarding of DNOs are noted, the DNO is of the view that the award would bring additional welfare to the end customer.
- 4.9. The DNO that disagreed with the application of financial incentives on performance in these RMS, stated that incentives would distort or reduce competition from developing. This DNO also stated that the impact on consumers arising from an absence of financial incentives would likely be relatively low as connectees are protected by a regulated price, CiCCOP licence obligations and the prospect of enforcement action.
- 4.10. In relation to the regulated margin, it was widely agreed that it should continue to be in place in these RMS, and the removal of it may negatively impact on the development of competition.
- 4.11. Some respondents proposed that the level of the regulated margin lowered in subsequent years if there is sufficient evidence that competition is developing. One DNO also highlighted that there may be some reason for us to consider increasing the margin for these RMS, but this must balance the benefits of a higher margin (in relation to competition development) and the drawbacks (in relation to the immediate increase in costs).

## **Decision**

- 4.12. In relation to the application of price control incentives for these RMS, we have decided to apply financial incentives on performance in the form of the Strategy Delivery ODI. For contestable services this will apply on a penalty-only basis. For

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<sup>17</sup> Following the completion of the previous Competition Test, DNOs were not exposed to rewards in RMS that they passed, and had penalty-only incentives in RMS that did not pass

non-contestable services, we will apply financial penalties, but we will also explore whether these can operate alongside upside financial incentives.

4.13. We have decided to retain the 4% regulated margin.

### **Reasons for our decision**

4.14. We have decided to apply the Strategy Delivery ODI on a penalty-only basis, as rewarding DNOs for the provision of contestable services may distort competition in the market, as competitors would not receive similar financial benefit for the provision of the same (or better) service. For non-contestable services, exposing DNOs to the threat of penalties if they are unable to meet the expected standard of service, will help to ensure DNOs deliver adequate service.

4.15. In relation to non-contestable services, we consider that there could be potential merit in applying upside financial incentives, therefore, we have also decided to further explore the possibility of applying them through the Strategy Delivery ODI. This could drive improvements to the service provided to end consumers without distorting competition in the market, as third parties do not compete with the DNO in the provision of these services. Additionally, third parties rely on DNOs for the provision of non-contestable services, therefore, improvements in this area might equally benefit third parties. However, we note that at this time it is not entirely clear how these incentives would apply, so that only performance in relation to the provision of non-contestable services is rewarded.

4.16. In relation to the application of the regulated margin, we consider that removing it may stifle the development of competition, and would not be in the best interest of existing or future consumers.

4.17. We have not seen evidence to suggest that a different level to the 4% margin would provide a better balance between providing headroom for competition to develop and protect existing and future customers.



## **RMS does not pass the competition review, and we consider there to be no prospect of competition developing**

### **Our consultation positions**

- 4.18. We stated that we may choose to use price control incentives in RIIO-ED2 to improve the level of connection services DNOs provide. In these market segments, the application of incentives may be unlikely to distort competition. We may therefore choose to apply a combination of penalties to ensure an adequate level of service is provided, and rewards to drive DNOs to continually improve their service offering.
- 4.19. In relation to the regulated margin, we stated that we may choose to remove it, as the additional cost of maintaining the 4% margin, may not be in the best interests of the consumers.

### **Response summary**

- 4.20. We received mixed views for how these RMS should be treated. Non-DNO respondents questioned why the status quo of no-competition would be tolerated or accepted, and that financial incentives on performance and mechanisms should be put in place to induce competition. A non-DNO also suggested that “agile” incentives be put in place to accommodate any sudden increases in connections activities.
- 4.21. Some DNOs indicated a preference for a reward-and-penalty approach, with the rationale being that DNOs should be held to account where they do not deliver in these RMS and the rewards would act as an incentive to exceed minimum standards of performance.
- 4.22. A DNO also highlighted that permitting rewards in these RMS may be reasonable for higher quality service. However, we should take into account the level of competition that exists in the equivalent RMS in other regions. For example, it may be reasonable to apply rewards if there is only limited evidence of competition existing in other RMS, as this may indicate that the lack of competition was not due to factors such as the behaviour or processes applied by an individual DNO.
- 4.23. One DNO flagged that financial incentives on performance may not be necessary. This DNO noted that the regulated price of connections, alongside the relevant

licence obligations in respect of CiCCOP, and combined with enforcement action would serve to sufficiently protect customers in these RMS.

- 4.24. One DNO mentioned that the most appropriate treatment of these RMS would be to align the regulatory arrangements with those applied to the EMS, where there is an equivalent absence of competition.
- 4.25. Responses were mixed on whether the regulated margin should be maintained or removed. One DNO indicated that a 4% regulated margin should be maintained in these RMS, as removing it could deter competition from developing. Lower margins could be a barrier for third parties due to reduced DNO prices, and should only be pursued if there is absolutely no competition present or likely to develop in a market segment.
- 4.26. A non-DNO respondent indicated that the removal of the margin would likely be in the best interest of consumers but could subsequently be re-introduced as a means of inducing competition, if there is a sudden growth in competitive activity.
- 4.27. A DNO that disagreed with the removal of the regulated margin in these RMS believes that competition could be developed through innovative means if we incentivised DNOs to do so, and as such, the focus should be on exploring ways in which this could be possible and maintaining the regulated margin while doing so.

## **Decision**

- 4.28. In relation to the application of price control incentives for these RMS, we have decided to apply financial incentives on performance in the form of the Strategy Delivery ODI and this will apply on a reward-and-penalty basis.
- 4.29. Our minded-to decision is to remove the application of a 4% regulated margin in these RMS.

## **Reasons for our decision**

- 4.30. We have decided to apply the Strategy Delivery ODI on a reward-and-penalty basis for both contestable and non-contestable work, as we believe this will not distort competition, where there is a current absence of competition and no evidence that there is a prospect of competition developing. Competition has been permitted in the

connections market for approximately 20 years. In that time, we have introduced a range of different measures to stimulate competition, and we now have licence conditions and the CiCCOP to provide protection to third parties from barriers that that may arise through DNO practices and processes. If we now conclude that there is simply no evidence that competition is present or likely to develop, then in line with our statutory duty we must consider how best to protect consumer interests. Where this is the case, we consider that incentives on DNOs to not just deliver minimum standards of service, but also to exceed these, are appropriate.

- 4.31. In relation to the regulated margin, we consider that maintaining it would not be in the best interest of the customers, as the additional headroom brought about by the 4% margin ultimately only leads to extra costs to the connecting customer. Additionally, this extra cost would not be justified as a means of facilitating competition, as the data would indicate the absolute lack of competition or prospect of its development. As previously stated, we will consult on the application of this minded-to decision in relation to any RMS where we consider there is no prospect of competition developing. This will provide stakeholders with a further opportunity for comment, which we will consider when publishing our final decision.

## **RMS that pass the competition review**

### **Our consultation positions**

- 4.32. We indicated that we are likely to limit the application of price control incentives in RIIO-ED2, in particular, those that might apply to contestable services. This is because we consider the presence of competitive pressure to be sufficient to ensure customers receive high-quality connection services, and that competition could be distorted by exposing DNOs to financial incentives that their competitors are not subject to.
- 4.33. In relation to the regulated margin, we stated that we may consider removing it and permitting DNOs to charge an unregulated margin, in the expectation that competitive pressure should drive prices to the efficient level.

### **Response summary**

- 4.34. Most DNO respondents indicated that where a competitive market exists, market forces would determine the outcomes for market participants and as such, incentives (both reward and reward-and-penalty) do not need to be applied to contestable

services as competitive pressure should act as the incentive to improve service levels. This view is applied to the regulated margin as well, where most DNO respondents and one non-DNO respondent indicated that the DNO should be allowed to charge an unregulated margin, based on the existence of competitive pressures.

4.35. Most non-DNO respondents were more supportive on the application of financial incentives, noting that limiting these and enabling DNOs to charge an unregulated margin may restrict competition. They considered that the existence of these financial incentives on performance, as well as the regulated margin, may have contributed to the development of competition and their removal could have a detrimental impact. It was stated that we should target incentives in areas which allow the continuation of the development of competition.

4.36. A non-DNO respondent also indicated that penalties on poor performance in areas where there is competition and rewards for higher quality service in non-contestable activities would be supported, given the increasing difficulty in obtaining non-contestable connection services in some DNO regions.

### **Decision**

4.37. In relation to the application of price control incentives for these RMS, we have decided to remove all financial incentives on performance for contestable activities. For non-contestable services, we will continue to explore the potential application of reward-and-penalty financial incentives.

4.38. In relation to the 4% regulated margin, we have decided to remove it and permit DNOs to charge an unregulated margin.

### **Reasons for our decision**

4.39. We consider that where effective competition exists, this is likely to be the most effective means of driving a high quality of service of customers. Financial incentives on performance are designed to mimic the presence of third parties in their absence. Therefore, where effective competition has developed, these incentives are likely to be redundant, and have the potential to distort competition. This is particularly relevant for the provision of contestable services in these RMS.

4.40. In relation to non-contestable services, we have decided to further explore the possibility of applying financial incentives through the Strategy Delivery ODI. As noted previously, at this time, it is not entirely clear how these might be applied so that only performance in relation to non-contestable services are subject to the financial incentive. If we conclude that it is possible to apply financial incentives focussing solely on non-contestable services, then we will also need to consider whether these should be applied to RMS that previously passed the Competition Test.

4.41. In relation to permitting DNOs to charge an unregulated margin; if there is effective competition, then we do not believe direct regulation in the form of Ofgem determining the margin that DNOs can charge is appropriate. Competitive dynamics should lead to margins being set at the efficient level, or DNOs will lose market share. There is a risk that a level of margin that has been predetermined by Ofgem could be either set too high or too low and in either event this could distort competition.

**Table 1: Summary of the impact of the competition review on RIIO-ED2 output and incentive arrangements**

Incentive / Measure	Excluded Market Segments	An RMS passes the competition review		An RMS does not pass the competition review, but we consider there to be a prospect of competition developing	An RMS does not pass the competition review and we consider there to be no prospect of competition developing
		Contestable	Non-contestable		
4% Regulated Margin	Not apply	Not apply	Not apply	Apply	Not apply <sup>18</sup>
Guaranteed Standards of Performance (GSoP)	Apply	Apply	Apply	Apply	Apply
Time to Connect Incentive	Apply	Not apply	Not apply	Not apply	Not apply
Customer Satisfaction Survey	Apply	Not apply	Not apply	Not apply	Not apply
Complaints Metric	Apply	Apply	Apply	Apply	Apply

<sup>18</sup> Presently, we are minded-to remove the regulated margin under these RMS

Strategy Delivery ODI	Not apply	Not apply	Apply	Apply	Apply
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## 5. Decision on the data template

### Section summary

This section discusses our consultation positions, the responses received and our decisions in relation to the data template, through which we will request for relevant data to conduct this review

## Data template

### Our consultation position

- 5.1. The data template would serve as the primary source of information for reviewing the levels of competition in the RMS.<sup>19</sup>
- 5.2. We requested both contestable and non-contestable data from DNOs. However, the key figures we would be taking into consideration in our final analysis would be the contestable figures, as third parties do not undertake non-contestable activities.
- 5.3. We proposed to only use the data template to capture data from the 2017/18, 2018/19 and 2019/20 regulatory years.
- 5.4. We also sought views on whether the structure of the data template remained appropriate to undertake our analysis.

### Response summary

- 5.5. Generally, the responses in this area came from DNOs, and they were of the view that broadly, the template appears suitable to collect the appropriate data to undertake this competition review. However, some responses indicated that more guidance was required on how DNOs should complete it in a standardised manner.
- 5.6. It was also flagged that some of the data in the template is also not routinely captured for regulatory reporting purposes, in particular data on reinforcement and total capacity. However, it was mentioned that this data is captured in DNO systems,

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<sup>19</sup> We are not reviewing DSAs generically, rather RMS within a DSA.

but will require additional data assurance and manual validation work to ensure it is appropriate for our work. We were asked to consider whether we had a meaningful need for this data, in light of resource burden.

## **Decision**

5.7. In relation to the data template, we have decided that this will serve as the primary source of information for reviewing the levels of competition in the RMS and invite DNOs to provide sufficiently complete submissions for all RMS that did not pass or did not apply for the previous Competition Test.

## **Reasons for our decision**

5.8. In the last Competition Test, some DNOs did not submit Competition Notices for certain RMS, under the rationale that market activity in these RMS was very low and effective competition had not developed. We invite these DNOs to provide submissions for these RMS for us to understand how the competition landscape has since developed.

5.9. For clarification, we consider the data we have identified is likely to be necessary for us to have a meaningful understanding of the level of effective competition in the RMS. We do not consider that the additional resource burden that a DNO has claimed this would impose, outweighs the value of us being able to assess competition in a market to a sufficiently degree.

5.10. In line with our decision to gather information from the 2020/21 regulatory year, as set out in Section 3, we have amended the data template to accommodate for this information.

5.11. We have provided more detailed guidance on how to complete the template in the guidance sheet of the data template. We have also made some changes to formula and structure to improve accessibility – these have been documented in the template as well.

5.12. While the data gathered through the data template will serve as the primary method of data collection and analysis, we consider that there is no single indicator that can be solely relied upon to evaluate whether effective competition exists. All indicators have limitations in this regard, however collectively they can be combined to provide



a sufficient insight into the level and nature of competition that exists. Additionally, this information would be considered, in the round with stakeholder feedback from our minded-to decisions.

## 6. General comments

### Section summary

This section discusses the comments we received on DNO behaviour, the IDNO's relative price control, re-running of the competition review in RIIO-ED2 and other connections related feedback.

6.1. Through their responses, respondents also raised points around:

- **DNO behaviour acting as a barrier to competition:** flagged by non-DNO respondents who stated that administrative issues like delaying the provision information imposes additional cost and time pressures on third parties in obtaining a connection. As a result, it was stated that we should consider this within our review, due to the fact that DNO behaviour can be an enabler or obstacle to competition;
- **Request for us to review the IDNO price control arrangements:** flagged by a DNO respondent, to assess whether these are appropriate. It was stated that we should focus on conducting a larger review that analysed whether competition in the connections market is sufficiently protecting energy customers. The current relative price control for IDNOs was flagged as one of the areas that we should consider, on the basis that it was implemented over a decade ago. Additionally, it was stated that we should consider whether the "uneven playing field" in place, in relation to tariff support for connection charges, is serving or harming energy consumers; and
- **Rerunning this competition review during ED2:** to assess whether circumstances have changed.

6.2. To clarify the purpose of this review; our fundamental reason for undertaking it is to apply price control incentives appropriately in RIIO-ED2, and as such, we are of the view that considering DNO behaviour or the IDNO's relative price control, in the capacity suggested by respondents, is not necessarily relevant, for the purposes of this review. We have not seen sufficient evidence of DNO malpractice to justify a wider review at this time, but we will continue to monitor activities and note that annual reporting requirements, together with the CiCCOP provide us with a

reasonably high level of visibility on changing market shares and complaints around DNOs failing to comply with CiCCOP. We will consider this information, together with other evidence that may be made available to us, in any future decision to review the connections market more widely.

- 6.3. In relation to specifically re-running this competition review during RIIO-ED2; we will only consider this, if we consider that sufficient evidence has been provided that doing so will likely lead to consumer benefit and that this work should be a priority use of Ofgem resource.
  
- 6.4. Other comments such as the lack of transparency in relation to the cost of reinforcement and the introduction of competition at the pre-application stage, were raised by respondents. While these comments have been noted, we are view that these fall outside the remit of the consultation and as such we do not view this decision document as an appropriate place to provide a response to them. For any connections related queries or concerns, please contact [connections@ofgem.gov.uk](mailto:connections@ofgem.gov.uk).