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15 October 2019.

Sent by email to: [RIIO2@ofgem.gov.uk](mailto:RIIO2@ofgem.gov.uk)

Dear Akshay,

**Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2)**

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

The *RIIO-2 Sector Specific Methodology*<sup>1</sup> for the transmission and gas distribution sectors is an improved framework, compared to that for previous price controls. We welcome these improvements being used as the basis upon which the framework for the RIIO-ED2 price control will be constructed.

The context that influences what distribution network operators (DNOs) should deliver during RIIO-ED2 is clearly set out in the consultation. Legislative targets for reducing emissions are now in place, and the transition of the energy system will continue and is likely to be accelerated. The requirements to support decarbonisation, decentralisation and digitalisation are expected to materially change how networks are operated, maintained and expanded. Therefore, we believe the following are important:

- **The role of DNOs as neutral market facilitators should be embedded in the RIIO-ED2 arrangements.**
- **Mechanisms for regulating Distribution System Operation functions should only be developed for those functions that cannot be delivered by competitive markets.**
- **Significant progress in implementing the recommendations of the Energy Data Taskforce is needed ahead of RIIO-ED2.**

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<sup>1</sup> See <https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-decision>.  
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**The role of DNOs as neutral market facilitators should be embedded in the RIIO-ED2 arrangements:**

Several sources, such as the Committee on Climate Change, cite the volumes of decentralised and low carbon/renewable sources of power needed to meet emissions reductions targets. However, connecting these power sources should not equate to an equivalent level of network expansion. It has been estimated significant savings in expenditure arising from deferred and avoided expenditure can be achieved if network companies utilise flexible resources<sup>2</sup>.

It is essential that competitive markets for flexibility services are allowed to develop, to realise this value for consumers. This means the roles and responsibilities of DNOs as neutral market facilitators need to be embedded in the RIIO-ED2 arrangements. Reliable, timely and good quality data relating to network needs should be made available to market participants, so that the industry can efficiently respond to the broad investment signals. DNOs should not be permitted to undertake activities that can be delivered by competitive markets, including providing ancillary services and modulating charging of electric vehicles, unless it can be demonstrated that DNOs delivering those activities represents better long-term value for consumers. In those circumstances, the activity should be treated as a regulated service with DNOs receiving the level of return consistent with the other regulated activities.

**Mechanisms for regulating Distribution System Operation functions should only be developed for those functions that cannot be delivered by competitive markets:**

We welcome Ofgem sharing its initial position on its approach and regulatory priorities for Distribution System Operation (DSO) functions<sup>3</sup>. The ways in which each DSO function is regulated is likely to depend on several factors, including by whom each is delivered. The principles and processes for identifying the party or parties best placed to deliver each service should now be defined and the identification progressed. Importantly, services that are already delivered (e.g. aggregation) or can be delivered by competitive markets should be excluded from scope.

Considerable benefits for consumers could be derived from increasing competitive forces in network operation, maintenance and expansion. The operation of competitions should be separate from traditional DNO functions. Instead, operation of competitions should be treated as a DSO function. As a minimum, this function should be delivered under strict functional separation arrangements within a DNO, if not by an entirely separate entity. Indeed, some DNOs are already investing in functional separation arrangements<sup>4</sup>. This should mitigate concerns about potential conflicts of interests. Obligations on DNOs relating to competition may need to be strengthened.

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<sup>2</sup> See:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/568982/An\\_analysis\\_of\\_electricity\\_flexibility\\_for\\_Great\\_Britain.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/568982/An_analysis_of_electricity_flexibility_for_Great_Britain.pdf).

<sup>3</sup> "Position paper on Distribution System Operation: our approach and regulatory priorities":

[https://www.ofgem.gov.uk/system/files/docs/2019/08/position\\_paper\\_on\\_distribution\\_system\\_operation.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/08/position_paper_on_distribution_system_operation.pdf).

<sup>4</sup> For example, Western Power Distribution states it "has restructured Strategy, Design, Innovation and Policy sections to effect a clear reporting line between DNO activities and DSO activities". See:

<https://yourpowerfuture.westernpower.co.uk/downloads/39199>.

It would be preferable to consider the regulation, allowances, outputs and incentives for DSO functions ahead of the start of the RIIO-ED2 price control review. This will make transparent what will be funded by the settlement. Further, this makes it easier to allocate DSO functions to different parties or progress changes to industry arrangements if necessary. This should make it less likely that some of the issues encountered resulting from the legal separation of the Electricity System Operator within the National Grid group during the RIIO-T1 price control will recur. A reopener mechanism should be included in the framework to cater for this eventuality.

**Significant progress in implementing the recommendations of the Energy Data Taskforce is needed ahead of RIIO-ED2:**

We welcome Ofgem stating DNOs must act on the principle that data is presumed open, and that they must readily collect, manage and share data on the networks that they own. Reliable, timely and good quality data are needed to support the decarbonisation, decentralisation and digitalisation of the energy system. However, some DNOs may still maintain legacy approaches to data collection, which are unsuitable for supporting the operation of a smart energy system. We also recognise the variability in the approaches to data collection across the sector.

Significant progress in implementing the Energy Data Taskforce (EDT) recommendations can and should be made ahead of RIIO-ED2. Regulatory initiatives may be required to support implementation. DNOs should be required to develop and deliver an ambitious roadmap for collecting, managing and sharing data on their networks, to ensure that they do not hinder innovation and digitalisation of the energy system. The roadmap should necessarily include the definition of data standards that are common across the sector. This will facilitate industry participants being able to make better use of the data to be made available.

We acknowledge DNOs may not have been explicitly funded for activities similar to those required to implement the EDT recommendations when the RIIO-ED1 price control was set. However, given the criticality of reliable, timely and good quality data for supporting the transition of the energy system, providing remuneration for efficiently-incurred expenditure should be considered as a part of the closeout of the RIIO-ED1 price control or as a part of the RIIO-ED2 settlement. Expenditure to be remunerated should be only that which is needed to deliver the roadmap as proposed above. Ofgem should ensure ex-ante funding provided for data-related activities is taken into account when considering whether additional funding should be provided.

Answers to the consultation questions are in the attached appendix. I hope you find these comments helpful. Please contact me if you would like to discuss any aspect of our response.

Yours sincerely,

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Head of Network Regulation, Industry Transformation, Investigations and Governance  
**Centrica Regulatory Affairs, UK & Ireland**

## Appendix – answers to the consultation questions

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### Proposed objectives for RIIO-ED2

#### 1. Do you have any views on the proposed objective for RIIO-ED2?

The proposed overarching objective is the same as that developed for the other network sectors. Since then, the UK and Scottish Governments have legislated to set the new net-zero emissions targets. This means DNOs may need to achieve consumer outcomes that go beyond the delivery of traditional network services. Also, it is reasonable to expect the electricity distribution sector will see the greatest impact arising from the forces of decarbonisation, decentralisation, and digitalisation. The ways in which networks are used may change given factors such as the implementation of network charging reforms and the increasing amounts of distributed energy resources (DER) connecting to the networks.

The overarching objective for the RIIO-ED2 price control should be extended to incorporate these factors. A potential revised objective could be:

*protect existing and future consumers by ensuring security of supply and facilitating decarbonisation to meet legislative emissions targets at lowest cost in the long term, favouring competitive markets for delivery wherever possible.*

### Strategic approach to RIIO-ED2

#### ***How to set price controls that support decarbonisation goals:***

#### **2. To what extent should we take into account outcomes linked to decarbonisation targets, and what outcomes might this involve?**

DNOs should play a proactive role in supporting transition to a low carbon energy system, by facilitating the increasing levels of power coming from cleaner and more diverse sources, the introduction of new load demands such as electrification of the heat sector, and the volume of electric vehicles and other low carbon technologies connecting to their networks. Taking into account outcomes that are linked to decarbonisation targets is reasonable. If provided, the level of revenues should not exceed the consumer benefit derived from the outcomes.

#### **3. Are there activities that DNOs are best placed to carry out in order to achieve these outcomes? What are the alternatives? Why would it be appropriate for energy consumers to fund these activities?**

There are already a number of outcomes that DNOs are required to achieve, including reductions in network losses, leakage of SF<sub>6</sub> insulating gases and business carbon footprints. It is sensible to retain these outcomes in RIIO-ED2.

There may be additional outcomes that it would be appropriate for DNOs to deliver. At this stage, we believe it would be more appropriate to define principles upon which a multi-criteria analysis can be undertaken to identify activities that DNOs are best placed to carry out. Some principles upon which the analysis should be based are:

- *Neutrality*: DNOs should act as neutral market facilitators. DNOs should not undertake activities that can be delivered by competitive markets unless it can be robustly demonstrated that DNOs delivering those activities represents better long-term value for consumers. The price control framework should not encourage DNOs to pick ‘winners’ or create distortionary effects.
- *Competitive delivery*: DNOs should not carry out activities that may inhibit the development of competitive markets or activities that the competitive markets can effectively deliver.
- *Effectiveness*: activities which DNOs are required to carry out should be able to result in the associated outcomes.
- *Performance measurability*: robust and repeatable measures of performance are necessary, in order to prevent windfall gains or losses.

## **5. How should we incentivise DNO performance when the achievement of outcomes could be dependent on the actions of others?**

There are examples of mechanisms to support decarbonisation in previous price controls that were less effective than anticipated. It is important that the design of future initiatives to support decarbonisation do not contain the same flaws. Two examples of mechanisms that were less effective than anticipated are:

*Losses incentive mechanism in the fourth and fifth distribution price controls (DPCR4/5):*

The Losses incentive was initially retained in DPCR5 “...to maintain an output incentive to ensure that DNOs play their role as the use of their networks begins to change as we move to a low carbon economy...”<sup>5</sup>. However, Ofgem subsequently decided not to activate the incentive due to major fluctuations in the relevant data<sup>6</sup>. The incentive was not carried forward RIIO-ED1 and, instead, DNOs were required to propose expenditure to reduce losses, an obligation was placed on the DNOs to reduce losses and a discretionary incentive was made available<sup>7</sup>.

This demonstrates it is necessary that reliable performance data are available to support mechanistic incentives. If such data are not available, other types of mechanisms, such as discretionary rewards, may be used to encourage network companies to deliver similar outcomes.

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<sup>5</sup> Electricity Distribution Price Control Review Initial Proposals - Incentives and Obligations”; paragraph 6.8: [https://www.ofgem.gov.uk/sites/default/files/docs/2009/08/initial-proposals\\_2\\_incentives-and-obligations\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2009/08/initial-proposals_2_incentives-and-obligations_0.pdf).

<sup>6</sup> “Strategy decision for the RIIO-ED1 electricity distribution price control”; paragraph 5.26:

<sup>7</sup> “Strategy decision for the RIIO-ED1 electricity distribution price control”; paragraph 5.27-5.28.

*Distributed generation (DG) incentive in DPCR5:*

The DG incentive was introduced in DPCR4 to encourage the efficient and economic connection of DG, in response to the targets set by government for the amount of energy to be supplied by renewables and combined heat and power<sup>8</sup>. The incentive was retained in DPCR5 despite analysis suggesting the reasons why the volumes connected difficulties in DPCR4 were significantly below forecast were because of planning permission difficulties and the DNOs' forecasts were overambitious<sup>9</sup>. The incentive was not retained in the RIIO-ED1 price control<sup>10</sup>. This highlights that it is important to correctly identify outcomes that network companies can realistically deliver.

***How to set price controls that support strategic investment:***

**6. How do we ensure that network companies are best placed to undertake strategic investment and manage the associated risk? How should the risks of these investments be managed?**

We are unsure of the benefits of the proposal to encourage new high-value highly anticipatory investment. Depending on the timing of the trigger point assessment, we consider the approach could create an asymmetric risk to the detriment of consumers.

**8. How should we hold the companies to account for the delivery of strategic investment, and the outcomes that they are expected to deliver?**

We accept it can be challenging to assess the efficiency of investment in one period when it may take many years to demonstrate it has achieved its intended outcome. This does not mean DNOs should not be held accountable. If highly anticipatory investment is permitted, DNOs should be held accountable for factors that are wholly or largely within their control e.g. the timeliness and the quality of the delivery of the investment. DNOs should also be held accountable if they have not adequately performed other roles, such as acting as neutral market facilitators, which prevents consumer benefits being realised.

***How to set price controls for DSO functions:***

**9. Is there a need to separate out the revenues and outputs for 'traditional' DNO functions from DSO functions? How could this be achieved?**

We note the position paper, published alongside this consultation, relating to Distribution System Operation. Particularly, 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.

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<sup>8</sup> "Electricity Distribution Price Control Review Policy Paper"; paragraph 2.22:  
[https://www.ofgem.gov.uk/sites/default/files/docs/2008/12/policy-paper-document-file-problem-use-this-one-20081126-pr\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2008/12/policy-paper-document-file-problem-use-this-one-20081126-pr_0.pdf).

<sup>9</sup> "Electricity Distribution Price Control Review Policy Paper"; paragraph 2.23.

<sup>10</sup> "Strategy consultation for the RIIO-ED1 electricity distribution price control - Outputs, incentives and innovation"; paragraph: 8.15.



Allowances and outputs for ‘traditional’ DNO functions should be separated from DSO functions. We believe several of the DSO functions can and should be delivered by third parties as part of a competitive market or by entities that, at a minimum, are functionally separate from ‘traditional’ DNO functions (including entities that are entirely separate from DNOs). Some of these activities are already being delivered via competitive markets including aggregation of distributed energy resources (DERs), operation of flexibility trading platforms, dispatch of DER and supply of grid-operational services using DER assets. Functional separation could help with measuring DNO performance in delivering non-contestable DSO functions and help mitigate potential conflicts of interests when deciding between the procurement of flexibility services and reinforcement. Further, separation ahead of the start of RIIO-ED2 may better facilitate changes to industry arrangements if they become necessary.

It is now important that the principles and process to be used to identify the party (or parties) best placed to deliver each DSO function are defined. The identification is a crucial input for the RIIO-ED2 price control review. Also, we recommend a reopener is included to the RIIO-ED2 price control if it becomes necessary to revisit the allocation of DSO functions across industry parties or if changes to industry arrangements become necessary.

**10. In the event of the DSO function being delivered by a separate party, how might we determine the revenues for DSO activities? What type of funding model would be appropriate to set DSO revenues? In this event, would changes also be required to DNO revenues and outputs?**

There is no need to consider allowances for undertaking DSO functions that should be delivered by competitive markets<sup>11</sup>. In principle, allowances for each of the remaining DSO functions, whether delivered by a DNO or not, should be clearly quantified. We are aware that some DNOs are currently developing functional structures that separate the delivery of DSO functions from traditional DNO functions. This may be a useful guide for determining allowances for the DSO functions not delivered via competitive markets. The setting of a separate price control for the Electricity System Operator (ESO) as of 2021 is also a useful guide.

It is too early to identify the type of funding model would be appropriate to set revenues for DSO functions since it has not yet been decided which party is best placed to deliver each DSO function not that will not be delivered by competitive markets. Nevertheless, funding models for ‘central’ bodies such as the ESO, Xoserve, Elexon, the Data and Communications Company and the Market Operator (in the water sector) should be explored.

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<sup>11</sup> Allowances to remunerate market participants for services procured from competitive markets should be considered separately.

**11. Where a DNO is undertaking a DSO function, what type of outputs or outcomes are necessary to measure how efficiently they are performing this function? Over what time period could these be measured?**

It is too early to identify outputs or outcomes where a DNO undertakes a DSO function since those functions have not yet been identified. It is important that obligations on DNOs to act as neutral market facilitators remain, regardless of which DSO functions are to be undertaken by DNOs.

***How to set price controls that drive innovation and competition:***

**12. In what ways could the existing arrangements drive more innovation and competition?**

***Innovation:***

We agree network companies should, just like any other company, move with the times, take advantage of opportunities and innovate as part of BAU activities<sup>12</sup>. We welcome the approach to the RIIO-2 price controls, in which companies will be expected to fund more innovation as BAU using their totex allowances rather than relying solely on additional innovation stimulus funds.

We welcome Ofgem's commitment to seek ways of increasing third party involvement and to pursue legislative changes to enable third party direct access to network innovation funds<sup>13</sup>, as current arrangements largely see the DNO as the arbiter of different solutions, or as the proposer of innovation projects. Previously, we concurred with concerns relating to the Network Innovation Allowance (NIA), including the lack of sharing of lessons and uncertainty that some of projects that have been progressed genuinely fall within scope. We, therefore, welcome innovation funding stimuli being refocussed on the strategic challenges relating to the transition of the energy system and consumer vulnerability, and reformed governance arrangements if the NIA is retained. It is necessary to ensure projects supported by innovation funding are genuinely innovative and are not projects that should be delivered as a part of BAU (such as IT upgrades for customer information management systems).

We note concerns about the quality of and the motivations for undertaking certain projects<sup>14</sup>. These concerns can be mitigated by requiring all innovation projects to be subject to independent scrutiny by industry participants and academics, to ensure they are effectively managed and deliver good outcomes.

We recognise that dedicated innovation funding within the RIIO framework is meant to be time-limited, until network companies undertake more innovation themselves. We also recognise a finding of the review of the Low Carbon Network Fund is innovation is not yet a core part of the network companies' businesses<sup>15</sup>. In due course, Ofgem should consider the extent to which the provision of innovation stimuli acts as a barrier to companies undertaking more innovation themselves and the conditions that should exist that indicate stimuli can be withdrawn.

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<sup>12</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.19.

<sup>13</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.77.

<sup>14</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.52.

<sup>15</sup> "An independent evaluation of the LCNF"; page 30:

[https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation\\_of\\_the\\_lcnf\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation_of_the_lcnf_0.pdf).



### *Competition:*

For the benefits of competition to be realised, it is essential that independence is embedded within the regulatory framework. The operation of competition could be classified as a DSO function and could be delivered by a third party or by an element of the DNOs' operations that are subject to strict functional separation arrangements. Also, it may be necessary to strengthen the minimum legal requirements relating to competition on the DNOs.

### ***How to set price controls for a smart, flexible energy system:***

#### **13. To what extent should we set (and incentivise performance against) baseline totex allowances for activities where flexible solutions could be provided?**

We acknowledge it may be challenging to set baseline totex allowances for activities where flexible solutions could be provided. This is due to a number of factors including the information asymmetry between the DNOs and Ofgem, continuing development of flexibility markets and availability of flexibility resources. Further, benchmarking proposed costs is unlikely to reveal the full extent to which flexible solutions may be utilised.

Setting totex incentive rates via the confidence-dependent incentive rate approach may be used as a mitigating mechanism, for those scenarios in which there is insufficient certainty that a traditional engineering solution is needed or will be deployed. An appropriately-calibrated Return Adjustment Mechanism should moderate higher-than-expected returns DNOs could earn by deploying flexible rather than engineering solutions.

#### **14. Should we instead set allowances based on the costs revealed through the flexibility tendering process? How might this work?**

We are aware that several DNOs have tendered for flexibility services in the current price control and this may reveal insight relating to the extent to which flexible resources could be utilised in RIIO-ED2. Ofgem could require DNOs to report annually on how network constraints are managed. As a starting point, DNOs could be required to explain:

- the volumes and types of constraints that occurred or are expected to occur,
- the volumes of those constraints that were managed by 'build' and 'non-build' solutions.
- the decision-making process for deploying flexibility services where applicable

This will allow Ofgem to develop a base of evidence, which could then be used as a cross-reference when assessing DNOs' Business Plans. Also, at an aggregate level, Ofgem could cross-reference the expected values of avoided or network reinforcement estimated in various studies, such as that produced by the Carbon Trust and Imperial College<sup>16</sup>. This could be used to help assess the extent to which the DNOs' Business Plans are ambitious in this regard.

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<sup>16</sup> See:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/568982/An\\_analysis\\_of\\_electricity\\_flexibility\\_for\\_Great\\_Britain.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/568982/An_analysis_of_electricity_flexibility_for_Great_Britain.pdf).

Though not directly related to how allowances should be set, a coordinated plan to engage with consumers, which will be providers of volumes of flexibility services, is needed. This should ensure flexibility markets are liquid.

***How to set price controls in a big data environment:***

**15. To what degree should DNOs modernise their handling practices to adhere to data best practice, and therefore (among other things) provide available, transparent, and interoperable data about their networks? What measures will be needed to ensure data remains secure?**

Reliable, timely and good quality data are needed to support the decarbonisation, decentralisation and digitalisation of the energy system. We recognise some DNOs may still maintain legacy approaches to data collection, which are unsuitable for supporting the operation of a smart energy system. We also recognise the variability in the approaches to data collection across the sector.

Significant progress in implementing the Energy Data Taskforce (EDT) recommendations can and should be made ahead of RIIO-ED2. Regulatory initiatives may be required to support implementation. DNOs should be required to develop and deliver an ambitious roadmap for collecting, managing and sharing data on their networks, to ensure that they do not hinder innovation and digitalisation of the energy system. The roadmap should necessarily include the definition of data standards that are common across the sector. This will facilitate industry participants being able to make better use of the data to be made available. We highlight National Grid Electricity Transmission's capacity map as an example of how capacity data may be made available to the industry in a user-friendly manner<sup>17</sup>.

We acknowledge DNOs may not have been explicitly funded for activities similar to the EDT recommendations when the RIIO-ED1 price control was set. However, given the criticality of reliable, timely and good quality data for supporting the transition of the energy system, providing remuneration for efficiently-incurred expenditure should be considered as a part of the closeout of the RIIO-ED1 price control or as a part of the RIIO-ED2 settlement. Expenditure to be remunerated should be only that which is needed to deliver the roadmap as proposed above. Ofgem should ensure ex-ante funding provided for data-related activities is taken into account when considering whether additional funding should be provided.

**17. Do you agree with the themes we plan to include in our guidance on data best practice?**

The proposed themes represent a reasonable starting point. We look forward to the guidance being developed.

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<sup>17</sup> See <https://www.nationalgridet.com/get-connected/network-capacity-map>  
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## **RIIO-ED2 Framework Consultation**

### ***Length of the price control:***

#### **18. We welcome views on our proposed position of a five-year price control for RIIO-ED2.**

A five-year control represents a reasonable balance between a longer price control that potentially offers greater incentives for innovation and long-term planning and a shorter price control that reduces the impact of inaccurate long-term forecasts.

#### **19. Are there any elements of RIIO-ED2 price control that we should consider setting over a longer or shorter period? Please give reasons.**

Setting those elements of the RIIO-ED2 price control relating to (some) DSO functions over a shorter period should be considered. This is preferable while experience of the regulation of those discrete functions is gained and the arrangements are embedded. Also, setting these elements over a shorter period may better facilitate changes in industry arrangements for some functions if they become necessary during the price control.

We have not identified any elements of the RIIO-ED2 price control that should be set over a longer period. Nevertheless, the criteria to identify those elements should be clearly defined. Some criteria could include:

- The need for investment should be certain e.g. arising from legislation.
- The cost of investment can be quantified and easily 'ring-fenced' within the price control framework.
- There should be clearly defined price control deliverables associated with the allowances, along with milestone delivery targets.
- The impact on other mechanisms within the price control can be normalised e.g. impact on performance against incentive mechanisms.
- There should be benefits to consumers to setting the costs over longer periods instead of resetting periodically.
- Mechanisms that capture the impact of ongoing efficiencies and of the rollout of newly-developed techniques on expenditure requirements can be designed.

### ***Giving consumers a stronger voice:***

#### **20. We welcome views on whether these enhanced engagement arrangements are appropriate for RIIO-ED2.**

The enhanced engagement arrangements that were developed for the other network sectors are also appropriate for the RIIO-ED2 price control.

***Meeting the needs of consumers and network users:***

**21. We welcome views on whether the proposed output categories and incentive arrangements are appropriate for RIIO-ED2.**

The proposed output categories that were developed for the other network sectors are also appropriate for the RIIO-ED2 price control. The use of licence obligations, price control deliverables and output delivery incentives (ODIs) has the potential to provide greater clarity over what has been funded by, and the outputs expected from, base revenue allowances. However, much will depend on Ofgem's ability to set baseline allowances that are consistent with both the minimum standards set and relevant targets for ODIs.

We continue to support the use of relative and dynamic targets where appropriate. The RIIO framework should mimic competition wherever possible and, so, performance should be assessed relative to other DNOs. The exact approach could vary by incentive scheme. Some should be designed to be at no overall cost. For example, if the Broad Measure of Customer Satisfaction (BMCS) is retained, it should be zero-sum (subject to a minimum standard) since, in a competitive market, it is improvements in customer service relative to competitors that will bring rewards. Under RIIO-1, BMCS is currently expected to give rewards to all network companies, totalling £525m<sup>18</sup> over the RIIO-1 price controls.

In other areas, such as reliability and availability, absolute incentive scheme targets could be used but updated on a rolling basis, or could be reset at certain points during the price control period, to capture revealed performance and ensure that overall rewards do not deviate from a broadly symmetric distribution for too long. This would allow the price control to react to changes in a similar way to a competitive market and would avoid the current situation in the RIIO-ED1 Interruptions Incentive Scheme where targets fixed at the beginning of the price control will result in the networks receiving £647m<sup>19</sup> in rewards for no improvement in performance. A 'backstop' level of performance could also be introduced.

Designing incentives to reward relative performance, either at an overall or individual incentive level, will also manage the issue of information imbalance. This means DNOs can no longer benefit as a group for any information imbalance and so should focus analytical resource into getting the 'right' solution. DNOs may have differing ideas of what the right solution is, which would create a competitive tension that improves the rigour of the final arrangements. Including a baseline minimum standard, reflecting revealed performance in RIIO-1, would also act as a barrier to networks ceasing to seek improvements.

We do not expect dynamic targets to affect DNOs' behaviour as long as the marginal incentive rate is maintained and caps and collars are not expected to be reached. We also do not see any conflicts between obliging DNOs to collaborate in some areas (e.g. funded innovation projects), whilst allowing them to compete in other areas of the price control (e.g. zero-sum incentives).

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<sup>18</sup> 2016/17 prices, assuming performance is held at 2016/17 levels.

<sup>19</sup> 2012/13 prices, assuming performance is maintained at 2014/5 levels.

**22. We are interested to hear if there are new elements of the services DNOs will need to deliver that should be included in the current output categories. Alternatively, we welcome views on whether these should be captured by a new output category. For these new elements, we are interested to hear how delivery of these services should be valued and measured.**

Elements of services relating to DSO functions that the DNOs will be required to deliver and new services linked to delivering outcomes relating to decarbonisation should be categorised. At this stage, we are unable to suggest how these services should be categorised, valued and measured because they have not yet been identified.

***Maintaining a safe and resilient network:***

**24. We welcome views on how DNOs should continue to ensure their networks are resilient, particularly in the context of the new or changing way assets are used.**

We agree it is necessary to measure and track the long-term risk benefit of network investment delivered during RIIO-ED2. However, we continue to have concerns about the Network Asset Risk Metric being used for the purposes of assessing costs, setting targets and assessing performance, which could lead to unintended consequences. These are:

- The approach may not fully recognise the degree of uncertainty about the long-term need for some assets and could encourage DNOs to develop aspects of their Business Plans based on an artificial degree of certainty about future need.
- The approach could create tension with elements of the proposals that encourage DNOs to prudently manage the uncertainty caused by significant policy decisions that are yet to be made. This could cause some incoherence in investment planning.
- The approach could create tension with elements of the proposals that encourage DNOs to prudently manage the risk of asset stranding. Flexibility services can be used to mitigate against the risk of investment becoming obsolete in the short-term, because the investment was undertaken before there was sufficient certainty of long-term need. There is a risk that the approach could conflict with government policy on the promotion of flexibility and the intent to require DNOs to fully and objectively consider 'build, and 'non-build' solutions.

The long-term monetised risk approach could inadvertently create a bias in investment decision-making towards 'lumpy' high cost investment, to deliver the greatest risk benefit over longer periods e.g. 45 years. This would be based on the assumption that the asset(s) will be needed over that time period.

**27. We would like to hear views on how we ensure DNOs remain resilient to the challenges presented by an ageing and changing workforce.**

We believe this is a 'core' activity and, as such, DNOs should bear full responsibility for managing these challenges.

***Delivering an environmentally sustainable network:***

**28. We welcome views on how DNOs should work to minimise the impact of what they do on the environment and facilitate the transition to a low carbon energy system. We are particularly interested in the implications of the government's updated target of net-zero emissions by 2050.**

DNOs should play a proactive role in supporting transition to a low carbon energy system, by facilitating the increasing levels of power coming from cleaner and more diverse sources, the introduction of new load demands such as electrification of the heat sector, and the volume of electric vehicles and other low carbon technologies connecting to their networks. This means it is imperative that DNOs always act as neutral market facilitators. This guiding principle should be applied to all aspects of network operation, maintenance and expansion. Further, DNOs should not undertake activities that can be delivered by competitive markets unless it can be robustly demonstrated that DNOs delivering those activities represents better long-term value for consumers.

As discussed above, DNOs should be required to develop and deliver an ambitious roadmap for collecting, managing and sharing data on their networks, to ensure that they do not hinder innovation and digitalisation of the energy system (see response to question 15). The roadmap should include the definition of data standards that are common across the sector. This will facilitate industry participants being able to make better use of the data to be made available. Significant progress can be made ahead of RIIO-ED2.

**29. We also welcome views on what this may mean for the type of activities networks undertake, how these may be funded, as well as the outputs and/or incentives they should be exposed to.**

It is too early to conclude how such activities may be funded or which outputs and/or incentives DNOs should be exposed to as those activities have not yet been identified.

**30. Finally, we are keen to understand how DNOs' performance should be measured, and how we should assess the value that consumers place on the provision of these services and activities.**

It is too early to conclude how performance should be measured as those activities have not yet been identified.

***Enabling whole system solutions:***

**31. We welcome views on how RIIO-ED2 can best capture the benefit of whole systems solutions. We are also interested in views on how these benefits should be measured.**

We support the approach to enabling the delivery of whole system solutions, as set out in the Sector Specific Decision. In isolation, resolving problems relating to information sharing and coordination does not automatically enable the delivery of whole system solutions; DNOs are



required to participate in the delivery. Other mechanisms, such as balancing financial incentives, target commercial arrangements that may act as barriers to DNOs' participation. None of the proposed mechanisms compel networks to participate in the delivery of whole system solutions. Developing a 'participation' incentive that serves this purpose should be considered. This incentive could take the form of a licence obligation that compels participation or a penalty-only incentive that financially penalises DNOs that do not participate.

The consideration of coordination should be extended beyond coordination between networks and across sectors. Network companies and the ESO should adopt coordinated approaches when engaging with third parties. For example, network companies and the ESO should adopt coordinated approaches for identifying how 'non-build' solutions should be deployed to resolve system issues and for the competitive procurement of flexibility services.

**32. We further welcome stakeholders' opinions on whether the electricity distribution sector's approach to whole systems should be different from the other sectors and, if so, why.**

We believe the scope of whole systems and arrangements for electricity distribution, such as the design of the Coordinating Adjustment Mechanism, should be largely consistent with arrangements for the other network sectors, given, by definition, delivering whole system solutions requires interactions across network boundaries. Differences in the price control frameworks should be minimised, to reduce barriers to whole system solutions being delivered.

***Managing uncertainty:***

**33. We welcome views on how we should manage the uncertainty associated with forecasting allowances, and whether there are any mechanisms we could or should consider in helping to manage this uncertainty.**

We welcome the broad approach to managing uncertainty, as set out in the *RIIO-2 Sector Specific Methodology*. The approach maintains the principle that risks should be allocated to the parties best placed to manage them and can mitigate the risk of forecasting errors. Also, this reduces the risk of an incentive being created for the DNOs to over-forecast expenditure requirements. However, uncertainty mechanisms should be used to manage only those potential changes in circumstances that are genuinely beyond networks' control.

We think allocating a larger share of uncertain cost allowances to uncertainty mechanisms will help to maximise the efficiency of risk allocation in the RIIO-ED2 price control and this should also reduce the cost of capital. This means it is important that the uncertainty mechanisms are well-designed, robust and do not present opportunities for 'gaming'.

For the current price controls, the IQI was used to encourage companies to provide accurate and ambitious cost forecasts in their Business Plans. The IQI seeks to ensure that the optimal position is to seek funding at an efficient level (and so companies would be worse off seeking funding above the level that is justified). However, there is not an equivalent mechanism for reopener applications for in-period adjustments of revenues and outputs, meaning companies are no worse off submitting applications that are not justified. For RIIO-ED2, we recommend a methodology for

encouraging companies to propose only adjustments that genuinely meet the qualifying criteria and intent of the respective reopeners and to provide only accurate and ambitious cost forecasts in submissions, especially since a greater number of reopeners may be included.

**34. We seek views on the use of indexation, particularly on any adjustments for labour and construction cost inflation.**

We agree indexation should be used where feasible and appropriate. In keeping with the principle that risks should be allocated to the parties best placed to manage them, indexation (and uncertainty mechanisms generally) should be employed only when potential changes in circumstances are genuinely beyond networks' control.

We support the use of indexation to manage the uncertainty of movements in some types of costs. Network companies may have some ability to manage labour costs but are likely to have less control over movements in the costs of materials and equipment and so are exposed to these external risks. As has been recognised, the decision to allocate this risk to network companies in RIIO-1 has led to significant additional returns so far in RIIO-1<sup>20,21</sup>.

Indexing RPEs for materials and equipment moves the risk to consumers but, given the material divergence between Ofgem's forecasts and outturn costs, and networks not well placed to manage this risk, indexation is appropriate. It is important that the index is sufficiently resilient to DNOs' expenditure decisions, in order to avoid circularity.

As has been highlighted by CEPA, indexing RPEs should also reduce the companies' cost of capital<sup>22</sup>.

**35. We welcome views on our approach to highly anticipatory investment projects. We are interested to hear whether stakeholders would suggest additional processes or regimes for facilitating such investments that support the energy system transition whilst protecting consumers from potentially inefficient investments.**

We are unsure of the benefits of the proposal to encourage new high-value highly anticipatory investment. Depending on the timing of the trigger point assessment, we consider the approach could create an asymmetric risk to the detriment of consumers.

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<sup>20</sup> For example, see "RIIO-ET1 Annual Report 2016-17", para 4.11-4.14:

[https://www.ofgem.gov.uk/system/files/docs/2017/12/riio\\_transmission\\_annual\\_report\\_2017\\_final\\_1.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/12/riio_transmission_annual_report_2017_final_1.pdf).

<sup>21</sup> "Review of the RIIO framework and RIIO-1 performance"; page 5:

[https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa\\_review\\_of\\_the\\_riio\\_framework\\_and\\_riio-1\\_performance.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_review_of_the_riio_framework_and_riio-1_performance.pdf).

<sup>22</sup> "Review of the RIIO framework and RIIO-1 performance"; page 83.

***Driving efficiency through innovation and competition:***

**38. We welcome views on the proposed innovation stimulus. We are interested to hear views on the types of projects that should be funded through either the NIA funding or a new funding pot.**

We agree network companies should, just like any other company, move with the times, take advantage of opportunities and innovate as part of BAU activities<sup>23</sup>. We welcome the approach to the RIIO-2 price controls, in which companies will be expected to fund more innovation as BAU using their totex allowances rather than relying solely on additional innovation stimulus funds.

Previously, we concurred with concerns relating to the NIA, including the lack of sharing of lessons and uncertainty that some of projects that have been progressed genuinely fall within scope. We, therefore, welcome innovation funding stimuli being refocussed on the strategic challenges relating to the transition of the energy system and consumer vulnerability, and reformed governance arrangements if the NIA is retained. It is necessary ensure projects supported by innovation funding are genuinely innovative and are not projects that should be delivered as a part of BAU (such as IT upgrades for customer information management systems).

We recognise dedicated innovation funding within the RIIO framework is meant to be time-limited, until network companies undertake more innovation themselves. We also recognise a finding of the review of the Low Carbon Network Fund is innovation is not yet a core part of the network companies' businesses<sup>24</sup>. In due course, Ofgem should consider the extent to which the provision of innovation stimuli acts as a barrier to companies undertaking more innovation themselves and the conditions that should exist that indicate stimuli can be withdrawn.

**39. How can the benefits of the innovation stimulus be maximised by supporting schemes proposed by non-network parties?**

We welcome Ofgem's commitment seek ways of increasing third party involvement and to pursue legislative changes to enable third party direct access to network innovation funds<sup>25</sup>, as current arrangements largely see the DNO as the arbiter of different solutions, or as the proposer of innovation projects.

Separately, we note concerns about the quality of and the motivations for undertaking certain projects<sup>26</sup>. These concerns can be mitigated by requiring all innovation projects to be subject to independent scrutiny by industry participants and academics, to ensure they are effectively managed and deliver good outcomes.

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<sup>23</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.19.

<sup>24</sup> "An independent evaluation of the LCNF"; page 30:

[https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation\\_of\\_the\\_lcnf\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation_of_the_lcnf_0.pdf).

<sup>25</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.77.

<sup>26</sup> "RIIO-2 Sector Specific Methodology – Core document"; paragraph 10.52.

**40. We also welcome views on our proposals for the different competition models in RIIO-ED2, and what, if any, criteria should be set out for the use of early or late stage competition models.**

**41. We also seek input from stakeholders on how native competition obligations and best practices can be used to ensure the best outcomes for consumers and to drive changes in the role of the networks in a transforming energy system.**

We agree extending both early and late models of competition to electricity distribution is likely to provide better value for money for consumers. Also, we welcome the proposal to introduce arrangements which will enable native competition to be more effective.

It has not been described how the competitive process can be 'ring-fenced' and made sufficiently independent from the 'host' DNO. This could affect the effectiveness of both the 'early' and 'late' competition models to deliver consumer value. For example, DNOs operating flexibility markets is dependent on DNOs choosing flexibility to resolve network constraints. If criteria are not well designed, DNOs' optioneering could rule out flexibility where it is a valid alternative. Similar concerns exist about DNOs running 'late' competitions. It is not appropriate for networks to run competitions while also participating in competitions.

For the benefits of competition to be realised, it is essential independence is embedded within the regulatory framework. The operation of competitions could be classified as a DSO function and could be delivered by a third party or by an element of the DNOs' operations that are subject to strict functional separation arrangements. Also, it may be necessary to strengthen the minimum legal requirements relating to competition on the DNOs.

***Forecasting and scenarios:***

**42. We welcome views on our approach to planning, forecasting and scenarios for RIIO-ED2. In particular, do stakeholders have other suggestions as to how we can best manage forecasting risk for consumers?**

We agree with network companies being required to base their Business Plans on a common set of assumptions about the primary drivers of investment, including relevant government policy, across a range of plausible future scenarios. This should aid comparability and assessment of the Business Plans. DNOs should be required to base their Business Plans on the same set of assumptions, but which have been updated if better information becomes available in the intervening period.

***Business plan and totex incentives:***

**43. We welcome views on our proposal to remove the early settlement process for RIIO-ED2, instead focusing on alternative mechanisms to receive high-quality and ambitious business plans.**

We support the early settlement process for RIIO-ED2 being removed. We are not convinced that fast-tracking has brought benefits to any sector. The costs of fast tracking in RIIO ED1 are clear

- CEPA state that this as £510m<sup>27</sup>, in terms of increased allowed revenues for WPD resulting from fast tracking. The benefits are less clear-cut. We believe the incremental improvements between DPCR5 and RIIO-ED1 can be largely ascribed to the networks' understanding of the Information Quality Incentive (IQI) mechanism improving between the two price controls i.e. there was little incremental impact of fast-tracking. This is consistent with both IQI and fast-tracking providing similar incentive signals. The benefits of reduced scrutiny (saving time and effort for both the fast-tracked network and Ofgem) seem relatively trivial with the risks of approving an inefficient business plan.

**44. We also welcome views on our proposals to use the Business Plan Incentive and the confidence-dependent incentive rate arrangements for RIIO-ED2. In line with this, we are interested to hear stakeholder views on the range that should be used for both of these.**

*Business Plan Incentive:*

We accept that it is challenging to form a reliable view of efficient costs that is independent of DNOs' Business Plans. So, it is necessary to include a mechanism that encourages DNOs to 'truth-tell' and submit ambitious Business Plans. There is also little evidence that the IQI as currently designed influenced DNOs to provide their best view of likely expenditure.

We supported an improved and simplified form of the IQI, with interpolation removed and the differential in rewards/penalties increased for differences in efficiency of plans. If the differential in rewards/penalties is increased (i.e. rewards diminish, or penalties increase, more sharply as plans move away from Ofgem's view of efficient) then IQI should become more effective in encouraging truth-telling. This would be an improvement to the current situation and preferable to removing IQI. We would note that this does not necessarily mean increasing the rewards for a plan viewed as efficient. It could be achieved by increasing the penalties for those networks with plans not viewed as efficient. The IQI 'breakeven point' should be set at 100 i.e. a DNO whose bid matches Ofgem's view of efficient costs, would be able to achieve a return equal to the allowed cost of capital, if it were to spend, over the price control period, the amount it had forecast.

An improved IQI would seem to us to be a 'safer bet' in terms of delivering an incremental improvement relative to RIIO-1 arrangements, with limited down side risk of unintended consequences. We are not opposed to the proposed Business Plan Incentive, although it does not seem to us to provide as strong a truth-telling incentive, which could have unintended consequences.

*Confidence-dependent incentive rate arrangements:*

This should encourage companies to provide more compelling justification for their proposals. It is also likely to result in a better allocation of risk between consumers and companies. However, if an improved form of the IQI is retained for the RIIO-ED2 price control, these arrangements would not be necessary.

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<sup>27</sup> "Review of the RIIO framework and RIIO-1 performance"; page 68.  
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***Fair returns and financeability:***

**45. We welcome stakeholder views on our proposals to introduce measures to enable network companies to finance their activities whilst ensuring they receive a fair return.**

Price control settlements should appropriately remunerate investors for the risks they face when investing in energy networks. This should positively affect investor confidence and increases the legitimacy of the settlements from the consumer perspective. Network companies are relatively low-risk businesses because they are monopolies subject to price control with a high degree of certainty on their future revenues. However, it is uncontroversial that previous settlements have not fully reflected the low-risk nature of this type of investment.

The improvements in the methodology for calculating the cost of capital for the RIIO-2 price controls, compared to previous settlements, to better reflect the low-risk nature of network investment are a positive development. We welcome the proposal to apply the same methodology to the RIIO-ED2 price control. We also welcome the use of other mechanisms in the RIIO-2 controls that even further reduce the risks associated with investing in energy networks, such as RPEs indexation, greater use of volume drivers, allowing companies to propose uncertainty mechanisms and indexing financing costs. The appropriate lowering of the risk to which investors are exposed should result in lower bills for consumers.

**46. We are interested to hear from stakeholders on how they believe we should set allowances for the cost of debt, particularly around the method of recalibrating the index.**

We believe the approach that would deliver best value for consumers would be one which provided a fixed allowance for efficiently incurred existing debt plus indexation for new debt only. Separating the treatment of efficient embedded and future debt could result in the construction of a shorter trailing average index for future debt that will more closely reflect prevailing market conditions. This would complement the incentive on companies to obtain efficient financing and would ensure consumers do not pay more than efficient future costs.

We do, however, recognise the challenges associated with assessing the efficiency of embedded debt costs and so whilst we remain concerned that full indexation could weaken the incentive on companies to obtain efficient financing relative to our preferred approach, we are also cautiously comfortable with the proposal to retain full indexation as set out in the *RIIO-2 Sector Specific Methodology*, subject to the treatment of company-specific adjustments.

***Company-specific adjustments:***

We welcome Ofgem's decision to, to the extent any company-specific allowances are granted (based on efficient costs of debt), exclude these costs from the calibration of the index more generally such that for the sectors as a whole, consumers would pay no more than an efficient cost of debt<sup>28</sup>.

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<sup>28</sup> "RIIO-2 Sector Specific Methodology Decision – Finance"; paragraph 2.37.



We note debt performance-sharing arrangements have been ruled out<sup>29</sup>. However, company-specific adjustments could be perceived to be a mechanism for sharing debt underperformance. Any DNO seeking an increase in the allowed cost of debt should have to pass a high evidential bar before cost of debt above that produced by the index is allowed. Ofgem should ensure that DNOs which have incurred higher allowed costs of debt are not able to pass those costs through to consumers except in very limited circumstances; DNOs should be encouraged to reduce those costs where possible. If a DNO has raised finance inefficiently then it should be the DNO's shareholders that fund any shortfall, not consumers.

We encourage Ofgem to consider introducing consumer benefits tests and cost efficiency tests, similar to those Ofwat has adopted<sup>30</sup>, if any DNO seeks a company-specific adjustment. There should be clear evidence that consumers support a higher cost of debt and there should be strong incentives for companies with high costs of debt to ensure that they are delivering services that represent good value for money for consumers overall (taking into account any higher cost of debt).

**47. We also welcome views on our proposed approach to setting allowances for the cost of equity, as well as our proposal to move away from RPI.**

We support the proposed approach to setting allowances for the cost of equity as set out in the *RIIO-2 Sector Specific Methodology*.

**48. Finally, we would like to hear stakeholders' views on our proposed introduction of a 'sculpted sharing factor' in instances of high out- or under-performance, or whether an alternative mechanism could be more effective.**

We support the use of a return adjustment mechanism (RAM), to protect against the systematic sectoral outperformance observed in the current and previous distribution price controls. To the extent a RAM helps to ensure that the rates of return earned by investors (as measured via return of regulator equity (RoRE)) are less likely to significantly exceed the level assessed as fair, the mechanisms are likely increase consumer legitimacy. Further, a RAM should have a downward effect on the cost of equity (assuming this is reflected in the risks to which the sector is exposed) since the extent to which RoRE can deviate from the allowed cost of equity is constrained.

We discount discretionary adjustments because of the potentially negative impact on incentives to improve and on the risk profile of the sector. We also discount sector average sculpting because of the implementation difficulty and the muted competitive pressures. Our preference remains for anchoring to be implemented because we believe it is a superior mechanism, compared to sculpted sharing factors. The advantages of anchoring are:

- Anchoring is a true failsafe mechanism since the sector average RoRE would be guaranteed to fall within a range for the cost of equity that Ofgem has assessed as fair. Sculpted sharing

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<sup>29</sup> "RIIO-2 Sector Specific Methodology Decision – Finance"; paragraph 2.40.

<sup>30</sup> See <https://www.ofwat.gov.uk/wp-content/uploads/2019/02/Technical-Appendix-4-Company-Specific-Adjustments-to-the-Cost-of-Capita....pdf>.

factors do not provide the same level of protection as it would still be possible for all DNOs to outperform.

- The question of legitimacy arises from the general ability of DNOs to outperform and not that of the best performing networks receiving high returns. With sculpted sharing factors, the best-performing DNOs could see returns reduced without justification.
- Both manage the risk of an individual DNO receiving an unjustified generous settlement. Currently, customers fully bear that risk. With sculpted sharing factors, consumers still bear that risk but at a reduced level. Under anchoring, the risk is moved to the other DNOs. Risk should be placed on the parties most able to manage it. We believe those parties are the DNOs, who have the opportunity and capability to ensure a fair settlement for all. This supports anchoring.
- Anchoring provides a stronger level of restraint on returns, and so more effectively limits the deviations of actual rates of return from the allowed cost of equity. This should have a downward effect on the allowed cost of equity.
- It should be less likely that sectoral performance exceeds acceptable bounds (triggering anchoring) than for an individual company (triggering the application of sculpted sharing factors). We accept this depends on how both mechanisms would be calibrated.

We recognise the impact that either RAM would have on a DNO's behaviour would depend on whether the DNO expected it to be triggered:

- If a DNO does not expect RoRE (its own for sculpted sharing and the sectoral average for anchoring) to fall outside the threshold ranges, the presence of a RAM is unlikely to influence the DNO's behaviour.
- It would be harder for a DNO to predict whether anchoring will be triggered, relative to sculpted sharing factors, because of the dependence on the performance of other DNOs.
- if a DNO anticipates its RoRE might exceed the threshold for triggering sculpted sharing factors, it may take sculpted sharing factors into account when deciding whether to try to increase outperformance.
- if a DNO assumes the sector is likely to outperform beyond the defined thresholds, thereby triggering anchoring, it can anticipate a negative adjustment. That DNO could translate that adjustment into the equivalent of sculpted sharing factors i.e. some percentage of any further outperformance that they would be able to retain.
- Unlike sculpted sharing, however, whilst the marginal incentive may be weaker, DNOs do not have the option to 'stand still' if anchoring has been triggered. If a DNO chooses not to strive for further outperformance it is likely to see its absolute level of returns reduce as other DNOs continue to improve. This may not be acceptable to shareholders, creating a competitive dynamic between DNOs – the need to 'run to standstill' as in a competitive market.