

**NOTICE OF APPEAL
ENERGY LICENCE MODIFICATION**

NORTHERN POWERGRID (NORTHEAST) LIMITED

NORTHERN POWERGRID (YORKSHIRE) PLC

Appellants

- and -

GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

RIIO-ED1 PRICE CONTROL

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LIST OF ABBREVIATIONS

ABBREVIATION	MEANING
ASHE	Annual Survey of Hours and Earnings (a resource compiled by the ONS recording data on levels, distribution and make-up of earnings and hours worked for UK employees by sex and full-time/part-time status in all industries and occupations).
BEAMA	British Electrotechnical and Allied Manufacturers' Association.
BCIS	Building Cost Information Service.
CC	Competition Commission.
CMA	Competition and Markets Authority.
CRCs	Charge Restriction Conditions, the terms of which are specific to an individual DNO's licence.
DNO(s)	Electricity distribution network operator.
DPCR5	Distribution Price Control Review 5, the price control prior to RIIO, operative from 1 April 2010 to 31 March 2015.
EA89	Electricity Act 1989.
ED	Electricity distribution.
EHV	Extra high voltage.
ENWL	Electricity North West Limited, a DNO.
<u>E.ON</u>	<i>E.ON UK Plc and GEMA and British Gas Trading Limited: Decision and Order of the Competition Commission (Case CC02/07) (10 July 2007).</i>
GEMA	Gas and Electricity Markets Authority.
HV	High voltage.
IQI	Information Quality Incentive, an incentive scheme designed to reward the provision of high-quality information by DNOs.
LCT	Low carbon technology.
LV	Low voltage.

NPg	NPN and NPY.
NPN	Northern Powergrid (Northeast) Limited, a DNO.
NPY	Northern Powergrid (Yorkshire) Plc, a DNO.
NIA	Network Innovation Allowance, a sum set within each DNO's RIIO-ED1 price control allowance to be spent on small-scale innovation projects.
<u>NIE</u>	<i>Northern Ireland Electricity Limited price determination. Final determination (26 March 2014).</i>
Ofwat	The Water Services Regulation Authority.
ONS	Office for National Statistics.
RIIO-ED1	The first price control under the Revenue = Incentives + Innovation + Outputs (RIIO) regime for electricity distribution (ED), to operate from 1 April 2015 to 31 March 2023.
RLCAs	Regional Labour Cost Adjustments.
RLCDs	Regional Labour Cost Differentials between London or the South East, relative to the remainder of Great Britain.
RLCIs	Regional Labour Cost Indices.
RPEs	Real price effects.
RPI	Retail Prices Index.
RPI-X	The system of electricity network regulation introduced at privatisation of the Regional Electricity Companies in 1990.
RPI-X@20	GEMA's review of the RPI-X system of energy network regulation, conducted 2008-2010.
SGBs	Smart grid benefits.
SLCs	Standard Licence Condition(s), applicable to all DNOs.
SOC	Standard Occupational Classification.
SSes	Scottish and Southern Energy Power Distribution: Southern Electric Power Distribution, a DNO.

UQ	Upper quartile.
WPD	Western Power Distribution, the trading identity of four DNOs (WPD South West, WPD South Wales, WPD East Midlands and WPD West Midlands).

SECTION 1: INTRODUCTION

A. Overview

- 1.1 Northern Powergrid (Northeast) Limited ("**NPN**") and Northern Powergrid (Yorkshire) Plc ("**NPY**") (together the "**Appellants**" or "**NPg**") are, respectively, the electricity distribution network operators ("**DNOs**") for the North East of England and for Yorkshire and Northern Lincolnshire.
- 1.2 The Appellants each hold a distribution licence under section 6(1)(c) of the Electricity Act 1989 ("**EA89**") (each a "**Licence**" and together, the "**Licences**").
- 1.3 This appeal concerns the first determinations for electricity distribution ("**ED**") to be made by the Gas and Electricity Markets Authority ("**GEMA**") under the new RIIO price control regime (setting Revenue using Incentives to deliver Innovation and Outputs). This price control, known as "**RIIO-ED1**", will operate from 1 April 2015 to 31 March 2023.

B. Request for permission to appeal

- 1.4 The Appellants seek permission under sections 11C(1) and (3) EA89 to bring an appeal (and, if permission is granted, to bring an appeal) against the decision of GEMA to proceed with modifications to the Licences published on 3 February 2015 (the "**Decision**") under section 11A EA89.¹
- 1.5 The Appellants seek permission to bring this appeal in their capacity as relevant licence holders. Section 11C(2)(a) EA89 provides that a relevant licence holder (within the meaning of section 11A EA89) may bring an appeal:
 - (A) Under section 11A(10)(b) EA89, the Appellants are holders of particular licences the conditions of which are to be modified by the Decision.
 - (B) Both Appellants were named as relevant licence holders in the Decision.
 - (C) Accordingly, the Appellants have standing to bring this appeal.

C. Scope of the Appellants' appeal

- 1.6 The Appellants have given careful consideration to the overriding objective of the appeals regime, i.e. for the Competition and Markets Authority ("**CMA**") to dispose of appeals fairly and efficiently within the time periods prescribed by the EA89 (and for the

¹ A hard copy of the Decision is included in **NOA1** at Tab 22. The Decision is also available online at: <https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-modifications-special-conditions-electricity-distribution-licences-held-slow-track-licensees>.

Appellants to assist the CMA to further this objective),² and to the CMA's guidance that it will seek to narrow the issues and points in dispute during the course of the appeal.³

- 1.7 As such, the Appellants have focused their appeal on three discrete issues, the errors in relation to which are both material and of material importance to the Appellants' RIIO-ED1 cost allowances. More specifically, the three particular issues where GEMA is "wrong" within the meaning of section 11E(4) EA89 concern respectively: smart grid benefits ("**SGBs**"), real price effects ("**RPEs**") and regional labour cost adjustments ("**RLCAs**"). The grounds of appeal in respect of these three issues are summarised in Section 2 below.
- 1.8 These errors had a cumulative impact on GEMA's view of total costs of £104.3 million in 2012/13 prices.⁴
- 1.9 More generally, the Appellants believe that GEMA's review was deficient in a number of other respects, including its failure properly to take into account the prevailing levels of efficiency of the DNOs. Whilst such deficiencies contributed to GEMA's errors in respect of Ground 1 below (SGBs), they also have the effect that, even if the present appeal succeeds on all three Grounds, there will still be a significant shortfall between the costs allowed by GEMA and the costs expected to be incurred by the Appellants in delivering the "Outputs" (i.e. standards of performance for consumers) on which the Decision is predicated.⁵
- 1.10 In setting out the grounds of appeal, the Appellants have been conscious that this is not only the first appeal under section 11C EA89, but the first appeal in relation to the application of the RIIO price control methodology, and concerns the first occasion on which RIIO has been applied to the DNOs. As a result, and with a view to assisting the CMA, in this Notice of Appeal, after having summarised their grounds, the Appellants outline aspects of the relevant legal and factual background before developing their grounds more fully.

² Competition Commission Energy Licence Modification Appeals Rules (September 2012), rules 4.1 and 4.2.

³ Energy Licence Modification Appeals: Competition Commission Guide (September 2012), paragraph 3.5.

⁴ Section 5 of Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report) also explains the impact of the total adjustment on cost allowances, IQI additional income (which is described in paragraph 5.16 below) and the efficiency incentive rate. This figure does not include the impact arising from the error in respect of RPEs for 2015/16, as the information required to quantify that error is not yet available (although it will become available during the course of the appeal, if permission is granted); see further paragraph 2.19 below.

⁵ More precisely, outputs as defined by GEMA are essentially the objectives of any DNO seeking to deliver a good service, such as a safe and reliable electricity supply, taking care of the environment during day to day work, timely connections, good customer service and so on.

D. The new RIIO approach to price control and assessment of the Appellants' business plan

- 1.11 The new RIIO approach replaces a system known as “**RPI-X**”, which was the system of regulation that was applied following the privatisation of the Regional Electricity Companies and operated from 1990 to 2015. Under RPI-X price control, GEMA focused, broadly, on assessing the case made by each DNO for the inputs required to carry on its activities (e.g. asset value, cost of capital, operating and capital expenditure, etc.) in order to determine the revenue that it was permitted to recover. The permitted revenue was allowed to rise by reference to general inflation, less a factor ‘X’ (sometimes called an “efficiency factor”, but which was designed simply to put downward pressure on prices).⁶
- 1.12 By contrast, the RIIO model was intended to place greater responsibility on the DNOs themselves, working with their stakeholders, to identify the best way of providing sustainable network services (“Outputs”) for the long term, including by seeking long term value for money.⁷ For example, once the Outputs were set, the DNOs were to identify the optimal balance between operating and capital expenditure and to take investment decisions using a long-term horizon, which may extend beyond the price control period.⁸ GEMA was then to assess each DNO’s business plan for achieving these Outputs in the coming price control period and set revenues, again subject to inflation but after taking account of productivity improvements and efficiencies that were built into the plan.
- 1.13 Thus, in RIIO-ED1, the DNOs were required to produce business plans which were to be assessed by GEMA, in particular in the light of comparisons between the DNOs using benchmarking techniques.
- 1.14 GEMA explained that it would then decide whether to fast-track one or more of the DNOs by proceeding quickly to licence modifications, and require the remaining DNOs to submit revised business plans for further scrutiny. Any such further scrutiny was to “*vary according to the categories in which they are placed in line with our approach to proportionate assessment, focusing on areas of particular concern*”.⁹

⁶ Witness Statement of John France, paragraphs 11 to 19.

⁷ Handbook for implementing the RIIO Model (4 October 2010) (“**RIIO Handbook**”), paragraph 1.10 (**NOA1** Tab 5).

⁸ RIIO Handbook, paragraphs 1.10 and 1.12 (**NOA1** Tab 5).

⁹ Ibid, paragraphs 2.7 and 2.8.

- 1.15 Subsequently, GEMA explained that it would allocate DNOs to three broad categories: fast-tracking, “*other proportionate treatment*” (involving proportionately lower scrutiny of the well-justified sections of the business plans) and “*full scrutiny*”.¹⁰
- 1.16 GEMA explained that the differing levels of scrutiny were intended to operate as an incentive on DNOs to produce realistic and well-justified business plans.¹¹ As a significant incentive, any DNO which was fast-tracked was promised upfront additional revenues of 2.5% of total expenditure¹² (“*totex*”).¹³ GEMA was also at pains to emphasise that any DNO that was fast-tracked would not be worse off as a result of GEMA’s decisions on the slow-track licensees.¹⁴
- 1.17 In reliance on the guidance provided by GEMA, the Appellants submitted a business plan that was lean and challenging.¹⁵ It promised more in terms of Outputs for less in terms of like-for-like costs by comparison with the previous price control. Indeed, the Appellants were the first DNOs to offer such a like-for-like reduction in costs.
- 1.18 GEMA assessed the DNOs’ plans by reference to a “traffic light” system, which was applied to five criteria: process; outputs; resources – efficient costs; resources – efficient finance; and uncertainty and risk.
- 1.19 GEMA considered that one DNO, Western Power Distribution (“**WPD**”), achieved a “green” rating for all five criteria and was therefore fast-tracked in respect of its four DNO licences in a decision published on 28 February 2014. GEMA considered that the Appellants achieved a “green” rating on four of the five criteria and on one an “amber” rating. On the basis that the Appellants did not get five “green” ratings, GEMA decided not to fast-track the Appellants.
- 1.20 As a result, GEMA required the Appellants to undertake the slow-track process in relation to all five criteria.
- 1.21 For a fuller account of the process and the manner in which GEMA proceeded, the Appellants refer to:

¹⁰ Strategy decision for the RIIO-ED1 electricity distribution price control. Business plans and proportionate treatment (4 March 2013) (“**Strategy Decision Business Plans and Proportionate Treatment**”), paragraph 2.24 (**NOA1** Tab 8).

¹¹ Ibid, paragraph 2.1 (**NOA1** Tab 8).

¹² Capital expenditure (capex) and operating expenditure (opex), taken together.

¹³ Strategy Decision Business Plans and Proportionate Treatment, paragraph 2.3 (**NOA1** Tab 8).

¹⁴ Ibid, paragraphs 2.3 and 2.14 (**NOA1** Tab 8).

¹⁵ Northern Powergrid, Our business plan 2015-23. Executive summary (March 2014), in particular the foreword from the Chief Executive (**NOA1** Tab 11A).

- (A) Paragraphs 23 to 51 of John France's Witness Statement, which describes in further detail the differences between RIIO and RPI-X, the process which the RIIO-ED1 price control followed, and the manner in which the Appellants responded to GEMA's clear incentives to produce "well-justified" business plans.
 - (B) Section 2 of the report of Frontier Economics, exhibited to the Witness Statement of Michael Huggins as **FE1** (the "**Frontier Report**"), which describes the eight steps used by GEMA when setting the RIIO-ED1 cost allowances.
- 1.22 The Appellants welcome the shift from RPI-X to RIIO and believe that the principles of proportionate assessment identified by GEMA and summarised above form a sound and improved basis for regulation. This appeal does not in any way call into question the overall shift by GEMA to the RIIO system, but instead concerns several important errors which GEMA made in operating this price control.

E. Key documents

- 1.23 The Appellants have provided written evidence for this appeal, principally in the form of the Witness Statements of Keith Noble-Nesbitt, John France, Mark Drye, Professor Philip Taylor and Michael Huggins (to which the Frontier Report is exhibited). Frontier Economics assisted the Appellants through the price control process and have direct experience of the RIIO regime. The Exhibits to these Witness Statements also include correspondence and other exchanges with GEMA over the course of the RIIO-ED1 price control review.
- 1.24 The Appellants have also exhibited the documents in Exhibit **NOA1** to this Notice. GEMA's reasoning for the Decision is contained primarily in the following documents, which are contained in **NOA1**:
- (A) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies: Overview" (28 November 2014) ("**Final Determination (Overview)**") (**NOA1** Tab 15);
 - (B) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies: Business plan expenditure assessment" (28 November 2014) ("**Business Plan Assessment**") (**NOA1** Tab 16);
 - (C) "Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators: Supplementary annex to RIIO-ED1 overview paper" (28 November 2014) (**NOA1** Tab 17); and
 - (D) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies: Detailed figures by company. Supplementary annex to RIIO-ED1 overview paper" (28 November 2014) (**NOA1** Tab 18).
- 1.25 Other relevant documents to which the CMA should have regard include:

- (A) The RIIO Handbook (**NOA1** Tab 5);
- (B) "Strategy decision for the RIIO-ED1 electricity distribution price control. Overview" (4 March 2013) ("**Strategy Decision**") (**NOA1** Tab 7);
- (C) "RIIO-ED1: Draft determinations consultation for the slow-track electricity distribution companies. Overview" ("**Draft Determination**") (30 July 2014) (**NOA1** Tab 12);
- (D) "RIIO-ED1: Draft determinations for the slow-track electricity distribution companies. Business plan expenditure assessment" ("**Draft Determination Business Plan Assessment**") (30 July 2014) (**NOA1** Tab 13);
- (E) "Statutory consultation on proposed modifications to special conditions of the electricity distribution licences held by the slow-track licensees" (17 December 2014) (**NOA1** Tab 19); and
- (F) "RIIO modifications to amend the special conditions of the electricity distribution licence held by the above named licensees and reasons for the decision pursuant to section 11A and 49A of the Electricity Act 1989" (3 February 2015) (**NOA1** Tab 22).

F. Contact details

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SECTION 2: SUMMARY GROUNDS OF APPEAL AND RELIEF SOUGHT

A. Overview

- 2.1 Under section 11E(4) EA89, the CMA may allow an appeal where it is satisfied that the decision appealed against was wrong on one or more of the specified grounds. For present purposes the relevant grounds are that:¹⁶
- (A) GEMA failed properly to have regard and/or to give the appropriate weight to its principal objective under section 3A EA89 and its statutory duties under sections 3A-C EA89 and section 132(1) and (2) Energy Act 2013 (section 11E(4)(a) and (b) EA89);
 - (B) the Decision was based, wholly or partly, on errors of fact (section 11E(4)(c) EA89);
 - (C) the licence modifications fail to achieve, in whole or in part, the effect stated by GEMA (section 11E(4)(d) EA89); and
 - (D) the Decision was based, wholly or partly, on errors of law (section 11E(4)(e) EA89), namely procedural unfairness, discrimination, acting disproportionately, breaching legitimate expectations, defiance of logic, failure properly to inquire, failure to consider relevant factors, reaching conclusions without adequate supporting evidence and/or mathematical or formula-specification errors (to the extent that these are characterised as procedural errors of law, rather than errors of fact).
- 2.2 The application of the above grounds to each of the three issues being challenged (SGBs, RPEs and RLCAs) is addressed in further detail below.

B. Ground 1: Smart Grid Benefits

- 2.3 Smart grid benefits (“**SGBs**”) are the forecast net cost savings in RIIO-ED1 arising from the application of so-called smart grid technologies and other innovation. Smart grid technologies, inter alia, enable more effective monitoring of, and response to, electricity capacity and demand, in particular in the context of low-carbon electricity generation and use. GEMA erred in its consideration of SGBs and wrongly reduced its view of the Appellants’ total costs.

¹⁶ The Appellants explain what is meant by “wrong” in Section 3 (*Statutory Framework to Determine the Appeal*) below, which explores these grounds in greater detail.

Ground 1A: Unjustified, disproportionate and discriminatory approach in Final Determination

- 2.4 During the fast-track stage, GEMA awarded the Appellants' business plan four "green" rankings and one "amber" and told NPg that "*some work will be required*" to the business plan to "*produce acceptable proposals*" in relation to efficient expenditure.
- 2.5 At Final Determination, however, GEMA did not focus its assessment on the revisions made to the Appellants' business plan or the further justifications they provided in response to GEMA's concerns. Instead, it adopted a wholly new approach on the basis that it considered that all DNOs (including WPD, which had been fast-tracked) were 'inefficient' in their assessment of SGBs (i.e. had not proffered enough savings):
- (A) First, GEMA adopted a general benchmarking exercise of the DNOs' business plans. This led GEMA to reduce its view of the DNOs' collective total costs by £82 million to reflect SGB savings that GEMA's initial benchmarking had captured, beyond those already included in the DNOs' business plans. This exercise was consistent with GEMA's approach at fast-track.
 - (B) In addition, however, GEMA undertook a further partial benchmarking exercise (which had not been presaged at the fast-track or the Draft Determination stage) which resulted in the Appellants themselves being required to make a *further* £42 million of SGB savings, increasing their total to £134 million.
- 2.6 The second partial benchmarking exercise in the Final Determination was a significant departure from GEMA's approach at fast-track and at Draft Determination and is fundamentally flawed:
- (A) GEMA wrongly departed from the (proportionate) approach it had itself indicated would be adopted under RIIO to address issues where substantially acceptable plans had been submitted but some further work would be required to render the plans satisfactory (particularly where there had been a positive appraisal of the Appellants' business plan in GEMA's decision not to fast-track the Appellants).
 - (B) GEMA sought to justify undertaking the second partial benchmarking exercise on the grounds that the benchmarking exercise itself showed that *all* the DNOs were 'inefficient' on SGBs. However, GEMA's benchmarking in the Final Determination simply showed that if a benchmark is set using the upper quartile, or the best performing (or "frontier"), company then the majority of companies will fail to meet it. This is a mathematical inevitability,¹⁷ rather than

¹⁷ Other than in completely unrealistic hypotheticals, e.g. if all the DNOs were at the benchmark.

evidence of industry-wide inefficiency. There was, therefore, no sufficient basis for this entirely new (and disproportionate) approach.

- (C) GEMA's back-up justification, namely that the emergence of SGBs should result in DNOs obtaining greater levels of ongoing efficiency savings than they had historically¹⁸ was also flawed. There is no reason to believe that the emergence of SGBs – a *new* category of saving – should result in an increase in the rate of available efficiency savings, because *all* efficiency savings involve a DNO doing something *new*. The supposed back-up justification simply re-states the results of GEMA's benchmarking.

- 2.7 The process was also discriminatory in that it imposed on the Appellants, without justification, a wholly different measure of SGBs from that properly assessed to constitute a “*good strategy*” in GEMA's decision at the fast-track stage. In addition, the result of the Final Determination was to require of the Appellants, without justification, a level of SGBs which was (proportionately) materially greater than that required of WPD (which was fast-tracked) and, as such, was discriminatory and inconsistent with the approach that GEMA indicated would be adopted under RIIO.

Ground 1B: Final Determination methodology inappropriate

- 2.8 If, contrary to Ground 1A, GEMA was entitled wholly to change its approach to the assessment of SGBs in the case of the Appellants, its second partial benchmarking exercise suffered from serious methodological and data flaws, and the results were not robust and could not be relied upon in order to impose significant cost reductions on the Appellants:

- (A) Double counting: GEMA carried out its SGB benchmarking using the DNOs' modelled costs, i.e. *after* £82 million of additional SGB savings had been captured by GEMA beyond those identified in the DNOs' business plans. This resulted in double counting of SGB savings. GEMA did not adequately resolve this. By contrast, when modelling RPEs, GEMA first reconstructed the DNOs' plans *without* any RPE adjustments, thereby eliminating the risk of double counting.
- (B) Failure to factor in prevailing levels of efficiency: GEMA wrongly set the benchmarked level of SGB savings by relying significantly on data from DNOs that GEMA's own detailed first stage benchmarking characterised as *inefficient* in that category of spend. DNOs that are *inefficient* have much greater scope to make proportionate savings than more *efficient* DNOs, because the availability of “smart” savings is greater, the less efficient that DNO is in “conventional” terms. GEMA wrongly failed to take adequate account of the DNOs' prevailing

¹⁸ Business Plan Assessment, paragraph 11.51 (NOA1 Tab 16).

levels of efficiency either in carrying out its benchmarking or by carrying out a “reality check” on the results (by “reality-check”, the Appellants mean that GEMA’s benchmarking exercise generated results which, on their face, should have caused GEMA to consider whether they had been produced by sound means). By way of illustration, demanding the same level of savings from every DNO is equivalent to treating Mo Farah, who is already at or near the *frontier* of achievement in 10km distance running events, the same as someone who has just taken up running. While Mo Farah could only reasonably be expected to shave seconds from his 10km time, the individual who has just taken up running might be able quite readily to take several minutes off their own.

- (C) Distorted incentives: The approach adopted by GEMA wrongly distorts DNOs’ incentives by rewarding savings made through “smart” solutions over those made through conventional solutions. This is liable to prejudice the interests of consumers by incentivising spending in “smart” costs categories, even if other solutions better minimise total costs. It is not consistent with the RIIO principles and is a consequence of wrongly partially benchmarking one cost category, especially after already including those costs in the general benchmarking exercise.

Ground 1C: Final Determination approach misapplied

2.9 If, contrary to Grounds 1A and 1B, GEMA was entitled to adopt its second partial benchmarking exercise of SGBs in its Final Determination, it made material errors in implementing that exercise in practice:

- (A) GEMA made a basic mathematical error in calculating the percentage of smart savings to be applied to the Appellants (and other slow-track DNOs).
- (B) GEMA made a mathematical consistency error (and/or an error in specifying its formula) in identifying the efficient smart savings embedded in the plans of the Appellants (and other slow-track DNOs) for the “Other” category.
- (C) In the case of spending on fault-level reinforcement, GEMA wrongly: (i) failed to “reality-check” that the Appellants would be able as a matter of commercial and industrial reality to achieve the avoided costs forecast by GEMA when, in fact, they could not; (ii) excluded important data-points; and (iii) relied on a single unrepresentative outlier to set the benchmark.
- (D) GEMA was wrong to find that the Appellants’ forecast savings by adopting smart solutions to LV / HV reinforcement were not “smart” within its revised definition.

Ground 1D: Unfairness, failure to consult

2.10 GEMA’s change in approach to SGBs was introduced very late in an extensive process and with inadequate consultation of the Appellants on novel and significant issues. The Appellants were not given an opportunity intelligently to comment on:

- (A) the aspects of GEMA's approach which are challenged in Grounds 1A, 1B and 1C above; or
- (B) GEMA's decision to change its definition of "smart" in the Final Determination and its reasons for not classifying as "smart" the Appellants' smart solutions to two of their extra high voltage (EHV) reinforcement projects, Jarratt Street and Audby Lane, and/or to their "smart" savings in low voltage / high voltage (LV/HV) reinforcement.

2.11 This was an unfair process and breached the Appellants' legitimate expectations about how the RII-ED1 price control process would be operated.

Legal consequences

2.12 Accordingly, by reason of the foregoing, the Decision was wrong in that:

- (A) GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties under:
 - (i) section 3A(1) EA89 (protection of the interests of consumers);
 - (ii) section 3A(2)(a) EA89 (securing that all reasonable demands for electricity are met);
 - (iii) section 3A(2)(b) EA89 (securing that licence holders are able to finance their activities);
 - (iv) section 3A(5)(a) EA89 (promoting efficiency and economy) EA89; and/or
 - (v) Article 36(a), (d) and (f) of EC Directive 2009/72¹⁹,

in particular because, in the Decision, GEMA's view materially under-assessed the Appellants' total costs ("**a Material Underfunding Error**") and/or the Decision does not promote efficiency and economy for the reasons given in paragraph 2.8(B) and (C) above;
- (B) GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to its duties under section 3A(5A)(a) EA89 to have regard to the principle under which regulatory activities should be

¹⁹ Directive 2009/72/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (13 July 2009).

transparent, accountable and consistent in that GEMA wrongly failed properly to consult and was not transparent as explained in Ground 1D above;

- (C) the Decision was based on the errors of fact identified in Grounds 1B and 1C (section 11E(4)(c) EA89);
- (D) the modifications fail to achieve the effect stated by GEMA (section 11E(4)(d) EA89) in that they do not give effect to the policy set out in the Strategy Decision as regards proportionate appraisal and the treatment of SGBs (as explained further in paragraphs 3.38 and 3.39 below); and/or
- (E) GEMA erred in law by discriminating, acting disproportionately, unfairly and/or in defiance of logic, breaching the Appellants' legitimate expectations, failing properly to inquire, reaching conclusions without adequate supporting evidence, and/or making mathematical or formula specification errors²⁰ (section 11E(4)(e) EA89).

C. Ground 2: Real Price Effects

- 2.13 Real Price Effects ("RPEs") are the expected changes in the prices, relative to general inflation as measured by the Retail Prices Index ("RPI"), of the inputs that DNOs purchase, over the course of the price control. GEMA reflected the impact of RPEs in its view of the DNOs' total costs.
- 2.14 In the case of labour, which accounts for 66% of DNOs' costs, the obviously relevant data for the first year on which GEMA made RPE assumptions, 2014/15, was pay settlements awarded by DNOs. GEMA uses DNOs' own data for most of its comparative benchmarking and the Competition Commission ("CC") in the Northern Ireland Electricity Limited Price Determination ("NIE") used actual labour costs data for this purpose.²¹ However, in this case, GEMA did not use actual relevant comparative data, but instead used more general labour data which was not focused on electricity distribution.
- 2.15 GEMA did not present an adequate basis for rejecting the use of the obviously relevant data – DNOs' own pay settlements – for 2014/15:
 - (A) GEMA's concern that use of actual pay settlement data might reward inefficiency is wrong. The DNOs have no incentive to make lax pay awards and did not in fact do so; in any event, the CC had found a method of mitigating this risk in NIE, which could readily have been applied.

²⁰ To the extent that these are characterised as procedural errors rather than errors of fact.

²¹ Competition Commission, Northern Ireland Electricity Limited price determination: Final determination (26 March 2014).

- (B) GEMA referred to the role of contractors, presumably as casting doubt on the use of actual DNO pay data, whereas the DNOs' own pay settlements are also the best available proxy for changes in the rate of pay of contractors.
- 2.16 GEMA wrongly used data that plainly did not reflect the labour costs faced by the Appellants: it used labour data that covered areas of economic activity other than electricity distribution and, as a result, was plainly not fit for GEMA's stated purpose of identifying the extent to which the actual costs pressures facing DNOs differ from RPI because data about private sector earnings in other parts of the economy has been affected significantly by the recession, whereas the market for labour for DNOs has not. This is evidenced by a comparison of DNOs' historic pay settlements with the data used by GEMA.
- 2.17 GEMA also wrongly failed to "reality-check" the data that it did use by referring to actual pay settlements agreed by DNOs, when doing so would have led a reasonable authority to question the output from its chosen approach.
- 2.18 Further, the clear inadequacies of its method in respect of 2014/15 apply equally to 2015/16. It is highly likely that the index used by GEMA for 2015/16 will fail to capture well the labour cost pressures faced by the DNOs.
- 2.19 As a result, GEMA has materially understated the RPEs faced by the Appellants for the first year for which GEMA made RPE assumptions, 2014/15 and the following year, 2015/16. If this appeal succeeds, the CMA (or GEMA on remission) will also be able to correct the error for 2015/16 in the same way as most, if not all, DNO pay settlements will by then be available.

Legal consequences

- 2.20 Accordingly, by reason of the foregoing, the Decision was wrong in that:
 - (A) GEMA made a Material Underfunding Error;
 - (B) GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties under section 3A(5)(a) EA89 (promoting efficiency and economy);
 - (C) the Decision was based on errors of fact (section 11E(4)(c) EA89); and/or
 - (D) GEMA erred in law by acting in defiance of logic, failing properly to inquire and/or reaching conclusions without adequate supporting evidence (section 11E(4)(e) EA89).

D. Ground 3: Regional Labour Cost Adjustments

- 2.21 Regional Labour Cost Adjustment ("RLCAs") are adjustments that GEMA made to DNOs' submitted costs in order to reflect differences in labour costs between London,

the South East and other regions collectively. They are designed to ensure that GEMA's comparative assessment of different DNOs' costs compare like-with-like.

- 2.22 In its Decision, GEMA sought to identify those differences by using general 2-digit Standard Occupational Classification ("**SOC**") data from the ASHE dataset (2008-2012), which is published by the Office for National Statistics ("**ONS**"). This 2-digit data was not accurate because the results were distorted by mix or compositional issues. The ONS itself warned users of its database of this issue, stating that the data do not "*take account of differences in the regional composition of the workforce, meaning that like-for-like comparisons may not be appropriate*". The CC in NIE used the ASHE dataset for the purposes of assessing RLCAs but, contrary to GEMA's suggestion in the Final Determination,²² used more granular 3- or 4-digit data, not the 2-digit data used by GEMA.
- 2.23 GEMA could readily have resolved this issue, for example by using more granular like-for-like data for labour categories employed by DNOs and/or other robust like-for-like data, which showed a much lower premium for London and the South East relative to the rest of Great Britain.
- 2.24 Further, GEMA failed to explain properly or at all why it had used the very general 2-digit ONS data despite the concerns that the Appellants raised throughout the slow-track process.

Legal consequences

- 2.25 Accordingly, by reason of the foregoing, the Decision was wrong in that:
- (A) GEMA made a Material Underfunding Error;
 - (B) GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to its duties under section 3A(5A)(a) EA89 to have regard to the principle under which regulatory activities should be transparent, accountable and consistent in that the Decision was not expressed in sufficiently clear and transparent terms, as regards GEMA's failure to explain why it did not accept the Appellants' argument that GEMA should use more granular data in preference to 2-digit SOC data in order to ensure a comparison on a like-for-like basis;
 - (C) the Decision was based on errors of fact (section 11E(4)(c) EA89); and/or
 - (D) GEMA erred in law by acting in defiance of logic, failing to consider adequately or at all the ONS's warning about the use of the ASHE dataset, failing properly

²² Business Plan Assessment, paragraph 4.17 (**NOA1** Tab 16).

to inquire and/or reaching conclusions without adequate supporting evidence (section 11E(4)(e) EA89).

E. The consequences for the Appellants

2.26 GEMA's errors had material adverse consequences. These consequences are explained in the Sections that follow and in the Witness Statements accompanying this Notice. In summary:

- (A) GEMA's errors in relation to SGBs led GEMA materially to overstate the SGBs that it considered the Appellants should have included in their business plan, but had not.

GEMA's decision wrongly to carry out a "second swipe" (which is challenged in Grounds 1A and 1B), resulted in GEMA's view on the Appellants' total costs being £41.9 million lower than it otherwise would have been.²³

The errors in Ground 1C are quantified in the Frontier Report at Table 19.

- (B) GEMA's errors in relation to RPEs resulted in GEMA's view on total costs for 2014/15 being £41.1 million lower than it otherwise would have been.²⁴

GEMA's errors also apply to 2015/16, although the precise quantification will not be available until later in the appeal.

- (C) GEMA's errors in relation to RLCAs resulted in GEMA's view on total costs being £21.3 million lower than it otherwise would have been.²⁵

2.27 Section 5 of the Frontier Report²⁶ shows the individual impacts of the remedies on GEMA's view of the Appellants' total costs, and sets out the impact of the remedies on the Appellants' cost allowances, IQI²⁷ additional income, and efficiency incentive rate.

²³ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

²⁴ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

²⁵ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

²⁶ Exhibit **FE1** to the Witness Statement of Michael Huggins.

²⁷ As explained further at paragraph 5.16 below, Information Quality Incentive ("IQI") is an incentive which GEMA calibrated to encourage companies to provide accurate forecasts of necessary costs.

F. The consequences for consumers

- 2.28 The effect of the Final Determination is to create a significant shortfall between the cost and revenue allowances set by GEMA for the Appellants and the costs that need to be incurred by the Appellants in delivering the Outputs to their customers. The Appellants are committed to delivering, and want to deliver, the Outputs that customers have asked for. Yet they may be forced to choose between some or all of: (A) not delivering those Outputs in full, to the limited extent to which they can choose to do so (which would be bad for customers in the short term); (B) delivering them in a way that is not optimal for the future resilience of their networks; or (C) failing to provide a reasonable return to their investors (which could result in under-investment, to the detriment of customers in the medium to long term).
- 2.29 GEMA recognised the importance of these points in its City Briefing (“Introducing the RIIO Model”), stating:

“It is in the interest of consumers that efficient network companies are able to secure equity and debt financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations.”²⁸

- 2.30 If the RIIO-ED1 price control is not conducted fairly and proportionately, contains errors and does not allow for the recovery of efficient costs (as the Appellants contend in this case), this will deter equity and debt investors from investing in the sector, undermining the Appellants’ ability to deliver Outputs, which will harm customers for the reasons GEMA identifies.
- 2.31 Moreover, if there are uncorrected deficiencies in one price control review, the next price control, RIIO-ED2, is likely to suffer from similar deficiencies, which are liable to harm consumers. For example, if smart solutions are arbitrarily more valued than conventional solutions in RIIO-ED1, DNOs may make sub-optimal investments in the RIIO-ED1 period and prepare sub-optimal business plans for RIIO-ED2 in each case with an artificial and unjustified bias to smart solutions, to the ultimate detriment of consumers.

G. Relief sought

- 2.32 The Appellants seek permission to appeal.
- 2.33 If permission is granted, the Appellants request that the CMA quash the Decision under section 11F(2)(a) EA89 and substitute its own decision to the extent necessary to remedy the errors in the Decision.

²⁸ GEMA, City Briefing: Introducing the RIIO Model (26 July 2010), at 40 (**NOA1** Tab 4).

2.34 The specific relief sought is explained in detail in the Sections which follow, and in the Frontier Report.²⁹ In summary:

- (A) in relation to SGBs, the Appellants request that the CMA substitute its own decision which either:
 - (i) reinstates the assessment of SGBs used by GEMA in the slow-track Final Determination cost assessment (under which SGBs were subject to quantitative assessment through the main benchmarking exercise, but were not subject to the “second swipe” adjustment described at paragraphs 6.31 to 6.32 below); or
 - (ii) corrects the errors within GEMA's methodology;
- (B) in relation to RPEs, the Appellants request that the CMA substitute its own decision, using data for calculating labour RPE assumptions which accurately proxies the DNOs' labour costs; and
- (C) in relation to RLCAs, the Appellants request that the CMA substitute its own decision which corrects for the compositional bias in the data GEMA used to calculate RLCAs.

2.35 In the alternative, the Appellants request that the CMA remit the matter to GEMA under section 11F(2)(b) EA89 for reconsideration and determination in accordance with such directions as are necessary adequately to address the errors.

H. The facts and reasons supporting the appeal

2.36 The grounds of this appeal, reasons and supporting evidence are contained in this Notice, in **NOA1** and in the Witness Statements and Exhibits to the Witness Statements.

2.37 The Appellants have endeavoured to provide all their facts, reasons, documentary evidence and witness statements with this Notice. If permission to appeal is granted, however, it may be necessary for the Appellants to file further material, particularly following receipt of GEMA's response and any disclosure.

²⁹ Exhibit **FE1** to the Witness Statement of Michael Huggins, paragraphs 3.139 to 3.144, 4.90 to 4.96 and Section 5.

SECTION 3: STATUTORY FRAMEWORK TO DETERMINE THE APPEAL

A. Overview

- 3.1 In this Section, the Appellants identify the statutory framework that governs this appeal under the EA89.
- 3.2 This Section has two parts:
- (A) First, the Appellants identify the standard of review to be applied in determining whether to allow this appeal; and
 - (B) Second, the Appellants identify the statutory grounds of appeal.
- 3.3 The Appellants have included this Section so as to explain the requirements that they understand will apply under the statutory framework, and to assist the CMA by providing context for their case, since the new appeals regime is so far untested.

B. Standard of review

- 3.4 Section 11E EA89 contains the grounds on which the CMA may allow an appeal brought under section 11C EA89 against a decision by GEMA to proceed with the modification of a condition of a licence authorising a person to distribute electricity. The key provision establishing the standard of review under section 11E EA89 is subparagraph (4), which provides that:
- “(4) The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—
 - (a) that the Authority failed properly to have regard to any matter mentioned in subsection (2);
 - (b) that the Authority failed to give the appropriate weight to any matter mentioned in subsection (2);
 - (c) that the decision was based, wholly or partly, on an error of fact;
 - (d) that the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b);
 - (e) that the decision was wrong in law.”
- 3.5 As no appeal under section 11C EA89 has been brought prior to this appeal, neither the CMA nor its predecessor, the CC, has had the opportunity to consider section 11E(4) EA89 directly, although some relevant guidance can be obtained from a review of decisions of the CC taken in exercise of its appellate functions under the Energy Code and the Communications Act 2003. In particular, in *E.ON UK Plc and GEMA and British Gas Trading Limited: Decision and Order of the Competition Commission* (“E.ON”), the

CC was required to determine an Energy Code modification appeal under the Energy Act 2004.³⁰ In that decision, the CC considered the standard of review it was required to apply under a substantially identical statutory provision.³¹

- 3.6 Furthermore, when consulting on the decision to amend the EA89 to introduce the current appeal provisions (as part of the implementation of the European Union Third Internal Energy Market Package), the Government indicated that its intention was that the grounds of appeal in energy licence modification cases should be similar to those applying to Energy Code modification appeals:

“Respondents were generally in favour of an appeal on the merits, but some commented that the grounds proposed in the consultation documents were too narrow. Some respondents commented that the proposed grounds are effectively the same as those available in the industry code appeals regime and were the subject of some debate when the appeal process was first used. One respondent pointed out that in the case of *E.ON UK Ltd v GEMA on Energy Code Modification UNC116* (CC 02/07), the Competition Commission took the view that the grounds for appeal enabled it to go beyond a narrower judicial review approach and to consider the merits of the case. **It is the Government’s intention that the proposed grounds for appeal for licence modification decisions also enable the appeal body to take account of the merits of the case in a similar manner. The Government considers the Competition Commission’s approach in relation to code modifications to be helpful in this regard.**”³² [emphasis in original]

- 3.7 As such, the Appellants treat the CC’s approach to the standard of review in *E.ON* as persuasive precedent in its discussion below of the standard of review to be applied in this appeal.
- 3.8 In *E.ON*, the CC considered that its role under section 175(4) of the Energy Act 2004, to decide whether GEMA’s decision was wrong on one or more of the specified grounds meant that the standard of review was different from judicial review:

“Those grounds clearly differ from the judicial review grounds of illegality, irrationality or procedural impropriety. This is clear on the face of the legislation, and it is also consistent with the purpose of

³⁰ *E.ON UK Plc and GEMA and British Gas Trading Limited: Decision and Order of the Competition Commission* (Case CC02/07) (10 July 2007).

³¹ Section 175(4) of the Energy Act 2004 provided that: “*The Competition Commission may allow the appeal only if it is satisfied that the decision appealed against was wrong on one or more of the following grounds — (a) that GEMA failed properly to have regard to the matters mentioned in subsection (2); (b) that GEMA failed properly to have regard to the purposes for which the relevant condition has effect; (c) that GEMA failed to give the appropriate weight to one or more of those matters or purposes; (d) that the decision was based, wholly or partly, on an error of fact; (e) that the decision was wrong in law.*”

³² Department of Energy and Climate Change, “*Implementation of the EU Third Internal Energy Package: Government Response*” (January 2010), paragraph 2.24 (NOA1 Tab 2).

the section 173 [of the Energy Act 2004] jurisdiction, which is to subject GEMA to a greater level of accountability than would be the case in judicial review.”³³

3.9 The CC also observed that:

“leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator.”³⁴

3.10 The CC also noted, however, that the degree of GEMA’s discretion will vary according to the aspect of the decision being considered:

“This is not to say that every aspect of a code modification decision will be a matter for GEMA’s discretion. There may be issues in respect of which it can more easily be said that GEMA’s decision is wrong – for example, if GEMA has made an error of principle. The CC will therefore consider on a case by case, and issue by issue, basis whether GEMA’s decision is wrong on one or more of the statutory grounds.”³⁵

3.11 The CC’s observations on its appellate role in its decision in *Verizon UK Limited / Vodafone Limited v Office of Communications*³⁶ – which, as the CC explains below, also concerned an appeal on the merits under section 192 of the Communications Act 2003 – is also relevant:

“Section 195(2) of the 2003 Act provides for an appeal on the merits. Section 192(6) shows that appeals can be brought on the basis of errors of fact or law or against the exercise of discretion. The Tribunal interpreted its role under a section 192 appeal as being one of a specialist court designed to be able to scrutinize the detail of regulatory decisions in a profound and rigorous manner. In our view, our role in determining the specified price control matters that have been referred to us is similar.”³⁷

3.12 The Appellants recognise that there is a line that must be drawn in deciding whether a particular decision of GEMA is wrong on one (or more) of the statutory grounds – in which case the appeal must be allowed; or whether the decision is one that the CMA might not have taken itself were it the regulator, but which is not wrong on one (or more) of the statutory grounds – in which case the CMA may not allow the appeal. The

³³ E.ON, paragraph 5.3.

³⁴ E.ON, paragraph 5.11.

³⁵ *Ibid*, paragraphs 5.12 to 5.13.

³⁶ *Verizon UK Limited / Vodafone Limited v. Office of Communications* (Case 1210/3/3/13) (12 December 2013).

³⁷ *Ibid*, paragraph 1.23.

Appellants have, therefore, limited their appeal to areas in which they consider that GEMA has exceeded any margin of regulatory discretion it may enjoy.

- 3.13 By limiting itself to specific areas, the Appellants' appeal is consistent with the CMA's objective in the Appeal Rules that appeals are to be disposed of efficiently and fairly. The specific areas the Appellants have appealed have caused GEMA's Decision to be wrong.

C. Statutory grounds of appeal

- 3.14 Section 11E(4) EA89 provides that the CMA may allow the appeal if it is satisfied that the decision appealed against was wrong on one (or more) of the statutory grounds in sub-sections (4)(a)-(e).

Sub-section (4)(a): GEMA failed properly to have regard to any matter in sub-section (2)

- 3.15 In this Notice, the Appellants refer to those matters in sub-section (2) of section 11E EA89 as GEMA's "obligations". This was the term the CC used in E.ON.³⁸
- 3.16 GEMA's relevant obligations for the purposes of this appeal are set out below.

The principal objective

- 3.17 Under section 3A(1) EA89, GEMA's principal objective in carrying out its functions under Part 1 EA89 (which includes GEMA's functions of granting licences to distribute electricity (s 6 EA89) and modifying the conditions of those licences (section 11A EA89)) is to:

"protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems."

- 3.18 Section 3A(1A) EA89 provides that "*the interests of existing and future consumers*" means:

"Those interests of existing and future consumers are their interests taken as a whole, including:

[...]

(b) their interests in the security of the supply of electricity to them; and

(c) their interests in the fulfilment by the Authority, when carrying out its functions as

³⁸ E.ON, paragraph 2.12.

designated regulatory authority for Great Britain, of the objectives set out in Article 36(a) to (h) of the Electricity Directive.”

3.19 In NIE, the CC interpreted the duties in Article 36 of the Electricity Directive as follows:

“At least some of these additional objectives and considerations may, properly understood and in terms of their substance, be part and parcel of an overall objective to further the interests of consumers.”³⁹

3.20 The term “consumers” is not defined (other than that it is existing and future consumers) in EA89. The Appellants consider that “consumers” in this context includes end users of electricity, notwithstanding that these are not direct customers of the DNOs, since charges levied by DNOs can be passed on to end users of the electricity network via suppliers’ charges.

3.21 In the context of price control regulation, the interests of consumers as end users of electricity will be protected by a regulatory settlement that ensures consumers receive a quality of service that meets their preferences (e.g. in relation to the number of supply interruptions), that the price of providing that service reflects the efficient costs (including the cost of capital) of providing that service, and that DNOs are able to recover reasonable revenues that enable them to make the necessary investments to provide the appropriate quality of service to consumers. Making investments is necessary to sustain DNOs’ performance over the longer term, to the benefit of consumers.

3.22 The Northern Ireland Authority for Utility Regulation – which is also charged with protecting the interests of electricity consumers⁴⁰ – explains the objective of price control regulation in similar terms:

“The objective of price controls is to ensure that [electricity lines service providers] do not abuse their monopoly position by charging customers prices which are too high, whilst at the same time ensuring that [electricity lines service providers] can finance [their] licensed activities to provide an adequate service. Economic regulation of [electricity lines service providers] aims to achieve a balance of interests between the company itself, shareholders and consumers.”⁴¹

3.23 Consumers’ interests in security of electricity supply under the principal objective also encompass the need for suppliers to be appropriately remunerated for their efficiently incurred costs. As GEMA has explained:

³⁹ NIE, paragraph 11.

⁴⁰ The Energy (Northern Ireland) Order 2003, Article 12(1).

⁴¹ Northern Ireland Electricity plc Transmission and Distribution Fifth Price Control (RP5): Strategy Paper (July 2010), page 2 (**NOA1** Tab 3).

“Our remit is to support the interests of energy consumers. The legal framework in which we operate makes clear that the interests of consumers include the future security and sustainability of energy...Ongoing security needs ongoing investment. We recognise that investors need confidence that investments they make now will be appropriately remunerated over the life of the assets.”⁴²

3.24 Security of supply, in the case of electricity distribution, is a necessary condition for securing that all reasonable demands for electricity are met.⁴³

3.25 Accordingly, in determining this appeal, the CMA must determine whether, in making the Decision, GEMA had proper regard to its principal objective (in particular, consumers’ interests in the security of supply of electricity to them).

The need to secure that all reasonable demands for electricity are met

3.26 While section 3A(1) EA89 establishes GEMA’s principal objective, GEMA has a number of additional obligations set out in the remainder of section 3A. Section 3A(2) EA89 provides that, in performing the duties under sections 3A(1B) and (1C) EA89⁴⁴, GEMA shall have regard to:

“(a) the need to secure that all reasonable demands for electricity are met...”

3.27 The Appellants note that this obligation refers to the need to “secure” that such demands are met. This is an onerous test. While it encompasses the absolute availability of electricity from generators and suppliers, it also invokes the need to secure that electricity can be delivered to an appropriate standard of quality and continuity by DNOs.

The need to secure that licence holders are able to finance their regulated activities

3.28 Section 3A(2) EA89 also provides that in performing the duties under sections 3A(1B) and (1C) GEMA shall have regard to:

“(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part, the Utilities Act 2000, Part 2 or 3 of the Energy Act 2004, Part 2 or 5 of the Energy Act 2008 or section 4, Part 2, sections 26 to 29 of the Energy Act 2010 or Part 2 of the Energy Act 2013;”

⁴² Ofgem, “Promoting Security of Supply” webpage. Available online at: <https://www.ofgem.gov.uk/about-us/how-we-work/promoting-security-supply>.

⁴³ See paragraph 3.26 below.

⁴⁴ Section 3A(1C) EA89, which is not reproduced here, applies only where GEMA is carrying out its functions by promoting effective competition. In the situation at hand, the principal objective is not being advanced by promoting effective competition but by economic regulation.

- 3.29 Section 3A(2)(b) EA89 is relevant in this appeal because the Decision is in relation to activities which are the subject of obligations imposed “under this Part” – that is, Part 1 EA89.
- 3.30 This obligation refers to the need to “secure” that licence holders are able to finance their regulated activities, which is the same onerous test. The Appellants submit that the obligation entails that DNOs are able to cover the reasonable costs of meeting the required Outputs *and* make reasonable returns on capital for providing distribution services.⁴⁵ The Appellants also note GEMA’s comments in its City Briefing (‘Introducing the RIIO Model’):

“It is in the interest of consumers that efficient network companies are able to secure equity and debt financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations.”⁴⁶

Promoting efficiency and economy

- 3.31 Section 3A(5) EA89 provides that, subject to subsections (3A)(1B) and (2) EA89, and to section 132(2) of the Energy Act 2013 (duty to carry out functions in manner best calculated to further delivery of policy outcomes) GEMA shall carry out its functions under Part 1 EA89 in the manner which it considers is best calculated:
- “(a) to promote efficiency and economy on the part of persons authorised by licences or exemptions to distribute, supply or participate in the transmission of electricity, to participate in the operation of electricity interconnectors or to provide a smart meter communication service and the efficient use of electricity conveyed by distribution systems or transmission systems;”
- 3.32 The Appellants note that “*the manner in which [GEMA] considers is best calculated*”, whilst a less onerous test than that provided for in those obligations which refer to the need to “secure”, nonetheless imposes a high standard on GEMA. When faced with a range of possible approaches to an issue GEMA’s obligation is to act in the manner “best calculated”. Accordingly its margin of appreciation does not extend to choosing an approach that is clearly inferior to another available choice.

⁴⁵ See, for example, the CC’s approval of Ofwat’s understanding of the duty to secure that companies are able to finance the proper carrying out of their functions in *Sutton and East Surrey Water plc: Interim Price Determination* (17 August 2009) at paragraph 4.65: “The approach that we have taken is also consistent with that adopted by Ofwat in setting the price controls. In particular, Ofwat considered that the duty to secure that companies are able to finance the proper carrying out of their functions had two strands: The first strand is that an efficiently managed and financed company was able to earn a return at least equal to the cost of capital. The second is to ensure that revenues, profits and cash flow must allow companies to raise finance on reasonable terms in the market. With regard to this second strand, Ofwat said that it was important that companies maintained their investment grade credit rating.”

⁴⁶ GEMA, City Briefing: Introducing the RIIO Model (26 July 2010), at 40 (NOA1 Tab 4).

Best practice regulation

3.33 Finally, section 3A(5A) EA89 requires that GEMA, in carrying out its functions under Part 1 EA89 in accordance with the preceding provisions of section 3A EA89, must have regard to:

- “(a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and
- (b) any other principles appearing to [GEMA] to represent the best regulatory practice.”

3.34 The principles of good regulation identified in section 3A(5A)(a) were defined by the Better Regulation Task Force as follows:⁴⁷

- (A) **Transparent:** Regulators should be open, and keep regulations simple and user-friendly.
- (B) **Accountable:** Regulators must be able to justify decisions, and be subject to public scrutiny.
- (C) **Proportionate:** Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.
- (D) **Consistent:** Government rules and standards must be joined up and implemented fairly. This includes the principle that regulation should be predictable in order to give stability and certainty to those being regulated.
- (E) **Targeted:** Regulation should be focused on the problem, and minimise side effects.⁴⁸

3.35 In E.ON, the CC found that GEMA had erred in its decision because it failed properly to have regard to the principle that regulatory activities be transparent because GEMA’s decision “*was not expressed in sufficiently clear and transparent terms*”.⁴⁹ It follows that section 3A(5A)(b) EA89 should be interpreted as requiring GEMA to express decisions in terms that are clear both as to the substantive effect that is proposed and the reasoning underpinning that decision.

⁴⁷ The parliamentary debates leading to the amendment of the EA89 which introduced the obligation in section 3A(5A) explicitly references the work of the Better Regulation Task Force in developing the principles. See HL Deb 4 March 2004, vol 658, col GC203. Available online at: <http://www.publications.parliament.uk/pa/ld200304/ldhansrd/vo040302/text/40302-14.htm>.

⁴⁸ Better Regulation Task Force, Principles of Good Regulation (2003) (NOA1 Tab 1).

⁴⁹ E.ON, paragraph 7.14.

GEMA failed to give appropriate weight to its obligations

- 3.36 GEMA will have failed to give appropriate weight to any of its obligations (the relevant obligations are set out above) where it has given insufficient or excessive weight to any of its obligations. The CC's interpretation of the same ground in E.ON is expressed similarly:

"In relation to section 175(4)(c), it is important to note the precise language of that section. Section 175(4)(c) provides that a decision may be wrong on the grounds that GEMA failed to give the appropriate weight to one or more of the matters or purposes referred to in subparagraphs (a) and (b). Subparagraph (c) is therefore concerned with the weight given by GEMA to the relevant matters and purposes."⁵⁰

GEMA's decision was based wholly, or partly, on an error of fact

- 3.37 The Appellants submit that GEMA will have based its decision wholly, or partly, on an error of fact where GEMA has made a factual error in making its decision and that error materially affects the decision. The CC considered this same ground in E.ON and found that it had:

"a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact."⁵¹

The licence modifications fail to achieve, in whole or in part, the effect stated by GEMA

- 3.38 Under section 11A(7)(b) EA89 GEMA must include in its decision to proceed with the making of licence modifications a statement of the effect of the modifications. GEMA's summary statement of the effect of the modifications is as follows:

"to give effect to the policy set out in the Strategy Decision and in the Final Determinations."⁵²

- 3.39 There is no dispute that the modifications give effect to the Final Determinations. But, as noted in paragraph 2.6 above, the Final Determinations do not properly reflect the policy set out in the Strategy Decision as regards "proportionate appraisal" and the treatment of SGBs. The Appellants submit that, where the licence modifications fail to achieve, in whole or in part, the effect stated by GEMA above, the CMA must allow the appeal.

GEMA's decision was wrong in law

⁵⁰ Ibid, paragraph 7.16.

⁵¹ E.ON, paragraph 5.16.

⁵² See the Decision (**NOA1** Tab 22). The reasons and effects of the modifications are set out in more detail in Schedule 3.

- 3.40 GEMA's decisions will be wrong in law where GEMA has misdirected itself on its obligations in making its decision.
- 3.41 It is also clear from the CC's comments in E.ON that the phrase "wrong in law", used in both the Energy Act 2004 and EA89, includes the public law concept of procedural unfairness/breach of natural justice.⁵³ The Appellants submit that this requires GEMA, in making its decision, to conduct the consultation prior to the decision with an open mind, allow interested parties to make representations, and to provide clear reasons for its decision (including responding properly to any material points made by interested parties).⁵⁴ The "wrong in law" wording also catches basic arithmetic errors.⁵⁵

⁵³ E.ON, paragraph 5.18.

⁵⁴ de Smith's Judicial Review, 7th ed., 2013, Sweet & Maxwell, Chapter 7.

⁵⁵ Danae Air Transport v. Air Canada [2000] 1 WLR 395, at page 406.

SECTION 4: THE INTRODUCTION OF RIIO AND THE CONTEXT OF THIS APPEAL

A. Overview

- 4.1 As stated in Section 1, the Appellants are supportive of the introduction of the RIIO regime, and in particular of the greater emphasis being given to the role of outputs in the price control settlement.⁵⁶
- 4.2 However, the Appellants believe it is important to a proper understanding of this appeal for the CMA to have an appreciation of the change in process and approach that RIIO represented, as well as the teething troubles that accompanied the introduction of RIIO in the context of ED1. It appears to the Appellants that the issues that are raised in this appeal can be attributed in part to the demands that the new RIIO process placed on GEMA.

B. The RPI-X regime from 1990 – 2015

- 4.3 The Witness Statement of John France describes the background to the RPI-X regime that preceded the RIIO regime.⁵⁷ In summary:
- (A) The RPI-X regime was introduced following the privatisation of the predecessor companies to the DNOs;
 - (B) The RPI-X regime, in its original form, was designed with straightforward incentives for cost reduction that resulted from a simple price cap that would be reset periodically in the light of information revealed in the prior period as well as forecasts of future costs;
 - (C) Price control reviews under the RPI-X regime became progressively more focused on including consideration of the outputs that DNOs must deliver in return for their cost and revenue allowances.

C. The RIIO regime

- 4.4 Following a detailed review of energy network regulation, known as RPI-X@20, GEMA decided to change to the RIIO regime. The RIIO regime was a significant step in the evolution of the price control regime for electricity distribution. It was intended to take elements of the old RPI-X regime that had worked well (such as the assessment of DNOs' costs using, in particular, a benchmarking exercise⁵⁸) and to adapt and add other

⁵⁶ See paragraph 1.22 above.

⁵⁷ Witness Statement of John France, paragraphs 11 to 19.

⁵⁸ The RIIO Handbook emphasises that the use of benchmarking would not be "*mechanistic*" given potential concerns about the "*robustness*" of the analysis: see paragraphs 8.37 and 8.41 (NOA1 Tab 5).

elements, including a focus, when benchmarking, on total expenditure (to leave to the DNOs the choice between capital and operating expenditure) and the use of incentives to encourage DNOs to produce realistic, well-justified business plans. GEMA explained that: “*The model is designed to promote smarter gas and electricity networks for a low carbon future*”.⁵⁹

The high-level elements of RIIO

- 4.5 Under the RIIO model, GEMA sets an up-front (*ex ante*) price control, under which the outputs⁶⁰ that each of the DNOs must deliver are defined, and the revenue they are allowed to earn in order to deliver those outputs is determined.
- 4.6 The intention is that DNOs receive sufficient revenue to ensure that they can deliver the required outputs, provided that they are efficient. RIIO is therefore a more outputs-focused regime than RPI-X.
- 4.7 As set out in the Witness Statement of John France, the process to determine the RIIO price control settlement is as follows:
 - (A) The first step is a “Strategy Decision” issued by GEMA, which puts forward GEMA’s proposals for the primary outputs for the sector, as well as incentives to meet or beat these outputs (DNOs are entitled to make alternative outputs proposals in their business plan where they consider these can be justified);
 - (B) DNOs then develop “well-justified” business plans in conjunction with stakeholders, setting out a costed set of proposals for delivery of the outputs required by their stakeholders;
 - (C) GEMA assesses these business plans using a “toolkit” approach, focusing on aspects where most value can be added through regulatory scrutiny rather than subjecting each aspect to intensive review. This step includes GEMA determining whether a DNO will be fast-tracked or slow-tracked and the opportunity for slow-tracked DNOs to submit revised plans;
 - (D) GEMA sets DNOs’ allowed revenue following its review of the business plans. It publishes draft determinations, indicating its preliminary view of DNOs’ allowances, and allows a consultation period for stakeholders to respond. It then publishes final determinations before publishing the licence modifications

⁵⁹ RIIO Handbook, ‘Context’ section on the second unnumbered page at the front (NOA1 Tab 5).

⁶⁰ See paragraph 1.9 above for a definition of ‘outputs’.

which aim to implement the price control, with a further statutory consultation before its final, operative, decision is published.⁶¹

How RIIO differs from the RPI-X model

4.8 The key differences between the RIIO and RPI-X models for the purposes of this appeal are as follows:

- (A) the RIIO regime was intended to adopt a proportionate approach to the assessment of business plans (i.e. GEMA focuses its regulatory attention where it generates most benefits);⁶²
- (B) DNOs are required to be transparent with stakeholders and GEMA about their business plans and their justifications, and GEMA is required to be transparent in its Business Plan Assessment and the decisions it makes;⁶³
- (C) DNOs are incentivised to produce realistic, innovative and well-justified business plans; and
- (D) under RIIO-ED1, slow-track DNOs can be benchmarked against the business plans accepted for fast-track determination.

4.9 The first difference listed above – GEMA's proportionate approach – has particular relevance for this appeal. A key part of the proportionate approach is the suite of incentives that GEMA has created to motivate DNOs to reveal accurate information in their business plans. This is meant to place greater responsibility on the DNOs themselves, working with their stakeholders, to identify the best way of providing sustainable network services for the long term, to address the asymmetric information problem that regulators face in setting price control terms, and to relieve GEMA from the onerous task of scrutinising every minute detail of all the DNOs' plans.

How RIIO was implemented at ED1

4.10 The key stages of the implementation of the RIIO model at ED1 were as follows:

- (A) GEMA published its Strategy Consultation for RIIO-ED1 on 28 September 2012. Following consultation, its Strategy Decision was published on 4 March 2013;

⁶¹ Witness Statement of John France, paragraph 22.

⁶² Witness Statement of John France, paragraph 23(A). See also Strategy Decision, paragraph 6.2 (NOA1 Tab 7).

⁶³ Ibid, paragraph 23(B).

- (B) DNOs then submitted their business plans to GEMA;
- (C) As part of GEMA's RIIO process, DNOs that submitted high quality business plans had the opportunity to be "fast-tracked" – that is, to reach a price control settlement with GEMA up to a year earlier than the standard "slow-track" process.⁶⁴ Companies that qualified for the "fast-track" were to be subject to a truncated assessment timetable, and therefore a lesser level of regulatory scrutiny, than those which remained in the "slow-track". GEMA stated that the slow-tracked DNOs would receive either "*other proportionate treatment*" (involving proportionately lower scrutiny of the well-justified sections of the business plans) or "*full scrutiny*".⁶⁵
- (D) Following its review of those business plans, GEMA announced its draft decision to fast-track only one DNO group, the four licensees owned by WPD, on 22 November 2013. Its final decision to fast-track WPD was published on 28 February 2014.
- (E) The remaining "slow-track" DNOs submitted revised business plans in the period that followed,⁶⁶ and GEMA published its draft determinations for the slow-track on 30 July 2014; and
- (F) Following consultation, GEMA's Final Determination for the slow-track was published on 28 November 2014, with the draft licence modifications implementing those determinations published on 17 December 2014. GEMA's Decision was published on 3 February 2015.

4.11 The methodology that GEMA applied to assessing DNOs' business plans at the fast-track was different in a number of respects from the methodology applied to the slow-track. Some of the changes at slow-track – such as the increased weighting applied to total cost benchmarking – were aligned with expectations as to how the RIIO-ED1 process would operate. Others, however, involved a significant departure from the approach which had been adopted at fast-track where, for example, there had been no separate adjustment applied for SGBs or for RPEs.⁶⁷ At slow-track, GEMA applied an additional tranche of SGBs over and above those provided for in DNOs' business plans and GEMA's core cost assessment and made a separate adjustment for RPEs.

⁶⁴ RIIO Handbook, page 10 (NOA1 Tab 5).

⁶⁵ Strategy Decision Business Plans and Proportionate Treatment, paragraph 2.24 (NOA1 Tab 8).

⁶⁶ The Appellants' business plan runs to over 1,000 pages, and is available online at <http://www.yourpowergridplan.com>. Relevant sections are contained in the Exhibits to the Witness Statements.

⁶⁷ This is the subject of Grounds 1 and 2 in this Notice of Appeal.

- 4.12 As a result of its fast-tracking, WPD received a financial benefit relative to the slow-track DNOs. GEMA calculated this financial benefit to WPD's shareholder be around £250 million, although the Appellants believe the true benefit is hundreds of millions of pounds higher.⁶⁸

D. The context of this appeal

- 4.13 In order to assist the CMA with narrowing the points at issue in this appeal, and in the interests of enabling the CMA to dispose of this appeal fairly and efficiently, the Appellants have, as described at paragraph 1.7 above, focused their appeal on three discrete aspects of the Decision which are both wrong and which have a material impact on the Appellants' cost and revenue allowances.⁶⁹ This is consistent with the nature of this application as an appeal, rather than a rehearing of GEMA's whole decision.
- 4.14 More generally, however, the Appellants believe that GEMA's review was deficient in a number of other respects, including its failure to properly or at all take into account the prevailing levels of efficiency of the DNOs. Whilst such deficiencies contributed to GEMA's errors in respect of SGBs that are identified in Ground 1, they also have the effect that, even if the present appeal succeeds on all three Grounds, there will still be a significant shortfall between the costs allowed by GEMA and the expected costs to be incurred by the Appellants in delivering the Outputs.
- 4.15 This is important because the Appellants are obliged to deliver high standards of performance agreed with GEMA at the outset over the eight year duration of the price control period (Outputs which compare well with other DNOs, including WPD). However, the end result of the review is that the Appellants' cost and revenue allowances have been reduced significantly. They are underfunded, yet their performance against the agreed Outputs will be judged in comparison to other DNOs, including WPD.

⁶⁸ Witness Statement of John France, paragraphs 35 to 40. See also the House of Commons Energy and Climate Change Committee report, "Energy network costs: transparent and fair?" (10 February 2015), paragraph 13 (**JMF1** Tab 28).

⁶⁹ The Appellants note the comment in the CC's Appeals Guide that the CC (and therefore the CMA, as its successor) will seek to narrow the issues and points in dispute: "*Energy Licence Modification Appeals: Competition Commission Guide*" (September 2012), paragraph 3.5. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284452/cc15.pdf.

SECTION 5: OVERVIEW OF COST ASSESSMENT FRAMEWORK

- 5.1 In this Section, the Appellants provide an overview of GEMA's cost assessment framework as it was applied to slow-track DNOs. The purpose of this Section is to provide context for the Appellants' grounds of appeal, which can be located at particular stages of the cost assessment framework.⁷⁰
- 5.2 GEMA undertook the following steps as part of the Final Determination in order to set its cost and revenue allowances for the DNOs at RIIO-ED1.

Step 1: DNOs' business plan submissions

- 5.3 The process started with the DNOs submitting their business plans to GEMA. The business plans contained detailed, line-by-line cost forecasts for the RIIO-ED1 period and historical data on actual costs.

Step 2: Pre-benchmarking adjustments

- 5.4 GEMA then made adjustments to DNOs' submitted costs before entering the data into the comparative benchmarking models. These adjustments were made with the stated intention that DNOs' cost data was compared on a like-for-like basis in the comparative benchmarking models.⁷¹ There were three types of adjustment:
- (A) **Regional labour cost adjustments:** GEMA adjusted the labour costs within the DNOs' submitted costs to take account of the wage premium in London and the South East region relative to the rest of Great Britain. This adjustment had the impact of reducing (or increasing) each DNO's submitted costs that fed into the benchmarking models, depending on whether GEMA's view of the labour costs pressures the DNO faced was above (or below) the national average;
 - (B) **Company specific adjustments:** GEMA made an adjustment to three DNOs' submitted costs to take account of particular types of cost each of these DNOs face that other DNOs typically do not; and
 - (C) **Other adjustments:** Some specific costs were excluded from elements of the benchmarking (i.e. a sub-set of costs within some line items).⁷²

⁷⁰ A more detailed overview of the cost assessment framework is provided at Section 2 of Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report).

⁷¹ Business Plan Assessment, paragraph 4.1 (**NOA** Tab 16).

⁷² The term "line items" is used to refer to cost categories within GEMA's disaggregated model.

Steps 3 and 4: Cost assessment models and calculation of efficiency scores

- 5.5 GEMA then fed the adjusted submitted costs into its comparative benchmarking models (i.e. the two totex models and the disaggregated model). The purpose of the comparative benchmarking models was to use DNOs' cost data to generate a view of efficient cost for the provision of distribution services, against which each DNO's submitted costs could be compared. Having run the models, GEMA calculated efficiency scores for each DNO for each of the three models. The efficiency scores were calculated as the ratio of a DNO's submitted costs (after applying pre-benchmarking adjustments) to the costs produced by the comparative benchmarking models.
- 5.6 GEMA calculated a combined efficiency score for each DNO, by weighting the efficiency scores from the three models, assigning 25% weight to each of the two totex models, and 50% weight to the disaggregated model.
- 5.7 GEMA then calculated the upper quartile (i.e. the 75th percentile) of the combined efficiency scores (see step 6 below for GEMA's reasons for doing so).
- 5.8 The comparative benchmarking exercise in steps 3 and 4 included SGBs, but excluded RPEs. GEMA considered that the sector had under-forecast the SGBs available in RIIO-ED1, and over-forecast RPEs. It therefore undertook a separate assessment of both; but while RPEs were removed from the cost assessment, SGBs were not.

Step 5: Reverse pre-benchmarking adjustments

- 5.9 At Step 2, GEMA made adjustments to the DNOs' submitted costs to ensure that the costs that flowed into the models were on a more comparable basis. However, the cost allowances that were set for the DNOs needed to take account of those costs that a particular DNO faces but others typically do not (e.g. the higher labour costs that DNOs face in London and the South East compared to the rest of Great Britain). GEMA therefore reversed the adjustments that it had previously made.
- 5.10 When the adjustments were added back in (or subtracted), the amount was not always the same quantum as the pre-benchmarking adjustment. For example, in the case of regional labour cost adjustments, the quantum of the adjustment was scaled based on the results of GEMA's efficiency assessment – if a proportion of a DNO's costs was found to be inefficient, a corresponding proportion of the adjustment reversal was treated as inefficient and thus disregarded.

Step 6: Calculation of modelled costs

- 5.11 The overall benchmark that GEMA set for the DNOs was the upper quartile of the combined efficiency scores. To set the upper quartile of the efficiency scores as the benchmark, GEMA applied the upper quartile efficiency score to the combined costs resulting from its models, post-reversal of adjustments, for each DNO. Since the upper quartile was below 100%, this had the impact of reducing combined costs for all DNOs. This produced the modelled costs.

Step 7: SGBs and RPEs

- 5.12 GEMA made separate assessments of DNOs' costs in two areas: (A) SGBs; and (B) RPEs.
- 5.13 In relation to SGBs, GEMA decided that the DNOs could generate more benefits (i.e. cost savings) than DNOs submitted in their business plans and were extracted by GEMA's cost benchmarking. GEMA estimated the savings it believed each DNO could achieve in RIIO-ED1, using benchmarking, and applied an SGB adjustment to modelled costs, in addition to its relative assessment of the DNOs' submissions on SGBs in its cost assessment, in order to match GEMA's view of the SGBs each DNO could achieve. For example, GEMA estimated that £133 million of SGBs were achievable by the Appellants. GEMA also identified that £91 million of SGBs were already in the Appellants' plans. This meant that GEMA made a negative adjustment for the Appellants of £42 million (i.e. £42 million of the Appellants' submitted costs were disallowed).⁷³
- 5.14 In relation to RPEs, GEMA calculated its own forecasts of RPEs and set DNOs' modelled RPEs based on its forecasts. The modelled RPEs were added on to the modelled costs.
- 5.15 GEMA's view of total costs was the sum of modelled costs, modelled RPEs and the SGBs adjustment.

Step 8: Final allowances are set

- 5.16 The final step of the process was GEMA's implementation of an incentive which it had calibrated to encourage companies to provide accurate forecasts of necessary costs, called the Information Quality Incentive ("IQI"). The IQI has three core elements:
- (A) GEMA's view of total costs was given a 75% weight, with the company's submitted costs given a 25% weight;
 - (B) DNOs received an up-front financial reward or penalty based on the variance between a company's submitted costs and GEMA's assessment of efficient expenditure; and
 - (C) DNOs whose submitted costs were closer to GEMA's view of efficient costs received a higher efficiency sharing rate (a post-tax rate used in determining the proportion of any cost savings which companies achieve which will be returned to customers).⁷⁴

⁷³ Business Plan Assessment, Table 11.1 (NOA1 Tab 16).

⁷⁴ Final Determination (Overview), paragraph 4.85 (NOA1 Tab 15).

SECTION 6: ESTIMATION OF SMART GRID BENEFITS**A. Overview**

- 6.1 This Section of the Notice concerns GEMA's application of an SGB adjustment to the Appellants. SGBs are the net cost savings that GEMA expected to arise in RIIO-ED1 from the application of smart grid technologies and wider network innovation.⁷⁵
- 6.2 The Appellants respectfully request the CMA to read by way of introduction to this topic:
- (A) The Witness Statement of Professor Philip Taylor, which explains at paragraphs 13 to 15 and 29 to 38 the use of "smart" technologies to address current network challenges being faced by DNOs, and the factors which affect the uncertainty of their development and deployment.
 - (B) The Frontier Report (**FE1**), which describes at paragraphs 2.49 to 2.53 the role of SGBs in the price control.
 - (C) The Witness Statement of John France, which explains at paragraphs 52 to 60 the process which GEMA followed on SGBs and compares it with the procedure that GEMA described at the outset.
- 6.3 GEMA's errors in its calculation of the Appellants' SGBs adjustment are identified in Section 2 above.⁷⁶ In summary, there are four sets of errors:
- (A) GEMA was wrong to adopt in its Final Determination a wholly new approach to the assessment of SGBs as this was unjustified, disproportionate and discriminatory;
 - (B) further or alternatively, the methodology adopted by GEMA in its Final Determination was inappropriate;
 - (C) further or alternatively, GEMA also made a series of material errors in implementing its approach; and
 - (D) in any event, GEMA operated an unfair process and failed properly to consult.
- 6.4 Accordingly, GEMA's Decision in relation to its SGBs adjustment was wrong by reference to the statutory grounds detailed in Section 2.⁷⁷

⁷⁵ Ibid, paragraph 4.59.

⁷⁶ See paragraph 2.3 to 2.11 above.

⁷⁷ See paragraph 2.12 above.

6.5 GEMA's errors in relation to SGBs led GEMA materially to overstate the SGBs that it considered the Appellants should have included in their business plan, but had not. GEMA's decision wrongly to carry out a "second swipe" (see Grounds 1A and 1B), resulted in GEMA's view of the Appellants' total costs being £41.9 million lower than it would otherwise have been.⁷⁸ The errors in Ground 1C are quantified in the Frontier Report at Table 19.⁷⁹

6.6 The Appellants request the relief identified in Section 2 of the Notice.⁸⁰

B. GEMA's approach to assessing the SGBs

Defining SGBs

6.7 SGBs are the net cost savings in RIIO-ED1 that GEMA forecast to arise from the application of smart grid solutions and wider network innovation.⁸¹

6.8 GEMA defines a smart grid as:

"An electricity network that can intelligently integrate the actions of all the users connected to it – generators, consumers and those that do both – in order to efficiently deliver sustainable, economic and secure electricity supplies."⁸²

6.9 In general terms, a smart grid is a network that is able to monitor and respond to capacity and demand, and is flexible enough to accommodate different types of generation and use (especially low-carbon technologies) where required. GEMA explains that:

"Smart grid technology and innovative contractual arrangements with consumers and generators will offer DNOs a more cost-effective way of resolving constraints on the network than investing in more assets. They give DNOs more flexibility, especially if they are unsure of longer term demand."⁸³

⁷⁸ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

⁷⁹ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.144.

⁸⁰ See paragraph 2.32 to 2.35 above.

⁸¹ Final Determination (Overview), paragraph 4.59 (**NOA1** Tab 15).

⁸² RIIO-ED1 Glossary of Terms (28 September 2012) (**NOA1** Tab 6).

⁸³ Draft Determination, paragraph 4.27 (**NOA1** Tab 12).

- 6.10 An example of a smart grid technology and its corresponding benefits is Real Time Thermal Rating, which is described in the Witness Statement of Professor Philip Taylor at paragraphs 16 to 22.
- 6.11 As noted in paragraph 6.1 above, SGBs also included “*wider network innovation*”.⁸⁴ In the Final Determination, GEMA stated that it regarded a solution as “smart” (i.e. a smart grid solution or a wider network innovation) if it had either “*been developed using innovation funding during DPCR5 or [was] demonstrably smarter or more innovative than what other DNOs do as business as usual*”.⁸⁵

GEMA's published approach to RIIO-ED1

- 6.12 The Appellants refer to paragraphs 1.11 to 1.16 above, which explain that GEMA incentivised DNOs to produce “well-justified” business plans by the promise of “*proportionate assessment*” in the form either of fast-tracking (with upfront additional revenues of 2.5% of totex) or “*other proportionate treatment*”, involving proportionately lower scrutiny of these sections of the business plans that GEMA had not found to be “well-justified”. (GEMA explained that business plans not falling in either of these two categories would instead receive “*full scrutiny*”.⁸⁶) The Appellants responded as GEMA intended by formulating a business plan which, as explained in paragraph 1.17 above, was lean and challenging.
- 6.13 When GEMA explained to the DNOs how it would operate the first distribution price control applying RIIO principles, it never suggested that SGBs would be the subject of a separate assessment in addition to the main benchmarking exercise. Rather, the assessment of SGBs was intended to be integrated into the qualitative review by GEMA of the DNOs' business plans and its quantitative analysis through the cost assessment as part of the general benchmarking process.⁸⁷

GEMA's differing approaches to the assessment of SGBs

- 6.14 GEMA used three significantly different approaches to assess the SGB adjustment to be applied to its view of the Appellants' total costs between fast-track and the slow-track Final Determination, as explained in the Witness Statement of John France at paragraphs 52 to 60.

⁸⁴ Final Determination (Overview), paragraph 4.59 (NOA1 Tab 15).

⁸⁵ Ibid, paragraph 4.71.

⁸⁶ Strategy Decision Business Plans and Proportionate Treatment, paragraph 2.24 (NOA1 Tab 8).

⁸⁷ Exhibit FE1 to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 3.19 and 3.20.

Fast-track approach to SGBs

- 6.15 At fast-track, DNOs submitted business plans which included forecast SGBs. The inclusion of SGBs was based on the guidance provided by GEMA in its RIIO-ED1 Strategy Decision. Given the uncertainty about the roll-out of smart grid technologies, GEMA asked DNOs to incorporate their smart grids savings into their expenditure totals and provide a more detailed description of how the deployment of certain types of smart grid solutions impacted on the costs detailed (rather than preparing estimates on a line item basis).
- 6.16 Based on GEMA's statements in its RIIO-ED1 Strategy Decision, the Appellants expected that SGBs would form part of the comparative initial cost benchmarking exercise.⁸⁸ For example, in relation to the general reinforcement cost category, GEMA stated:

“Our latest thinking is that the ex ante allowance will be built up using forecast and historic data to determine the benchmark unit costs for conventional reinforcement interventions. Where robust and comparable cost data is available across DNOs, we will apply the same approach for smart solutions.”⁸⁹

- 6.17 At fast-track, GEMA duly carried out a general costs benchmarking exercise. The DNOs' submitted costs took SGBs into account. GEMA did not estimate the SGBs that it thought could or would arise. The reason that GEMA did not undertake a separate estimate of SGBs was that it recognised that the cost benchmarking would itself drive out any relative SGB 'inefficiency' (without a need to separately identify the precise quantum of SGBs for each DNO). For example, GEMA stated: *“In conducting our assessment of efficient costs we implicitly consider the costs and benefits from smart grids, smart meters, and innovation.”*⁹⁰ GEMA also said its method was *“designed specifically to avoid discrimination between the use of 'smart grid techniques' and conventional reinforcement”*.⁹¹
- 6.18 At fast-track, therefore, and consistently with the expectations it had given the sector in the documents published prior to the fast-track, GEMA treated SGBs like any other source of cost reduction or efficiency for the purposes of comparative cost benchmarking assessment. The result for the one fast-tracked DNO (WPD) was that it

⁸⁸ Witness Statement of John France, paragraph 55.

⁸⁹ Strategy decision for the RIIO-ED1 electricity distribution price control. Tools for cost assessment (4 March 2013), paragraph 5.30 (NOA1 Tab 9).

⁹⁰ RIIO-ED1 business plan expenditure assessment – methodology and results (6 December 2013) (“**Fast-track Business Plan Methodology**”), paragraph 1.13 (NOA1 Tab 11).

⁹¹ Fast-track Business Plan Methodology, paragraph 7.50 (NOA1 Tab 11).

did not receive an adjustment to its overall cost and revenue allowances to reflect additional SGBs.

- 6.19 At fast-track, the Appellants received the highest ranking, “green”, in four of the five categories reviewed by GEMA. In the fifth, “*Resources – efficient costs*”, they received an “amber” ranking which indicated that “*some work will be required to produce acceptable proposals in the business plan submitted at slow-track*”.⁹²
- 6.20 Insofar as the consideration of smart solutions was a part of the “Outputs” criterion, GEMA gave NPg a “green” which denoted “*aspects of companies’ plans that are broadly acceptable to*” GEMA.⁹³
- 6.21 GEMA explained its assessment of SGBs in the “Resources – efficient costs” category as follows:

“Smart grids, smart metering, and innovation ... NPg provides an excellent strategy for incorporating smart grids into its business and realising the full benefits of these approaches. In relation to smart meters NPg’s business plan clearly articulates the cost of obtaining smart meter data from the DCC. The latest figures from DECC are used in their calculation. NPg provides a coherent strategy that explains how £129m of total system benefits of using smart meter data will offset the £12.9m cost of using and obtaining smart meter data. However, while the overall plan is of good quality, the design of the IT system does not include a system for data aggregation or for storage of data. NPg’s plan outlines some good examples of specific innovation across its business and has identified where these innovations feed into outputs. However, there is no quantification of the benefits or financial savings to customers of these innovations, or the improvement they have made to output targets, in the plan.”⁹⁴ [emphasis added]

- 6.22 The Appellants understood from this assessment that there was nothing fundamentally awry with their SGBs strategy, but that some further work would be required as part of the “*proportionate assessment*”⁹⁵ of the efficiency of its business plan.

Slow-track approach to SGBs – Draft Determination stage

- 6.23 The Appellants accordingly sought to address GEMA’s specific criticisms in the revised business plan that they submitted.⁹⁶

⁹² Assessment of RIIO-ED1 business plans and fast-tracking (22 November 2013), page 3 (NOA1 Tab 10).

⁹³ Ibid.

⁹⁴ Assessment of the RIIO-ED1 business plans and fast tracking. Supplementary Annex (22 November 2013) (exhibited to the Witness Statement of John France at JMF1 Tab 5).

⁹⁵ Witness Statement of John France, paragraph 55.

⁹⁶ Ibid, paragraph 43.

- 6.24 However, rather than further investigating the Appellants' responses and considering the quantification of the – accepted – SGB strategy, at the Draft Determination stage GEMA embarked on a new exercise which was intended to forecast SGB savings *per se*, i.e. the money *not* expected to be spent as a result of smart solutions being implemented. It did not properly engage with the Appellants' strategy. Instead, GEMA undertook a separate assessment of smart benefits in addition to the SGB assessment contained in its standard cost assessment framework. The adjustment to GEMA's view of total costs associated with this new, further SGB analysis was additional to the tougher benchmarks established in the main cost benchmarking exercise due to SGBs.
- 6.25 GEMA sought to justify this at the Draft Determination stage by reference to “*evidence from the DNOs' business plans, the Energy Networks Association (ENA) assessment of smart metering benefits, the Smart grids Forum smart grid modelling work, the DECC smart metering impact assessment and expected trends in efficiency gains due to innovation*”.⁹⁷ The use of such evidence in this way was widely criticised by the DNOs in their responses to the Draft Determination.⁹⁸

Slow-track approach to SGBs – Final Determination

- 6.26 In the Final Determination for the slow-track DNOs, GEMA significantly changed its approach to SGBs yet again, offering a remarkably oblique explanation for doing so:

“We have seen evidence that **a number of DNOs** have not embedded sufficient savings from smart grids, innovation and smart metering in their business plans. We consider it appropriate to adjust DNOs' allowances **accordingly**.”⁹⁹ [emphasis added]

- 6.27 It did not say what the evidence was. Certainly, there was no reference to GEMA relying on any of the “external evidence” identified in the Draft Determination¹⁰⁰ and this “evidence” no longer featured anywhere in GEMA's calculations. GEMA must therefore be taken (rightly¹⁰¹) to have dropped that reliance. The Appellants infer from the use of the word “*accordingly*” that the evidence justifying GEMA's benchmarking exercise was the results of that exercise (since the adjustments to GEMA's view of DNOs' total costs were made in reliance on the benchmarking), even though such reasoning is evidently circular.

⁹⁷ Draft Determination Business Plan Assessment, paragraph 11.2 (**NOA1** Tab 13).

⁹⁸ Witness Statement of Mark Drye, Annex, paragraphs 19 to 22.

⁹⁹ Business Plan Assessment, paragraph 11.36 (**NOA1** Tab 16).

¹⁰⁰ GEMA confirmed in an email from Dora Guzeleva of Ofgem to John France dated 10 February 2015 (Exhibit **MD1** Tab 59 to the Witness Statement of Mark Drye) that it did not rely on any evidence on this point other than that referred to in “*paragraphs 11.2 to 11.58 of the Final Determination*” (which is presumably a reference to the Business Plan Assessment).

¹⁰¹ Witness Statement of Mark Drye, paragraph 16.

- 6.28 GEMA's approach to benchmarking in the Final Determination is summarised in Figure 1 of the Frontier Report.¹⁰²

The financial value of SGBs

- 6.29 GEMA stated that DNOs had embedded £641m of SGBs in their business plans.¹⁰³
- 6.30 In fact, the £641 million of costs avoided through SGBs had already been through the comparative benchmarking process. Frontier Economics estimates that GEMA reduced DNOs' cost allowances by £82 million as a result, i.e. the £641 million figure cited by GEMA *understates* by £82 million the reduction in GEMA's view of DNOs' total costs arising from SGBs following the comparative benchmarking process as explained at Annex 4 of the Frontier Report.¹⁰⁴ This was GEMA's "first swipe" at SGBs.
- 6.31 In its Final Determination, GEMA made an additional and separate downward adjustment – a "second swipe" – to its view of DNOs' total costs¹⁰⁵ to account for the additional SGBs it considered should be available to efficient DNOs. The Final Determination states that the total SGBs applied to GEMA's view of DNOs' total costs was £963 million.¹⁰⁶ The effect of the "second swipe" that was taken at Final Determination was therefore that the DNOs as a whole incurred a further reduction in GEMA's view of total costs resulting from SGBs of £322 million on GEMA's figures.
- 6.32 The "second swipe" resulted in a further reduction in GEMA's view of the Appellants' total costs of £42 million, raising the total reduction in the Appellants' costs resulting from SGBs implicit in GEMA's view from £91 million to £134 million.
- 6.33 The SGBs that GEMA identified in the Final Determination are set out in Table 1 below.

¹⁰² Exhibit **FE1** to the Witness Statement of Michael Huggins.

¹⁰³ Business Plan Assessment, Table 11.1 (**NOA1** Tab 16). Table 11.1 for some reason does not match the number in GEMA's spreadsheet, which is £651.4m. In addition, Table 11.1 excludes smart meter savings of £25.4m, which GEMA identified as being within the plans. If GEMA had maintained the figure of £641 million and it had turned out that the actual level of savings realised was greater, customers would have received around 50% of those additional savings through the outperformance scheme.

¹⁰⁴ Exhibit **FE1** to the Witness Statement of Michael Huggins.

¹⁰⁵ Following the determination of the 'final modelled costs resulting from the cost assessment'. See Step 6 in Section 5 above.

¹⁰⁶ Business Plan Assessment, Table 11.1 (**NOA1** Tab 16).

Table 1: GEMA's view of SGBs (£m)

DNO	Embedded benefit (savings embedded in efficient allowances after costs assessment)	Adjustment	Total smart savings
<i>Industry-wide</i>	-641*	-322*	-963
NPgN	-39	-21	-60
NPgY	-52	-21	-74
Total	-91	-42	-134

Source: Business Plan Assessment, Table 11.1 (NOA1 Tab 16) (figures are rounded)

* WPD's SGBs at initial cost assessment were carried through unaltered into Draft and Final Determination figures, for the purposes of comparison (see Business Plan Assessment, Tables 11.1 and 11.2).

C. GEMA's errors in determining the SGBs that were applied to the Appellants' modelled costs for RIIO-ED1

Ground 1A: Unjustified, disproportionate and discriminatory approach in Final Determination

- 6.34 In the Fast-Track Assessment, the Appellants obtained four "green" rankings and one "amber" and were told that "*some work will be required*" to the business plan to "*produce acceptable proposals*" in relation to cost efficiency.
- 6.35 GEMA considered that the Appellants had "*a good strategy for using smart grids solutions, and anticipate reasonable benefits from doing so*".¹⁰⁷ Insofar as the consideration of smart solutions was a part of the "Outputs" criterion, GEMA gave NPg a "green". The only concern expressed about the Appellants' business plan was that further work was required in relation to the "resources – efficient cost" criterion, "*particularly [NPg's] assumptions for real price effects and overall efficiency on asset replacement*".¹⁰⁸
- 6.36 In its Final Determination, GEMA did not focus its assessment on the revisions made to the Appellants' business plan or the further justifications they provided in response to GEMA's concerns.

¹⁰⁷ Assessment of RIIO-ED1 business plans and fast-tracking (22 November 2013), page 5 (NOA1 Tab 10).

¹⁰⁸ Ibid.

- 6.37 Instead, it adopted a wholly new approach on the basis that it considered that all DNOs (including WPD which had been fast tracked) were inefficient in their assessment of smart grid benefits.
- 6.38 In its assessment, GEMA adopted a general benchmarking exercise of the DNOs' business plans. Frontier Economics estimates that this led GEMA to reduce the DNOs' modelled costs by £82 million to reflect SGB savings that GEMA identified, going beyond those already included in the DNOs' business plans.¹⁰⁹ This stage was consistent with GEMA's approach at fast-track.
- 6.39 At Final Determination, however, GEMA undertook a further partial benchmarking exercise (which had not been presaged at the fast-track or the Draft Determination stage) which resulted in the Appellants themselves being required to make a further £42 million of SGB savings, resulting in a total of £134 million.
- 6.40 This second stage was a significant departure from GEMA's approach at fast-track and materially flawed for three reasons.
- 6.41 First, GEMA wrongly departed from the (proportionate) approach it had itself indicated would be adopted under RIIO to issues where substantially acceptable plans had been submitted but some further work would be required to render the plans satisfactory (particularly where there had been a positive appraisal of the Appellants' business plan in GEMA's decision not to fast-track the Appellants).
- 6.42 Second, there was no good basis for an entirely new (and disproportionate) approach.
- 6.43 In the Draft Determination, GEMA sought to justify its decision to take a "second swipe" at SGBs by assessing forecast SGB savings, in reliance on "external evidence". Following extensive criticism of the approach in the Draft Determination, a wholly different approach to the assessment of SGBs was adopted in the Final Determination.
- 6.44 In its Final Determination, GEMA does not rely in its reasons on any external evidence¹¹⁰ and therefore drops its reliance on the "external evidence" referred to in the Draft Determination,¹¹¹ which was in any event wrong for the reasons given by Mark Drye in his Witness Statement at paragraphs 13 to 14 and the Frontier Report, paragraph 3.54 and Annex 1.¹¹²

¹⁰⁹ See Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.55.

¹¹⁰ See Footnote 100.

¹¹¹ If GEMA wishes, contrary to the terms of its Final Determination, to rely on external evidence to support its approach, the Appellants would wish to have the opportunity to respond if the evidence is admitted.

¹¹² Exhibit **FE1** to the Witness Statement of Michael Huggins.

- 6.45 It was wrong for GEMA to pursue a further new methodology with a view to increasing the SGBs required of the Appellants and the other DNOs considered under the slow-track.
- 6.46 The Final Determination states *"We have seen evidence that a number of DNOs have not embedded sufficient savings from smart grids, innovation and smart metering in their business plans."*¹¹³ [emphasis added]
- 6.47 On its face, GEMA's reasoning indicates that *"a number of"*, but not all, DNOs were regarded as inefficient. If the supposed inefficiency was indeed not industry-wide but limited to certain DNOs, then there was no basis for a generalised "second swipe", as such relative inefficiency would have been addressed in the main benchmarking exercise.
- 6.48 GEMA explained this point itself in the Final Determination, saying that the use of an upper quartile in benchmarking *"works well for areas of costs where there are differences in efficiency across companies and forecasts reveal information about comparative efficiency across the DNOs."*¹¹⁴ GEMA did not explain (and could not explain) why this statement was not applicable to SGBs if the supposed inefficiency were not industry-wide.
- 6.49 GEMA is, however, inconsistent in its approach. Elsewhere in the Final Determination it stated that *"we consider all the DNOs to be inefficient"* on smart grids.¹¹⁵
- 6.50 If the supposed inefficiency was indeed industry-wide, GEMA's benchmarking in the Final Determination simply showed that if a benchmark is set using the upper quartile, or the best performing (or "frontier") company then the majority of companies will fail to meet it. This is a mathematical inevitability,¹¹⁶ rather than evidence of industry-wide inefficiency, and GEMA was illogical and wrong to rely on its conclusions as evidence of inefficiency. Benchmarking measures *relative* and not *absolute* performance and therefore cannot evidence inefficiency on the part of *all* DNOs.
- 6.51 Third, GEMA's back-up methodology, namely that the emergence of SGBs should result in DNOs obtaining greater levels of ongoing efficiency savings than they had historically,¹¹⁷ was also flawed.

¹¹³ Business Plan Assessment, paragraph 11.36 (NOA1 Tab 16). Emphasis added.

¹¹⁴ Business Plan Assessment, paragraphs 3.30 - 3.31 (NOA1 Tab 16).

¹¹⁵ Ibid, paragraph, 3.31 (NOA1 Tab 16). Emphasis added.

¹¹⁶ Other than in completely unrealistic hypotheticals, e.g. if all the DNOs were at the benchmark.

¹¹⁷ Business Plan Assessment, paragraph 11.51 (NOA1 Tab 16).

- 6.52 Even setting to one side the fact that GEMA identified no robust, objective evidence to support its expectation that SGBs should result in DNOs obtaining greater levels of saving, it is wholly artificial to allocate efficiencies into two categories (“conventional” and “smart”), and assume (without evidence) that “conventional” efficiencies will continue to be available at the same rate as historically, and that “smart” efficiencies will be incremental to those “conventional” efficiencies. There is no reason to believe that the emergence of SGBs – a *new* category of saving – should result in an increase in the rate of available efficiency savings, because *all* efficiency savings involve a DNO doing something *new*.
- 6.53 It follows that GEMA’s reasoning is circular as it raises the very question it seeks to answer, namely: what is the magnitude of available SGB savings available to the Appellants?¹¹⁸ The back-up methodology simply re-states the results of GEMA’s benchmarking.
- 6.54 Furthermore, the process was discriminatory in that it imposed on the Appellants, without justification, a wholly different measure of SGBs from that properly assessed to constitute a “*good strategy*” in GEMA’s decision at the fast-track stage. In addition, the result of the Final Determination was to require of the Appellants without justification a level of SGBs which was (proportionately) materially greater than that required of WPD (which was fast-tracked) and, as such, was discriminatory and inconsistent with the approach that GEMA indicated would be adopted under the RIIO process.
- 6.55 Specifically, WPD was not subject to the separate assessment of smart benefits in addition to the SGBs analysis within GEMA’s standard cost assessment framework, a process which increased the SGB savings required by the Appellants by £42 million.¹¹⁹ By avoiding the slow-track process and the separate assessment of smart benefits, WPD avoided a £99 million SGB adjustment that would have affected its cost and revenue allowances. It was discriminatory and wrong to subject the Appellants to such an unjustified “second swipe” when WPD was not.
- 6.56 It was particularly important for GEMA not to discriminate without objective justification because the Appellants (and the other DNOs) will be benchmarked against WPD for the purposes of RIIO-ED2 and GEMA’s discrimination has left WPD in a much better position than the Appellants to deliver its Outputs.
- 6.57 This Ground is addressed in the Witness Statement of John France at paragraphs 28 to 40 and the Frontier Report at paragraphs 3.42 to 3.54.¹²⁰

¹¹⁸ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.52.

¹¹⁹ Business Plan Assessment, Table 11.1 (**NOA1** Tab 16), copied at paragraph 6.33 above.

¹²⁰ Exhibit **FE1** to the Witness Statement of Michael Huggins.

Ground 1B: Final Determination methodology inappropriate

- 6.58 If, contrary to Ground 1A, GEMA was entitled significantly to change its approach to the assessment of SGBs in the case of the Appellants, its second stage of partial benchmarking suffered from serious methodological and data flaws, which led to results that were not robust and could not be relied upon to impose significant cost reductions on the Appellants in three respects.

Double counting

- 6.59 First, GEMA carried out its SGB benchmarking using the DNOs' modelled costs, i.e. *after* £82 million of additional SGB savings had been identified by GEMA beyond those identified in the DNOs' business plans.
- 6.60 This resulted in (or is highly likely to have resulted in) double counting of SGB savings. GEMA did not resolve this for the reasons given in the Frontier Report at paragraph 3.59.¹²¹
- 6.61 Indeed, GEMA wrongly identified the SGB savings in its Final Determination "*after costs assessment*" but prior to the SGB Adjustment at £641 million for the DNOs as a whole, without referring to the additional savings (estimated by Frontier Economics at £82 million for the DNOs as a whole)¹²² resulting from the costs assessment (i.e. the conventional benchmarking exercise).¹²³
- 6.62 By contrast, when modelling RPEs, GEMA first reconstructed the DNOs' plans *without* any RPE adjustments, thereby clearly eliminating the risk of double counting.

Failure to factor in prevailing levels of efficiency

- 6.63 Second, at Final Determination, GEMA benchmarked the DNOs' forecasts of costs that they could avoid through SGBs. This information is not economically meaningful unless it is considered in the context of the DNOs' prevailing levels of efficiency. To illustrate: someone who has just taken up running might be able quite readily to take several minutes off their 10km time, but Mo Farah could only reasonably be expected to shave seconds from his, because he is already at or near the frontier of achievement in this event. It would not be sensible to benchmark forecasts of improvements to Mo Farah's personal best against those of the new runner.

¹²¹ Ibid.

¹²² Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.55.

¹²³ See paragraphs 6.29 to 6.30 above.

- 6.64 The benchmarking of SGB savings is no different: DNOs that are *inefficient* have much greater scope to make proportionate savings than more *efficient* DNOs, because the availability of “smart” savings is greater, the less efficient that DNO is in “conventional” terms.¹²⁴ This is because savings – whether generated by “smart” initiatives or conventional efficiency – bring a DNO closer to the optimal (or frontier) level of total expenditure necessary to meet the Outputs or performance standards agreed with GEMA. The closer a DNO is to the optimal (or frontier) level of total expenditure, the less scope there is to make proportionate savings in any form. For example, imagine that the optimal level of total expenditure of two DNOs is each 100. DNO A is relatively inefficient and has total expenditure of 150, whereas DNO B is relatively efficient and has total expenditure of 110. If DNO A identifies savings of 30 from smart initiatives, its proportionate saving is 20% (30 / 150), but DNO B cannot make a 20% saving, since a saving of only 9.1% (10/110) would take it right to the efficiency frontier.
- 6.65 The Frontier Report¹²⁵ shows at paragraph 3.87 that, in general, the benchmarks in the SGB models are set by DNOs who trail the efficient frontier in the cost models. This means that GEMA has used information about DNOs that it regards as inefficient in this category of spend to set the benchmark for SGB savings for more efficient DNOs. In doing so, GEMA's approach fails adequately (or at all) to address the logical conclusion that companies with more efficient conventional costs would be unable to secure similar proportionate reductions, as they start from a lower cost base and therefore have less potential for cost savings by deploying smart solutions.
- 6.66 GEMA therefore wrongly set the benchmarked level of SGB savings by relying significantly on data from DNOs that GEMA's own detailed first stage benchmarking characterised as *inefficient* in that category of spend.
- 6.67 GEMA also wrongly failed to take adequate account of the DNOs' prevailing levels of efficiency either in carrying out its benchmarking or by carrying out a “reality check” on the results.

Distorted incentives

- 6.68 Third, the approach adopted by GEMA wrongly distorts DNOs' incentives by rewarding savings made through “smart” solutions over conventional solutions.
- 6.69 GEMA's approach rewards smart savings over conventional savings because any failure by a DNO to make smart savings results in a potential reduction in its view of that DNO's total costs *both* during the normal comparative costs benchmarking stage and also at the “second swipe” stage of benchmarking by category of smart saving. By contrast, a failure to pursue a conventional efficiency saving results in only one penalty,

¹²⁴ Witness Statement of Professor Philip Taylor, paragraph 37.

¹²⁵ Exhibit **FE1** to the Witness Statement of Michael Huggins.

i.e. at the normal comparative cost benchmarking stage, as explained in the Frontier Report at paragraphs 3.63 to 3.66.¹²⁶

- 6.70 The introduction of such a significant distortion is at odds with the approach in RIIO of identifying the best way of providing sustainable network services for the long term, including by seeking long term value for money without preferring one category of spending over another, and is therefore wrong. As GEMA explained: “*total costs should be the basis of assessment given the ambition to avoid biasing the network company into particular solutions (e.g. capex solutions over opex)*”.¹²⁷ GEMA also said its methodology at fast-track was “*designed specifically to avoid discrimination between the use of 'smart grid techniques' and conventional reinforcement*”.¹²⁸
- 6.71 This systematic bias in favour of smart savings that was introduced in the Final Determination will, if thought by DNOs likely to be maintained in future regulatory periods, incentivise DNOs to favour smart solutions even if long term value for money would be better served by conventional solutions (and GEMA is currently encouraging DNOs to think this way). This may prejudice the interests of consumers by incentivising spending in “smart” costs categories, even if other solutions better minimise total costs. It is not consistent with the RIIO principles and is a consequence of wrongly partially benchmarking one cost category, especially after already including those costs in the general benchmarking exercise.
- 6.72 This ground is addressed in the Frontier Report at paragraphs 3.55 to 3.60, 3.63 to 3.68 and 3.84 to 3.91.¹²⁹

Ground 1C: Final Determination approach misapplied

- 6.73 GEMA's benchmarking was flawed in practice. If, contrary to Grounds 1A and 1B, GEMA was entitled to adopt its approach of benchmarking SGBs in its Final Determination, it made material errors in implementing its approach.

(i) Mathematical error in calculating percentages

- 6.74 GEMA made a basic mathematical error in calculating the percentage of smart savings to be applied to the Appellants (and other slow-track DNOs).¹³⁰

¹²⁶ Ibid.

¹²⁷ RIIO Handbook, paragraph 8.37, first bullet point (NOA1 Tab 5).

¹²⁸ Fast-track Business Plan Methodology, paragraph 7.50 (NOA1 Tab 11).

¹²⁹ Exhibit FE1 to the Witness Statement of Michael Huggins.

¹³⁰ Exhibit FE1 to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 3.95 et seq. set out in further detail this error.

- 6.75 GEMA's methodology across the SGB categories is based on the ratio of smart savings (the numerator) to costs (the denominator) in each category. The costs in each category are those costs submitted by the DNOs in their business plans. Those submitted costs incorporate SGBs.
- 6.76 In calculating this ratio the denominator should be those costs submitted by DNOs which do not incorporate any amount of SGBs (i.e. conventional costs). However, GEMA wrongly calculated the ratio with a denominator which was submitted costs (which incorporate submitted SGBs).
- 6.77 GEMA calculated the percentage as $100 \times (\text{savings} / \text{costs incorporating SGBs})$, which resulted in a higher percentage than the correct calculation which is $100 \times (\text{savings} / \text{conventional costs})$. By way of illustration, if savings of 10 were identified out of total conventional costs of 100, the percentage reduction should be 10% but GEMA wrongly calculated it as 11.11%.
- 6.78 Using conventional costs as the denominator is correct because it conveys the amount of SGBs a DNO has forecast as a share of the DNO's conventional costs without the saving implied in the submitted SGBs. This provides a ratio which indicates the amount of SGBs a DNO forecasts as a percentage of its conventional costs. The ratio that GEMA uses – i.e. the amount of submitted SGBs a DNO forecasts as a percentage of conventional costs minus submitted SGBs – overstates the ratio.
- 6.79 GEMA has therefore used a ratio for the SGBs adjustment which miscalculates the percentage of SGBs to be applied to the Appellants. This has the effect of overestimating the SGBs that DNOs can achieve.¹³¹
- 6.80 This ground is addressed in the Frontier Report at paragraphs 3.95 to 3.106.¹³²

(ii) Further mathematical error in treating "Other" costs inconsistently

- 6.81 GEMA made a mathematical consistency error¹³³ (and/or an error in specifying its formulae) in identifying the efficient smart savings embedded in the plans of the Appellants (and other slow-track DNOs) for the "Other" category. (This figure was deducted from GEMA's benchmark level of smart savings to identify the savings that the Appellants were required to make.)
- 6.82 The error was that the benchmark level of smart savings was calculated across the "Other" pot as an *overall* category, whereas the efficient smart savings embedded in the

¹³¹ This point is illustrated in Tables 14 and 15 of Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report).

¹³² Exhibit **FE1** to the Witness Statement of Michael Huggins.

¹³³ The error appears in GEMA's spreadsheets.

Appellants' business plan were calculated by treating each *sub-category* within the "Other" pot as individual and separate, even though GEMA stated that it intended to treat the "Other" category as a single pot.¹³⁴

6.83 GEMA's calculation of the SGBs to apply to the DNOs' modelled costs consisted of the following three steps:

- (A) *Step 1:* GEMA examined DNOs' plans and, late in the process, requested further information from DNOs with a view to reaching a view on the level of costs that the DNOs were not expecting to face because they were employing techniques that were deemed to be sufficiently smart;
- (B) *Step 2:* GEMA calculated the SGBs that it considered should have been included in the DNO's business plan; and
- (C) *Step 3:* GEMA applied the difference between the SGBs that were included in the DNO's business plan and the SGBs that GEMA calculated should have been in the DNO's business plan to the DNO's final cost allowance.

6.84 In relation to the "Other" SGB category, GEMA carried out Step 1 by:

- (A) Identifying each DNO's SGBs for each individual sub-category of the "Other" category;
- (B) Dividing the identified SGBs for each sub-category by the DNO's submitted costs for the same sub-category; and
- (C) Multiplying that sub-category specific ratio by GEMA's view of the DNO's total costs.

6.85 Accordingly, for Step 1 in relation to the "Other" category, GEMA treated each sub-category as separate.

6.86 However, for Step 2, GEMA treated the "Other" category as a single aggregated group. GEMA calculated the SGBs that it considered should have been in the DNO's business plan by:

- (A) summing all SGBs across the "Other" category;
- (B) dividing those SGBs by the sum of submitted costs across the "Other" category to derive the benchmark ratio; and

¹³⁴ Final Determination (Overview), paragraph 4.78 (NOA1 Tab 15). See also Business Plan Assessment, paragraph 11.19 (NOA1 Tab 16).

(C) multiplying that benchmark ratio with the benchmark costs of the category in question.

6.87 The effect of the inconsistent treatment by GEMA was that the Appellants were arbitrarily penalised because GEMA's formulas required them to make greater levels of savings than GEMA's assessment of the SGBs in the "Other" category required. The error would not have arisen had GEMA been consistent in its approach and treated the "Other" sub-category as an *overall* category.

6.88 This ground is addressed in the Frontier Report at paragraphs 3.107 to 3.122.¹³⁵

(iii) Basic data handling errors in the case of fault-level reinforcement

6.89 GEMA made three data handling errors in relation to spending on fault-level reinforcement.

6.90 First, GEMA was wrong to rely on the results of its benchmarking to adjust the Appellants' modelled costs, and hence cost and revenue allowances, without first "reality-checking" whether the results would arise in practice, in particular by confirming that as a matter of engineering and commercial reality that the Appellants would be able to realise the savings identified by the benchmarking exercise.

6.91 In fact the savings in the case of fault-level reinforcement were not available to the Appellants. GEMA identified the savings to be made by the Appellants from the plans of Scottish and Southern Energy Power Distribution ("**SSES**"), yet those plans related to different voltages, were not proven and would not in any event be applicable to the Appellants' network: see the Witness Statement of Mark Drye at paragraphs 19 to 32.

6.92 Second, GEMA wrongly disregarded data from DNOs which identified zero SGB savings. In order to assess the additional fault-level SGBs, GEMA selected 75% of the "*best performing*" DNO's proportion of submitted net expenditure in fault-level reinforcement as the benchmark (rather than an upper quartile), since it considered that "[a]n [upper quartile] is not appropriate due to the small number of data points".¹³⁶ GEMA found that there were not enough data points for an upper quartile calculation, since "*only a small number of DNOs considered the potential for savings*".¹³⁷ The Appellants' understanding is that, in fact, GEMA has interpreted the zeroes returned by many DNOs as "no returns", when they simply reflect companies' expenditure on projects where smart solutions cannot sensibly be deployed.¹³⁸ For example, Scottish

¹³⁵ Exhibit **FE1** to the Witness Statement of Michael Huggins.

¹³⁶ Business Plan Assessment, paragraph 11.4 (**NOA1** Tab 16).

¹³⁷ Final Determination (Overview), paragraph 4.75 (**NOA1** Tab 15).

¹³⁸ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.76.

Power owns two DNOs, one of which identified large SGB savings in fault-level reinforcement, whilst the other identified none, even though both must have had access to the same technology, implying that no savings were available to the DNO with a zero data-point. In those circumstances, a zero data-point is a valid data point. Accordingly there were sufficient data points to benchmark on an upper quartile basis and GEMA was wrong not to do so.¹³⁹

6.93 In any event, it was wrong to respond to a concern about lack of data by relying on a single data point.¹⁴⁰

6.94 Third, GEMA was wrong to use SSES as a benchmark for fault-level reinforcement SGBs. GEMA stated that SSES was the best performing DNO: it submitted a ratio of 41.1% of SGBs to expenditure in the category. However:

- (A) SSES's ratio of 41.1% was an outlier ratio compared to the ratios submitted by other DNOs. The nearest ratio was that of Electricity North West Limited ("ENWL") and that was 20.7%. The industry upper quartile was 10.7%. This is shown in Figure 1. As the Frontier Report explains at paragraph 3.127, it might in some circumstances be appropriate to use an outlying DNO's savings if the remainder of the industry was lagging but could achieve comparable savings if it were efficient;¹⁴¹ but it is also plausible that there was something unique or distinctive about the outlier that meant that other efficient DNOs could not be expected to replicate the level of savings given its work mix;
- (B) SSES's costs in this cost category accounted for only 3% of total industry costs in the category.¹⁴² This means that SSES's cost base is unlikely to be reflective of the other DNOs' cost bases;
- (C) GEMA could have addressed this issue¹⁴³ by not benchmarking this category¹⁴⁴ (or using the upper quartile), rather than using 75% of the best performing DNO.

Figure 1: GEMA's calculation of the benchmark for fault-level reinforcement SGBs

¹³⁹ Ibid, paragraph 3.77 to 3.78.

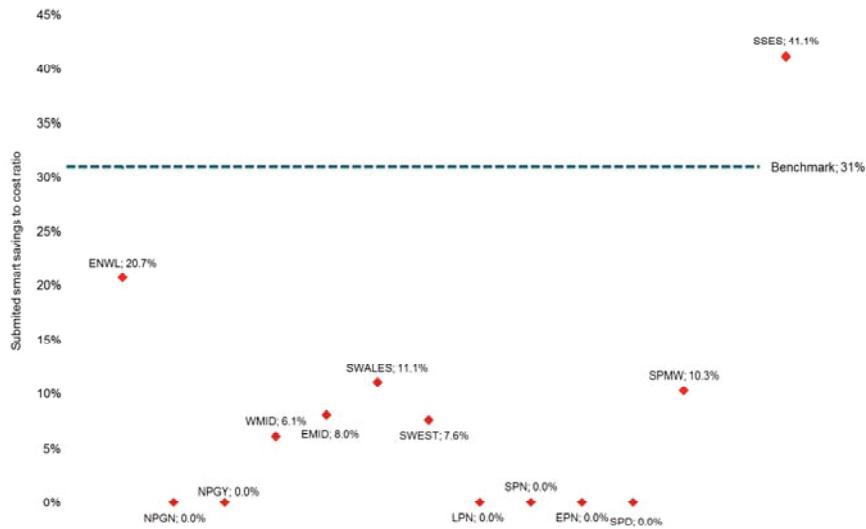
¹⁴⁰ Ibid, paragraph 3.79 to 3.82.

¹⁴¹ Exhibit **FE1** to the Witness Statement of Michael Huggins (the Frontier Report).

¹⁴² Ibid, paragraph 3.130.

¹⁴³ Subject always to Grounds 1A and 1B.

¹⁴⁴ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraph 3.127.



Source: GEMA

- 6.95 This Ground is addressed in the Frontier Report¹⁴⁵ at paragraphs 3.123 to 3.137 and the Witness Statement of Mark Drye at Section D and E.

(iv) GEMA wrongly refused to accept the Appellants' smart savings in general LV / HV reinforcement

- 6.96 The Appellants identified £18.7 million of savings arising from the use of “smart” solutions in general LV / HV reinforcement but GEMA rejected those savings on the grounds that “*Expert review indicates a lack of evidence that the expenditure reduction between fast-track and slow-track is due to smart or innovative solutions*”.¹⁴⁶
- 6.97 The £18.7 million of savings formed part of the Appellants’ plans throughout the price control review. They were not identified following the fast-track determination as GEMA implies.
- 6.98 The Appellants’ expenditure on LV / HV reinforcement does not typically involve major projects, but instead comprises a relatively large number of smaller-scale projects that respond to specific issues, as they arise. The Appellants’ business plan therefore forecast annual reinforcement costs across a series of six work categories, rather than at a project level.

¹⁴⁵ Exhibit FE1 to the Witness Statement of Michael Huggins.

¹⁴⁶ Business Plan Assessment, Table 11.5 (NOA1 Tab 16).

- 6.99 The Appellants explained in their business plan that they had decided to reduce expenditure in this area because “*we believe the smart solutions being developed for LCT growth will assist with traditional HV and LV load growth*”.¹⁴⁷
- 6.100 The Appellants did not, however, specifically ascribe a figure to the smart savings in their business plan. There was no requirement to specify the figure, and the Appellants did not do so.
- 6.101 Once the Appellants saw the Draft Determination, which rewarded “smart” savings and gave the Appellants no reward for their LV / HV reinforcement savings, they wrote to GEMA to explain that their SGB adjustment should be reduced to reflect these savings. In correspondence, the Appellants explained how they quantified the savings.
- 6.102 Despite this, GEMA rejected the claims in the Final Determination for the reasons quoted above in paragraph 6.96 to 6.106. The Appellants requested a copy of the “expert review” but were told there was nothing to be disclosed.¹⁴⁸
- 6.103 GEMA's reasoning is illogical. It refers to expenditure reductions between fast- and slow-track, but the Appellants made no reduction whatsoever in their forecast expenditures. The savings had always been referred to in the business plan.
- 6.104 Furthermore, GEMA's approach means that the Appellants are being expected to make the same savings twice over. The Appellants themselves identified £18.7 million of savings arising from the use of “smart” solutions in general LV / HV reinforcement and the cost forecasts in their business plan were reduced accordingly. By finding that the avoided costs were not “smart”, and increasing the SGB adjustment accordingly (thereby reducing the Appellants' cost allowances), GEMA has made a second deduction in respect of exactly the same saving. In both instances – the Appellants' reductions in the cost forecast in their business plan and GEMA's increased SGB adjustment – the precise manner in which the costs will be saved is not specified, but that does not in any way alter the reality that the Appellants need to find ways to save the money, and cannot save the same sums twice over.
- 6.105 GEMA was therefore wrong to reject the £18.7m of “smart” savings identified by the Appellants.
- 6.106 This ground is addressed in the Witness Statement of Mark Drye at Section D.

Ground 1D: Unfairness, failure to consult

¹⁴⁷ See Annex 1.29 (Reinforcement) to the Appellants' business plan (March 2014), which can be found in Exhibit **MD1** Tab 13 to the Witness Statement of Mark Drye.

¹⁴⁸ Witness Statement of Mark Drye, paragraph 56.

- 6.107 GEMA's change in approach was introduced very late in an extensive process and with inadequate consultation of the Appellants on novel and significant issues.
- 6.108 The obligation on GEMA to consult arose as a matter of fairness (which is an issue of law) and/or from its duty to have regard to the principles of best practice regulation that were summarised in paragraphs 3.33 to 3.35 above.
- 6.109 The scope of the legal obligation to consult was formulated by Stephen Sedley QC in argument in R v London Borough of Brent ex parte Gunning (1985) 84 LGR 168, as follows:

"First... consultation must be made at a time when proposals are still at a formative stage. Secondly... the proposer must give sufficient reasons for any proposal to permit of intelligent consideration and response. Thirdly... adequate time must be given for consideration and response and, finally, fourthly... the product of the consultation must be conscientiously taken into account in finalising any... proposals."

- 6.110 That formulation has been approved as "*the classic statement of the basic requirements of consultation*" by Auld LJ in R v London Borough of Barnet ex parte B [1994] ELR 357 at page 370H-371A.
- 6.111 The Appellants' legitimate expectations about how the RIIO-ED price control process would be operated arose from the representations in the RIIO Handbook and the Strategy Decision that were summarised in Section 1.D and paragraphs 6.12 to 6.13 above.
- 6.112 The Appellants were not given an opportunity intelligently to comment on:

- (A) The aspects of GEMA's approach which are challenged in Grounds 1A, 1B and 1C above.

If GEMA had consulted adequately, the Appellants would have made in response the points identified in this Ground 1 amongst others, as noted in the Witness Statement of John France at paragraph 60.

At a very late stage in the process, GEMA explained in outline terms¹⁴⁹ that it intended to change its methodology in its Final Determination from that set used in the Draft Determination, but GEMA's briefing was wholly insufficient to meet the Gunning criteria.

- (B) GEMA's decision to change its definition of "smart" in the Final Determination and its reasons for not classifying as "smart" the Appellants' smart solutions to

¹⁴⁹ In presentations of 14 and 31 October 2014 (JMF1 Tabs 24 and 26).

two of their extra high voltage (EHV) reinforcement projects, Jarratt Street and Audby Lane and/or to their smart savings in low voltage / high voltage (LV/HV) reinforcement.

6.113 The points in paragraph 6.112(B) are further developed below.

The new definition of “smart” savings

6.114 In its Draft Determination,¹⁵⁰ GEMA explained that it treated a solution as “smart” if either:

- (A) it appeared in the smart solution set included within the Transform model;¹⁵¹ or
- (B) it was identified by at least one DNO as smart, and this was not contradicted by any other DNO classifying it as business as usual.

6.115 In its Final Determination, GEMA significantly changed the test for “smartness” in the Final Determination. Specifically, a solution had either to have been developed using innovation funding during DPCR5 or “*be demonstrably smarter or more innovative than what other DNOs do as business as usual*”.¹⁵²

6.116 If it had been consulted in advance, the Appellants would have objected that the “demonstrably smarter” test was a general and subjective test which could only exacerbate the difficulties inherent in ensuring a consistent approach is taken across the industry: see the Witness Statement of Mark Drye at paragraph 74 to 77.

The EHV reinforcement projects

6.117 In response to the Draft Determination, the Appellants identified their EHV reinforcement projects at Jarratt Street and Audby Lane (“**the two projects**”) as being “smart”. GEMA sought further information on the smartness of various solutions, but not the two projects.¹⁵³

6.118 In its Final Determination, GEMA found that the two projects did not meet the test to be characterised as “*smart or innovative*” because “*Expert review indicates a lack of evidence that the schemes include a smart or innovative element*”.¹⁵⁴

¹⁵⁰ Draft Determination Business Plan Assessment, paragraphs 11.12 to 11.13 (NOA1 Tab 13).

¹⁵¹ A tool to analyse potential smart savings in some, but not all, areas.

¹⁵² Business Plan Assessment, paragraph 11.37 (NOA1 Tab 16).

¹⁵³ Witness Statement of Mark Drye, paragraph 72.

¹⁵⁴ Business Plan Assessment, Table 11.5 (NOA1 Tab 16).

- 6.119 GEMA requested further evidence on various schemes for the purposes of assessing “smartness” but did not do so for the two projects even though the Appellants had told GEMA on three occasions that it regarded the two projects as “smart”. In any event, the Appellants were not able properly to analyse the “smartness” of the two projects because the test is defined by reference to the practices of other DNOs, which are not transparent to the Appellants.
- 6.120 Further, the Appellants requested a copy of the “expert review” relied on by GEMA and were told there was none because the expert was “embedded” within the GEMA team. The Appellants therefore do not properly understand the reasons why the two EHV reinforcement projects were not classified as “smart” in circumstances where the test adopted by GEMA is so vague and subjective that the reasoning is not at all evident to the Appellants; nor do they understand whether or why the Appellants’ projects were materially different from those of WPD which were treated as “smart” in the fast-track determination.

LV/HV reinforcement

- 6.121 The point made in paragraph 6.118 above also applies in respect of the smart savings from LV/HV reinforcement described above in paragraphs 6.96 to 6.105. The Appellants requested a copy of the “expert review” relied on by GEMA in finding that the savings were not “smart” and were told there was none because the expert was “embedded” within the GEMA team. The argument made at paragraph 6.120 above applies equally here.
- 6.122 This ground is addressed in the Witness Statement of Mark Drye at paragraphs 33 to 60.
- 6.123 This was an unfair process and breached the Appellants’ legitimate expectations about how the RIIO-ED1 price control process would be operated.

D. Statutory grounds and relief sought

- 6.124 GEMA’s Decision in relation to SGBs was wrong under the statutory grounds identified in Section 2 of the Notice.¹⁵⁵
- 6.125 The errors are quantified in Section 2 of the Notice.¹⁵⁶
- 6.126 The Appellants request the relief identified in Section 2 of the Notice.¹⁵⁷

¹⁵⁵ See paragraph 2.12 above.

¹⁵⁶ See paragraph 2.26 above.

¹⁵⁷ See paragraph 2.32 to 2.35 above.

SECTION 7: REAL PRICE EFFECTS**A. Overview**

- 7.1 This Section of the Notice concerns GEMA's understatement of the RPEs faced by the Appellants for the first year on which GEMA made RPE assumptions, 2014/15, and the following year, 2015/16.
- 7.2 RPEs are the expected changes in the prices of the inputs that DNOs purchase, relative to general inflation as measured using the RPI, over the course of the price control.¹⁵⁸ For example, where the price of an input into a DNO's business (e.g. labour) is expected to increase at a greater rate than general inflation, the incremental cost is an RPE. GEMA took these changes into account in RIIO-ED1, and in previous price controls, by reflecting the impact of RPEs in its view of the DNOs' total costs.
- 7.3 The Appellants respectfully request the CMA to read by way of introduction to this topic Exhibit **FE1** to the Witness Statement of Michael Huggins (the Frontier Report) at paragraphs 4.1 to 4.22, which describe GEMA's approach and summarise Frontier Economics' views.
- 7.4 GEMA's errors in its calculation of RPEs are identified in Section 2 above.¹⁵⁹ In summary:
- (A) GEMA did not present an adequate basis for rejecting the use of the obviously relevant data – DNOs' own pay settlements – for 2014/15.
 - (B) GEMA wrongly used data that plainly did not reflect the labour costs faced by the Appellants: it used labour data that had been affected significantly by the recession, whereas the market for labour for DNOs has not.
- 7.5 Accordingly, GEMA's Decision in relation to RPEs was wrong by reference to the statutory grounds detailed in Section 2 of the Notice.¹⁶⁰
- 7.6 As a result, GEMA has materially understated the RPEs faced by the Appellants for the first year on which GEMA made RPE assumptions, 2014/15. These clear inadequacies in GEMA's methodology apply equally to the following year, 2015/16. If this appeal succeeds, the CMA (or GEMA on remission) will also be able to correct the error for 2015/16 as most, if not all, DNO pay settlements will by then be available.¹⁶¹

¹⁵⁸ See Annex of Exhibit **FE2** to the Witness Statement of Michael Huggins (Frontier Report Annexes) for a full definition of RPEs.

¹⁵⁹ See paragraphs 2.13 to 2.19 above.

¹⁶¹ See paragraph 2.20 above.

7.7 GEMA's errors in relation to RPEs resulted in GEMA's view on total costs for 2014/15 being £41.1 million lower than they otherwise would have been.¹⁶² As just noted, the error also applies to 2015/16, although the precise quantification of the correction to this period will not be available until later in the appeal.

7.8 The Appellants request the relief identified in Section 2 of the Notice.¹⁶³

B. GEMA's Decision

The Decision

7.9 The Appellants were required to specify RPEs in their business plan.¹⁶⁴

7.10 In its Final Determination, GEMA made separate assumptions for the years: (A) 2014/15; (B) 2015/16; and (C) 2016/17 to 2022/23. As RPEs are calculated on a cumulative basis, the assumptions for 2014/15 (and 2015/16) affect all of the future years for the ED1 period.

7.11 GEMA did not accept the RPEs specified by the Appellants. Instead, it set the Appellants' modelled RPEs as shown in Table 2 below.

Table 2: Appellants' submitted and modelled RPEs

DNO	Submitted RPEs (£m)	Modelled RPEs (£m)
NPN	63	3
NPY	85	4

Source: Business Plan Assessment, Table 12.1 (NOA1 Tab 16)

¹⁶¹ The CMA is empowered to consider evidence that was not available to GEMA at the time of the Decision because it did not then exist, namely DNOs' pay settlements for 2015/16: see section 11E(3)(a) EA89t and CC Energy Licence Modification Appeals Rules (September 2012), rule 5.3.4. However, it is worth emphasising that the evidence indicating that the data used by GEMA was unlikely to be a good proxy for the rate of change of labour costs faced by DNOs in 2015/16 was available to GEMA at the time of the Decision.

¹⁶² GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

¹⁶³ See paragraph 2.32 to 2.35 above.

¹⁶⁴ For a description of how the Appellants calculated their RPEs, see Annex A to the Witness Statement of Keith Noble-Nesbitt.

- 7.12 The modelled RPEs for the Appellants calculated by GEMA and used in its cost assessment are £141 million below the submitted RPEs proposed in the Appellants' business plan. The difference between the RPEs proposed by the Appellants and those calculated by GEMA arises not only because of the errors identified in this Ground 2, but also from other differences which are not part of this appeal, including changes in the capex/opex materials prices since the Appellants submitted their RPEs.

GEMA's approach to RPEs

Definition of RPEs

- 7.13 GEMA defines RPEs as follows:

"DNOs' allowances are indexed by the Retail Prices Index (RPI) as part of the price control framework. We expect some of the costs faced by DNOs during RIIO-ED1 to change over the period at a different rate than the RPI measure of economy-wide inflation. These differences in cost changes are real price effects (RPEs)."¹⁶⁵ [emphasis added]

- 7.14 In the Final Determination, GEMA forecast RPEs separately for five inputs: general labour, specialist labour, capex materials, opex materials and plant and equipment. GEMA assumed that all other costs would move in line with economy-wide inflation.¹⁶⁶ Labour costs account for 66% of the costs of the ten DNOs which filed the relevant business plan template tables.¹⁶⁷
- 7.15 GEMA's overall approach to determining modelled RPEs for each DNO had two steps:¹⁶⁸
- (A) First, GEMA calculated a set of RPE assumptions for each of the five inputs. These assumptions – expressed as percentages – specify the expected year-on-year rate of price inflation for the five inputs. GEMA then combined these individual RPE assumptions to create an overall RPE assumption;
 - (B) Second, in broad terms,¹⁶⁹ GEMA multiplied the overall RPE assumption by each DNO's modelled costs to determine the monetary impact of the RPE assumptions.

¹⁶⁵ Business Plan Assessment, paragraph 12.1 (NOA1 Tab 16). See also Final Determination (Overview), paragraph 4.36 (NOA1 Tab 15).

¹⁶⁶ Business Plan Assessment, paragraph 12.5 (NOA1 Tab 16).

¹⁶⁷ Exhibit FE1 to the Witness Statement of Michael Huggins (Frontier Report), paragraph 4.7.

¹⁶⁸ GEMA's explanation of its approach is at paragraphs 12.1-12.11 of the Business Plan Assessment (NOA1 Tab 16).

- 7.16 GEMA's error relates to the first step – that is, GEMA used incorrect data to calculate the labour RPE assumptions for the first year on which GEMA made RPE assumptions, 2014/15, and the subsequent year, 2015/16.¹⁷⁰ It used inaccurate proxies for the labour costs facing the Appellants. Data measuring the pay pressures actually facing DNOs was available, based on information on DNOs' own pay settlements.
- 7.17 In relation to the labour assumptions, GEMA selected the following three indices:¹⁷¹
- (A) For the general labour RPE assumption:
 - (i) For 2014/15 and 2016/17 onwards, GEMA selected the ONS Average Weekly Earnings index for the private sector;
 - (ii) For 2015/16, GEMA selected the HM Treasury consensus forecast (covering the public and private sector) with an uplift of 0.15% to reflect the fact that DNOs are private sector employers;
 - (B) For the specialist labour RPE assumption:
 - (i) For 2014/15 and 2016/17 onwards, GEMA selected the British Electrotechnical and Allied Manufacturers' Association ("BEAMA") Electrical Labour index and the Building Cost Information Service ("BCIS") Civil Labour (Labour and Supervision in Civil Engineering) index;
 - (ii) For 2015/16, GEMA selected the HM Treasury consensus forecast, with the same private sector adjustment as was made for the general labour RPE assumption.

¹⁶⁹ More precisely, GEMA determined the monetary impact of the RPE assumptions for each of its three models. For the two totex models, GEMA multiplied the overall RPE assumption by each DNO's modelled costs to determine the monetary impact of the RPE assumption. For the disaggregated model, GEMA determined what it considered to be the most appropriate input RPE assumption for each line item. It then multiplied the input RPE assumptions by each DNO's modelled costs for each line item, in accordance with the allocation of line items to cost categories specified in the GEMA's business plan data templates. The weighted average of the RPE assumptions in monetary terms across GEMA's three models was the final RPE assumption for the DNOs (i.e. 25% weight was applied to each of the two totex models, and 50% weight was applied to the disaggregated model).

¹⁷⁰ RPEs are cumulative in nature, so an error in any one year affects subsequent years.

¹⁷¹ Exhibit **FE2** to the Witness Statement of Michael Huggins (Frontier Report Annexes), Annex 7.

C. GEMA's errors in its determination of the Appellants' modelled RPEs

GEMA should have used information on DNOs' own pay settlements

7.18 GEMA's calculation of the appropriate labour RPE assumptions for the Appellants did not use information on DNOs' own pay settlements even though:

- (A) that data provides more reliable and accurate data than any of the economy-wide, construction sector or manufacturing sector labour input price indices relied on by GEMA and therefore should have been used by GEMA as all the evidence indicated that the pay outcomes *were* efficient;¹⁷² and
- (B) evidence of DNOs' own pay settlements was readily available for GEMA to use in calculating the labour input price index for 2014/15.¹⁷³

7.19 In choosing not to use data on DNOs' own pay settlements, GEMA departed from its treatment of other costs categories that are subject to comparative benchmarking.¹⁷⁴ Indeed, the point of RPEs is to reflect the extent that the rate of change in costs faced by DNOs differs from RPI, as GEMA explained in the Final Determination in the passage quoted at paragraph 7.13 above. Moreover, GEMA's approach risks stranding costs for the industry, as explained in Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report).

7.20 GEMA's reasons for not using the evidence of DNOs' own pay settlements were:

- (A) that to do so "*could*"¹⁷⁵ amount to consumers paying for inefficient pay settlements;
- (B) that the RPE assumptions are intended to reflect the external pressures on costs, relative to economy-wide inflation, that are outside of DNOs' control;
- (C) that a proportion of DNOs' labour forces is employed through contractors, who would not be subject to DNO pay settlements, and therefore *might* see their pay change at rates different from DNOs' labour forces;¹⁷⁶ and

¹⁷² Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 4.12 to 4.15, 4.23 to 4.33 and 4.44 to 4.62.

¹⁷³ Ibid, 4.34 to 4.40.

¹⁷⁴ Ibid, paragraph 4.52.

¹⁷⁵ Business Plan Assessment (**NOA1** Tab 16), paragraph 12.32.

¹⁷⁶ Ibid.

- (D) that no adjustment is needed to account for evidence that those in continuous employment receive higher wage growth because DNOs have not provided evidence that they have a higher proportion of continuously employed staff than the wider economy.¹⁷⁷

7.21 As discussed in Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), GEMA's reasons for not using the information on DNOs' own pay settlements are speculative and unsound:¹⁷⁸

- (A) DNOs face strong financial incentives to agree efficient pay settlements, and no material countervailing incentives to agree inefficient pay settlements. This is because DNOs retain a material proportion of the savings resulting from efficient pay settlements. DNOs would earn a higher pre-tax profit where the pay settlement is more efficient than the assumption used in setting their cost and revenue allowances.¹⁷⁹ Insofar as GEMA was concerned that the DNOs might have an incentive to game the system by agreeing unduly high pay settlements in the hope that they might somehow recoup those higher costs at a subsequent price control review, this is simply not realistic: any payments to labour which are over the odds are payable for certain now (and affect future pay rounds), whereas the potential pay-back in this theoretical construct is uncertain and anyway would largely benefit the other DNOs, not the Appellants, who hold two licences out of 14.

There was no evidence that all DNOs had concluded inefficient pay settlements. The divergence between DNOs' pay settlements and the indices relied on by GEMA is convincingly explained by the impact of the recession.¹⁸⁰ The Appellants' pay increases have been efficient relative to the wider utilities sector: the Appellants' salaries for staff in continuous employment increased by [REDACTED] in 2014/15 relative to 2013/14, while the increase in the wider utilities sector was [REDACTED].¹⁸¹

Accordingly, DNOs' incentives were plainly to negotiate the best deals they could, i.e. efficient deals.

In any event, the CC had in NIE found a method of mitigating any such risk in using DNOs' pay settlements. To avoid "*the risk that a company could be*

¹⁷⁷ Business Plan Assessment (**NOA1** Tab 16), paragraph 12.31.

¹⁷⁸ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 4.28 to 4.33, 4.41 to 4.43 and 4.44 to 4.62.

¹⁷⁹ Ibid, paragraphs 4.44 to 4.53.

¹⁸⁰ See paragraphs 7.24 to 7.26 below.

¹⁸¹ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), Table 20.

rewarded for inefficient wage settlements”,¹⁸² the CC in NIE considered a number of alternative sources of data, but “*placed most weight on the wage settlements of GB electricity network companies. This was because of the significant overlap with NIE in the type of labour these companies employed*”.¹⁸³ The problem in Northern Ireland, that there is only one operator, does not arise in Great Britain as GEMA could have assessed the Appellants using data from the other DNOs or benchmarked all DNOs’ pay settlements. Either solution would have avoided the risk that inefficient pay settlements reached by an individual DNO in future would be passed on to its customers.

- (B) There would be no reason to estimate intentionally RPEs that may be faced by some entity other than a DNO, as the effect would be to provide DNOs with a level of funding different to that necessary to meet their expected costs. As GEMA itself stated, the only rational purpose of RPEs is to capture the relative inflationary pressures actually faced by the DNOs.¹⁸⁴ In NIE the CC stated that using NIE’s pay settlements would have the “*advantage of accurately reflecting the actual agreements which it had reached with its workforce during the period in question*”¹⁸⁵ and it addressed the potential concern about passing through actual wage settlements to customers through the mechanism summarised in (A) above.
- (C) As to contracted labour, supply and demand conditions are very similar for DNO employees and contracted labour and there is often movement between the employee and contractor categories. Contractor labour tends to be employed for the long term. DNO employees and contractors differ from other labour categories because of the unique skills that are required to carry out work for DNOs and the associated relatively high training costs. Moreover, renewals of major service contracts indicate that contractors have faced real terms upward pressure on their costs between 2012 and 2014.¹⁸⁶ Accordingly, DNO pay settlements reflect very closely the supply and demand conditions in the parts of the labour market most relevant to the DNOs, thereby providing the best possible proxy for the labour market pressures faced by the DNOs.¹⁸⁷ Indeed, in

¹⁸² NIE, paragraph 11.52.

¹⁸³ *Ibid*, paragraph 11.61.

¹⁸⁴ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 4.41 to 4.43.

¹⁸⁵ NIE, paragraph 11.52.

¹⁸⁶ Witness Statement of Mark Drye, paragraph 94.

¹⁸⁷ Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report), paragraphs 4.24 to 4.33.

NIE, the CC used the DNOs' own labour costs notwithstanding their use of contracted labour;¹⁸⁸ and

- (D) The Appellants' workforce does in fact have higher proportions of continuously employed staff (93%)¹⁸⁹ than the wider economy (79%).¹⁹⁰ This must have been evident to GEMA.¹⁹¹ Despite NPg highlighting the issue, GEMA did not ask for this information during the review. Had it done so, the Appellants would readily have supplied it¹⁹² and they see no reason why other DNOs could not have done likewise. It is conspicuously unfair and wrong for GEMA to dispose of issues by saying that there was "*no evidence*" on a topic without first asking for such evidence.

- 7.22 The facts presented above show that GEMA's speculative concerns over using DNOs' pay settlement data and taking into account pay rises for staff in continuous employment were unfounded.

The indices GEMA selected were inaccurate proxies

- 7.23 A comparison of DNOs' own pay settlement data and GEMA's benchmark indices evidences the divergence of actual pay settlements from the indices used by GEMA and is set out in Figure 2 below.¹⁹³

¹⁸⁸ Ibid, paragraphs 4.71.

¹⁸⁹ Witness Statement of Mark Drye, paragraph 88.

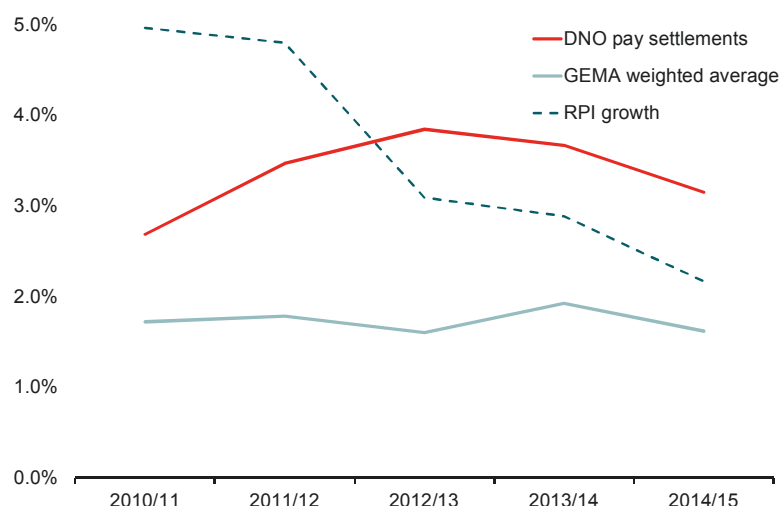
¹⁹⁰ ONS Published ad hoc data: labour market, request 20 November 2014, 003471. Available online at: <http://www.ons.gov.uk/ons/about-ons/business-transparency/freedom-of-information/what-can-i-request/published-ad-hoc-data/labour/november-2014/index.html>.

¹⁹¹ In DPCR5, GEMA devised specific regulatory mechanisms to deal with the very attractive final salary pension schemes (membership of which deters employees from switching jobs) and to enable DNOs to recruit over 1,000 people into the industry to avert a disastrous skills shortage.

¹⁹² For the purposes of CC Energy Licence Modification Appeals Rules (September 2012), rule 5.3.4, the reason the evidence was not before GEMA when it took its Decision was that it was not evident to the Appellants that GEMA would rely on the absence of such evidence as part of its reasoning and GEMA had not during its investigation asked the Appellants to supply such evidence.

¹⁹³ For further details of the comparison, see paragraphs 4.73 to 4.89 (and Annex 7) of Exhibit **FE1** to the Witness Statement of Michael Huggins (Frontier Report).

Figure 2: comparison of DNOs' own pay settlements and GEMA's benchmark indices (2010/11 to 2014/15)



Source: Frontier Economics

- 7.24 The question facing GEMA was: why is there such a divergence? GEMA seems to have found that it is because *all* of the DNOs are inefficient in negotiating pay settlements. However, this is implausible given the strong incentives on DNOs to procure labour efficiently: see paragraph 7.21(A) above. It is much more plausible that the divergence arises to a significant extent from GEMA's use of data that covered much broader areas of economic activity than electricity distribution.
- 7.25 As explained in the Frontier Report at paragraphs 4.80 to 4.84¹⁹⁴, the UK economy has experienced a structural change as a result of the deep recession that the economy fell into in 2008 as a result of the financial crisis, which has resulted in weak demand and low pressure on pay and employment, leading to lower pay awards. However, the recession has not had such significant effects on the supply and demand of labour for DNOs and the factors driving the lower pay awards in the wider economy are therefore not present to the same extent in markets for labour for DNOs. On the contrary, DNOs have experienced increased demand pressures in recent years as a result of DNO investment cycles and the continuing drive to decarbonise the electricity sector, which have required the DNOs to maintain their work force.¹⁹⁵
- 7.26 As a result, the data used by GEMA was not an appropriate proxy for calculating how the rate of change in costs faced by DNOs costs differs from RPI.

¹⁹⁴ Exhibit FE1 to the Witness Statement of Michael Huggins (Frontier Report).

¹⁹⁵ Ibid, paragraphs 4.81 to 4.82.

7.27 In summary:

- (A) The data on DNOs' pay settlements is a close proxy for the labour cost inflation faced by the Appellants;
- (B) The indices that GEMA selected to derive the labour RPE assumptions, on the other hand, were manifestly inaccurate proxies for the rate of labour price inflation faced by the Appellants because of the impact the recession had on the wider labour market, but not the markets for labour for DNOs;
- (C) GEMA therefore made errors in:
 - (i) rejecting without an adequate basis data on DNOs' pay settlements for the labour RPE assumptions;
 - (ii) using data that plainly did not reflect the labour costs faced by DNOs;
 - (iii) preferring inaccurate data over manifestly more accurate data because of points which were entirely speculative and unsubstantiated;
 - (iv) failing to "reality-check" adequately or at all its results against DNOs' actual pay settlements, when doing so would have led a reasonable authority to question the output from its chosen approach;
- (D) the Appellants made these points several times during the price control and provided all the relevant evidence to GEMA: see the chronology at Annex H of the Witness Statement of Keith Noble-Nesbitt.

7.28 This ground of appeal also applies to the calculations for 2015/16. The clear inadequacies of its method in respect of 2014/15 apply equally to 2015/16. It is highly likely that the index used by GEMA for 2015/16 will fail to capture well the labour cost pressures faced by the DNOs.¹⁹⁶ By the time this appeal is determined, the CMA (or GEMA in the event of a remission) will have sufficient data for DNOs' actual pay settlements for the year to use that actual data rather than the proxies relied on by GEMA.¹⁹⁷

¹⁹⁶ Ibid, paragraph 4.86.

¹⁹⁷ The Appellants recognise that they cannot make the same point about 2016/17 or subsequent years.

D. Statutory grounds and relief sought

7.29 GEMA's Decision in relation to RPEs was wrong under the statutory grounds identified in Section 2 of the Notice.¹⁹⁸

7.30 The errors are quantified in Section 2 of the Notice.¹⁹⁹

7.31 The Appellants request the relief identified in Section 2 of the Notice.²⁰⁰

¹⁹⁸ See paragraph 2.13 to 2.19 above.

¹⁹⁹ See paragraph 2.26(B) above.

²⁰⁰ See paragraphs 2.32 to 2.35 above.

SECTION 8: FAILURE TO COMPARE DATA ON A LIKE-FOR-LIKE BASIS IN CALCULATING RLCAS

A. Overview

- 8.1 The cost of labour differs as between certain regions of Great Britain for reasons that are beyond the control of the DNOs. In order to carry out its comparative benchmarking exercise with neutral labour cost data (i.e. data that does not reflect regional labour cost differences), GEMA concluded that there was sufficient evidence to make an adjustment to each DNO's labour costs as submitted in its business plan to reflect differences in the cost of labour between London, the South East and the rest of Great Britain. The method by which GEMA calculated the Regional Labour Cost Differentials ("RLCDs") and its RLCAs is the subject of this Section 8 of the Notice.
- 8.2 The Appellants respectfully request the CMA to read by way of introduction to this topic, paragraphs 16 to 28 and 39 to 43 of the Witness Statement of Keith Noble-Nesbitt, which describes GEMA's approach to RLCAs.
- 8.3 GEMA's errors in its calculation of RLCDs and consequently its RLCAs are identified in Section 2 above.²⁰¹ In summary:
- (A) GEMA sought to work out the differences in the cost of labour between London, the South East and the rest of Great Britain (RLCDs) by using general 2-digit data from the ASHE dataset (2008-2012), which is supplied by the ONS. This 2-digit data was not accurate because the results were distorted by compositional bias or mix issues. The ONS itself warned users of its database of this issue.
 - (B) GEMA could readily have resolved this issue, for example by using more granular like-for-like data for labour categories employed by DNOs and/or other robust like-for-like data, which showed a much lower premium for London and the South East relative to the rest of Great Britain.
- 8.4 The consequence of GEMA's errors in using data that failed to compare like-for-like data and/or failing properly to reality-check its conclusions was that:
- (A) GEMA materially overstated the difference between labour costs in London and the South East relative to the rest of Great Britain;
 - (B) GEMA therefore reduced the labour costs of those DNOs predominantly operating in London and the South East by too much before the DNOs' costs were entered into the comparative benchmarking models;

²⁰¹ See paragraphs 2.21 to 2.24 above.

- (C) conversely, GEMA increased the labour costs of those DNOs predominantly operating in the rest of Great Britain (including the Appellants) by too much for the purposes of the same benchmarking exercise; and
 - (D) the Appellants' relative efficiency determined through the benchmarking exercise was therefore worsened.
- 8.5 Accordingly, GEMA's Decision in relation to RLCDs and RLCAs was wrong by reference to the statutory grounds detailed in Section 2 of the Notice.²⁰²
- 8.6 GEMA's errors in relation to RLCAs resulted in GEMA's view on total costs being £21.3 million lower than it otherwise would have been.²⁰³
- 8.7 GEMA also failed to express its Decision on RLCAs and the reasons for that Decision in sufficiently clear terms.
- 8.8 The Appellants request the relief identified in Section 2 of the Notice.²⁰⁴

B. Definition of Regional Labour Cost Adjustments

- 8.9 As explained in Section 5 of the Notice, Step 2 of GEMA's process to determine cost allowances for the DNOs involved GEMA making adjustments to DNOs' submitted costs. It then entered those adjusted costs into the comparative benchmarking models. As part of this process, an adjustment was made for differences in labour costs between London, the South East and the rest of Great Britain. GEMA stated that RLCAs are made because "*operating in certain parts of the country attracts significantly higher labour costs*"²⁰⁵ (i.e. because of the existence of RLCDs).
- 8.10 The steps involved in calculating the RLCAs are summarised in the Witness Statement of Keith Noble-Nesbitt at paragraphs 39 to 43 and the Frontier Report (**FE1**) at paragraphs 2.10 to 2.17.
- 8.11 As is clear from the process outlined in the evidence, there is a knock-on effect: the RLCDs affect the RLCAs, which in turn affect the outcome of the comparative benchmarking exercise, i.e. the efficiency score of each company, by changing the location of each benchmarked firm and by changing the position of the upper-quartile.

²⁰² See paragraph 2.25 above.

²⁰³ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

²⁰⁴ See paragraphs 2.32 to 2.35 above.

²⁰⁵ Business Plan Assessment, page 41 (**NOA1** Tab 16).

Accordingly, if the RLCs used to calculate the RLCA are incorrect, the relative efficiency estimated through the cost benchmarking exercise and the cost allowance for each DNO will also be incorrect.

C. GEMA's Decision

- 8.12 The RLCs that GEMA used to inform the RLCA were specified in the cost assessment spreadsheets that GEMA provided alongside the Final Determination. In the Final Determination, GEMA stated:

"We continue to make a regional labour adjustment for three regions; London, South East and rest of Great Britain. We do not have a regional labour adjustment for BSCs."²⁰⁶

- 8.13 The Appellants' understanding of GEMA's approach to calculating the RLCs is as follows:²⁰⁷

- (A) GEMA used the ONS ASHE dataset (2008-2012),²⁰⁸ which includes average earnings data for various occupations by region in Great Britain,²⁰⁹ to determine its labour cost index levels for the three regions;
- (B) GEMA's calculations are based on mean gross hourly pay for eight 2-digit SOC codes that GEMA believes are representative of the types of labour that DNOs need to employ in close proximity to their electricity network assets, which are weighted together based on DNO labour shares and then mapped to DNO service areas to form a set of overall DNO Regional Labour Cost Indices ("RLCIs") and associated RLCs;
- (C) GEMA uses the resulting RLCs for each DNO to calculate the RLCA, by applying them to the labour costs that a notional DNO would need to locate near its electricity assets.

- 8.14 GEMA's cost assessment spreadsheets show that GEMA applied RLCs for London, South East and the rest of Great Britain regions with the following positions, relative to the national average:

- (A) London – a 19% positive cost differential to the Great Britain average;

²⁰⁶ Business Plan Assessment, paragraph 4.6 (NOA1 Tab 16). "BSCs" are Business Support Costs.

²⁰⁷ Witness Statement of Keith Noble-Nesbitt, paragraphs 39 to 40.

²⁰⁸ The ASHE dataset records data on levels, distribution and make-up of earnings and hours worked for UK employees by sex and full-time/part-time status in all industries and occupations.

²⁰⁹ Witness Statement of Keith Noble-Nesbitt, paragraphs 29.

- (B) South East – a 5% positive cost differential to the Great Britain average;
- (C) The rest of Great Britain – a 3% negative cost differential to the Great Britain average.²¹⁰

8.15 It is the net effect of these positive and negative RLCIs that affect the benchmarking results. Put in these terms, GEMA decided that, relative to the rest of Great Britain, like-for-like labour located in London attracts a 22.6% RLCD, while in the South East it attracts a 7.9% RLCD.

8.16 The outcome of GEMA's calculations also showed a positive 6% "premium" for the Scotland region.²¹¹ However, GEMA decided to include the Scotland region as part of the rest of Great Britain instead of applying a separate RLCD for it.²¹²

D. GEMA's error in its calculation of RLCAs for the slow-track DNOs

8.17 GEMA sought to work out the regional differences in labour costs by using 2-digit ONS data from the ASHE dataset. This comprises broad SOC (Standard Occupational Classification) categories, such as "*Science, research, engineering and technology professionals*" (SOC Code 21).

8.18 These broad categories will not isolate differences in labour costs faced by DNOs between regions, because of compositional bias or mix issues. The reasons that the data on regional labour costs that GEMA used fail to compare like-for-like are:

- (A) Differences in labour costs between regions for occupations within the same SOC code in the ASHE dataset are explained by two main factors:
 - (i) differences in pay for the same role and level of skill; and
 - (ii) differences in the types of role between regions (i.e. two roles may fall under the same SOC code, but be quite different). An example is provided at paragraph 34 (and Annex B) of the Witness Statement of Keith Noble-Nesbitt.
- (B) However, it is only the RLCD attributable to the first of those factors that should be used to inform the RLCA. The effects caused by the second factor should be isolated and removed from the RLCD calculation. The following example shows why. It would be relevant that the market rate for an electrical engineer

²¹⁰ Footnote 13.

²¹¹ Ibid, paragraph 61.

²¹² This appears to have been on the basis that labour market mobility between the Scotland region and other areas of Great Britain would eliminate any possible RLCD.

employed in London to carry out engineering duties at work sites is 10% more than the equivalent market rate for an electrical engineer employed outside of London or the South East to carry out such duties – this would largely reflect cost of living differences (which are not arbitrated away through equalisation of wages over time through labour market mobility) and represents a real difference in the position of a DNO seeking to employ engineers in London. It would not, however, be relevant that an electrical engineer employed in London as a professional consultant is paid 50% more than an electrical engineer employed in Newcastle to carry out field engineering duties at work sites, given that these are not like-for-like roles. The 50% difference in pay in the latter example would be largely attributable to a difference in the role (the second factor), not to a genuine difference in pay for the same role.

8.19 The ONS itself warned users of its database of this issue:

"It should be noted that earnings comparisons take no account of variations in prices for goods and services between regions and therefore do not necessarily indicate differences in the standard of living. Neither do they take account of differences in the regional composition of the workforce, meaning that like-for-like comparisons may not be appropriate."²¹³ [emphasis added]

8.20 GEMA decided not to allow for a separate Scotland premium, despite its calculation showing a 6% positive differential relative to the rest of Great Britain average: see paragraph 8.16 above. In making this decision, GEMA clearly acknowledged that its approach to calculating RCLDs using 2-digit SOC code ASHE data can generate 'false' results, i.e. ones due to factors unrelated to long term differences in market wages for like-for-like employees, and recognised implicitly that it was appropriate to reality-check the outcome of those calculations.

8.21 GEMA could readily have resolved this issue, for example using any of the following approaches which would have resulted in RLCDs materially below those estimated by GEMA of 22.6% for London and 7.9% for the South East:

- (A) By using more granular, 4-digit ASHE data in its calculations GEMA could have estimated RLCDs of 14% for London and 4% for the South East. The 4-digit data in particular provides less scope for variance in qualifications and role within the SOC code, eliminating a significant amount of the error.²¹⁴ Indeed, the CC in the NIE case did not use 2-digit ONS data. Instead, the CC used more granular 3-digit and 4-digit data. Therefore, contrary to its claims in the

²¹³ ONS, Bulletin on Annual Survey of Hours and Earnings, 2013 Provisional Results, page 26 (Exhibit **KNN1** Tab 16 to the Witness Statement of Keith Noble-Nesbitt).

²¹⁴ Witness Statement of Keith Noble-Nesbitt, paragraphs 44 to 48.

Final Determination, GEMA's approach of using 2-digit data was not supported by the CC's report in NIE.²¹⁵

- (B) A careful analysis of the ASHE dataset by the Appellants to identify SOC codes which appear to be less susceptible to compositional bias gives a range for RLCDs of 11% to 15% for London and 0% to 4% for the South East.²¹⁶
- (C) Alternative sources of evidence could also be used to further reduce the scope for error. The Appellants have used labour cost data from Hay Group, which indicates RLCDs for London and South East within the ranges of 13% and 5% respectively.²¹⁷ The Appellants have also used labour cost data from Income Data Services, which indicates RLCDs for London and South East in the range of 10% to 14% for London and 1% to 6% for South East).²¹⁸
- (D) GEMA could have followed Ofwat's approach by including the regional wage variable in the regressions as an explanatory variable, which would have allowed GEMA to test the quality of the regional wage variable as a factor explaining the observed variations in wages.²¹⁹

8.22 Keith Noble-Nesbitt's Witness Statement explains that, had GEMA adopted the alternative approach identified in paragraph 8.22(B) above, it would have resulted in GEMA's view on total costs for 2014/15 being £21.3 million lower than it otherwise would have been.²²⁰

8.23 The RLCDs resulting from this approach are as follows:

- (A) RLCDs of between 10% and 15% for London; and
- (B) RLCDs of between 0% and 5% for the South East.

8.24 GEMA's Strategy Decision clearly stated that regional labour adjustments would only be made where "*robust evidence*" was available to support them.²²¹ Consistently with this,

²¹⁵ Business Plan Assessment, paragraph 4.17 (**NOA1** Tab 16).

²¹⁶ Witness Statement of Keith Noble-Nesbitt, paragraph 67.

²¹⁷ Ibid, paragraphs Annex D.

²¹⁸ Ibid, paragraphs Annex E.

²¹⁹ Cambridge Economic Policy Associates Ltd, Ofwat Cost Assessment, Advanced Economic Models, Final Report, 20 March 2014, section 2.1, page 5 (Exhibit **KNN1** Tab 22 to the Witness Statement of Keith Noble-Nesbitt).

²²⁰ GEMA's view of total costs fed into its application of the IQI mechanism; its IQI calculations were therefore also flawed. GEMA's error therefore also affected the Appellants' cost allowance, IQI additional income, and efficiency incentive rate.

²²¹ Strategy Decision Tools for Cost Assessment, paragraph 3.1 (**NOA1** Tab 9).

it is appropriate to select the bottom end of the reasonable range (i.e. 10% for London and 0% for the South East), since that reflects the point at which there is a clear and consistent evidential basis.

E. Why GEMA has failed to be transparent, accountable and consistent in making its decision on RLCAs

- 8.25 Prior to the Draft Determination and during the RIIO-ED1 Draft Determination consultation, the Appellants made several submissions to GEMA in which they put the above arguments.²²² In the Final Determination, GEMA responded to the Appellants' submissions and analysis with the following short statement:

"We do not consider that the compositional issues evidence presented by one DNO demonstrates that the ONS data does not reflect DNOs' regional wages. The use of ONS data is in line with our previous price controls and with the Competition Commission's final determinations for Northern Ireland Electricity Ltd price control and Ofwat's PR14."²²³

- 8.26 This reasoning does not properly address the arguments the Appellants made in their submissions and accordingly GEMA has failed in its statutory duties of transparency and accountability in conducting its regulatory activities:

- (A) The statement that "[w]e do not consider that the compositional issues evidence demonstrates that the ONS data does not reflect DNOs' regional wages" is mere assertion and does not explain how GEMA reached that conclusion. For reasons set out at paragraphs 8.18 to 8.21 above, the evidence does not support this position;
- (B) The Appellants did not argue that the ONS data should not be used. Rather, they argued that it should have been used in a way that compared like-for-like;
- (C) While it is correct that GEMA, the CC and Ofwat have used ONS data in previous price controls, insofar as that implies that it was used in the same way as in RIIO-ED1, this is incorrect, because in all of these examples that data was used in different ways. Most relevantly, in the NIE price control determination, the CC used 3- and 4- digit SOC codes as opposed to the 2-digit SOC codes used by GEMA.²²⁴ As explained in the Witness Statement of Keith Noble-Nesbitt, using 4-digit SOC codes in particular is one means of reducing the scope for error, although it cannot be expected to eliminate it entirely.²²⁵ Ofwat

²²² For a full account of the Appellants' submissions to GEMA on the topic of regional labour costs, see Annex A to the Witness Statement of Keith Noble-Nesbitt.

²²³ Business Plan Assessment, paragraph 4.17 (**NOA1** Tab 16).

²²⁴ NIE, paragraph 8.61 to 8.221 (especially 8.67 and 8.203 to 8.204).

²²⁵ Witness Statement of Keith Noble-Nesbitt, paragraph 63, 64(i) and Annex G.

used RCLDs in their regression, which allowed the regression analysis to determine the extent to which the RCLDs explained the observed regional differences in labour costs and would also have allowed statistical testing of the results (whereas GEMA *assumed* the accuracy of its RLCAs).

- (D) For GEMA to have satisfied its statutory duty to be transparent and accountable in its regulatory activities, it would have needed to provide adequate reasons why it considered that the evidence the Appellants presented did not demonstrate the errors in the way the ONS data were used.

F. Statutory grounds and relief sought

- 8.27 GEMA's Decision in relation to RLCAs was wrong by reference to the statutory grounds identified in Section 2 of the Notice.²²⁶
- 8.28 The errors are quantified in Section 2 of the Notice.²²⁷
- 8.29 The Appellants request the relief identified in Section 2 of the Notice.²²⁸

²²⁶ See paragraph 2.25 above.

²²⁷ See paragraph 2.26(C) above.

²²⁸ See paragraphs 2.32 to 2.35 above.

SECTION 9: CHRONOLOGY

This chronology details the key steps leading up to GEMA's Decision, beginning with the consultation on the new RIIO regime.

Date	Event
2008 – 2010	GEMA undertakes its "RPI-X@20" review publishing consultations, responses, and working papers as part of its review of the regulatory regime for energy networks.
4 October 2010	GEMA issues its final decision on the RIIO model for energy network regulation – a product of its RPI-X@20 review.
6 February 2012	GEMA launches open letter consultation on the way forward for the next electricity distribution price control review - RIIO-ED1.
28 September 2012	GEMA publishes its strategy consultation for RIIO-ED1.
4 March 2013	GEMA releases its final decision on its approach to RIIO-ED1.
June 2013	The DNOs submit their fast-track business plans to GEMA.
1 July 2013	GEMA launches an open letter consultation on the RIIO-ED1 business plans that the DNOs have submitted.
4 September 2013	GEMA consults on the levels of reward/penalty that DNOs are to get under the RIIO-ED1 customer service and connection incentives.
4 October 2013	GEMA consults on whether there is benefit in making its decision on revenue to be recovered by DNOs in 2015/16 earlier than proposed.
22 November 2013	GEMA publishes its Draft Determinations on the 14 DNO business plans for the next price control period (RIIO-ED1) and considers that only WPD's plans are of sufficient quality to be fast-tracked. Between November 2013 and February 2015, in addition to providing formal responses to GEMA's consultations, Northern Powergrid writes privately to GEMA on a number of occasions in respect of specific issues, in particular: (i) regional labour cost adjustments; (ii) real price effects; and (iii) smart grid benefits.
6 December 2013	GEMA consults on its methodology for assessing equity market return for the purpose of setting RIIO price controls in light of the CC's provisional determination for Northern Ireland Electricity.
11 December 2013	GEMA issues its decision on the levels of reward/penalty that DNOs are to get under the RIIO-ED1 customer service and connection incentives.
19 December 2013	GEMA issues its decision on when it will set the revenue to be recovered by electricity DNOs in 2015/16.
10 January 2014	Northern Powergrid offers its own response and an opinion from Frontier Economics to GEMA's consultation dated 6 December 2013 on cost of equity market return.
10 January 2014	GEMA launches the first part of an informal consultation on fast-track licence drafting in respect of proposed changes to the Charge Restriction Conditions ("CRCs") affecting the four licensees owned by WPD.
10 January 2014	GEMA launches informal consultation on proposed changes to Standard Licence Conditions ("SLCs") required to implement RIIO-ED1 price control review for all DNOs.
20 January 2014	Northern Powergrid responds to GEMA's consultation on fast-track draft determinations dated 22 November 2013.

Date	Event
31 January 2014	GEMA launches the second part of its informal consultation on fast-track licence drafting in respect of proposed changes to the CRCs affecting the four licensees owned by WPD.
7 February 2014	Northern Powergrid responds to the first part of GEMA's consultation on CRCs dated 10 January 2014.
17 February 2014	GEMA issues its decision on methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls.
28 February 2014	Northern Powergrid responds to the second part of GEMA's consultation on CRCs dated 31 January 2014.
28 February 2014	GEMA issues its decision to fast-track WPD.
28 February 2014	GEMA sets out provisional values for the Network Innovation Allowance ("NIA") to which each DNO will be entitled in RIIO-ED1 (DNOs use the NIA to fund small-scale innovation projects).
March 2014	The five remaining "slow-track" DNO groups submit revised business plans.
7 March 2014	GEMA consults on the draft RIIO-ED1 Environment Report Guidance Document.
28 March 2014	GEMA commences statutory consultation on proposed modifications to the CRCs of the electricity distribution licences held by the four licensees owned by WPD.
28 March 2014	GEMA commences statutory consultation on proposed modifications to the SLCs of the electricity distribution licences which implement the policies described in the strategy decision dated 4 March 2013.
31 March 2014	GEMA launches open-letter consultation on revised RIIO-ED1 business plans submitted by five DNO groups.
29 April 2014	Northern Powergrid responds to GEMA statutory consultation dated 28 March 2014 on proposed modifications to the standard and special conditions of the electricity distribution licences.
21 May 2014	GEMA publishes modification notice amending the SLCs of the electricity distribution licences for RIIO-ED1.
21 May 2014	GEMA publishes modification notice amending the CRCs of the electricity distribution licences held by the four licensees owned by WPD for RIIO-ED1.
30 July 2014	GEMA publishes its draft determinations for the slow-track electricity distribution companies for RIIO-ED1.
28 August 2014	GEMA consults on the treatment of RPEs in the revenue allowances proposed for slow-track DNOs for RIIO-ED1.
26 September 2014	Northern Powergrid responds to GEMA's draft determinations consultation dated 30 July 2014.
26 September 2014	Northern Powergrid responds to GEMA consultation on RPEs dated 28 August 2014.
26 September 2014	GEMA launches informal consultation on changes to DNOs' SLCs for RIIO-ED1 that were not part of first consultation dated 21 May 2014.
26 September 2014	GEMA launches informal consultation on proposed changes to CRCs required to implement the RIIO-ED1 price control settlements for slow-track DNOs.
28 November 2014	GEMA publishes final determinations for RIIO-ED1 for the slow-track electricity distribution companies.

Date	Event
17 December 2014	GEMA publishes statutory consultation on proposed modifications to the slow-track distribution licences to implement its Final Determination.
3 February 2015	GEMA publishes its Decision.

SECTION 10: STATEMENT OF TRUTH

The Appellants believe that the facts stated in this Notice of Appeal are true.

Signed:

Dated:

for and on behalf of Northern Powergrid (Northeast) Limited

Signed:

Dated:

for and on behalf of Northern Powergrid (Yorkshire) Plc

BEFORE THE COMPETITION AND MARKETS AUTHORITY
AN APPEAL UNDER SECTION 11C ELECTRICITY ACT 1989

BETWEEN:

NORTHERN POWERGRID (NORTHEAST) LIMITED

and

NORTHERN POWERGRID (YORKSHIRE) PLC

Appellants

- v -

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

EXHIBIT NOA1

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1. Better Regulation Task Force, Principles of Good Regulation (2003)
2. Department of Energy and Climate Change, Implementation of the EU Third Internal Energy Package, Government Response (10D/953) (January 2010)
3. Northern Ireland Electricity plc Transmission and Distribution Fifth Price Control (RP5) Strategy Paper (July 2010)
4. Ofgem City Briefing, Introducing the RIIO Model (26 July 2010)
5. Handbook for implementing the RIIO model (4 October 2010)
6. RIIO-ED1 Glossary of Terms (28 September 2012)
7. Strategy decision for the RIIO-ED1 electricity distribution price control. Overview (4 March 2013)
8. Strategy decision for the RIIO-ED1 electricity distribution price control. Business plans and proportionate treatment (4 March 2013)

9. Strategy decision for the RIIO-ED1 electricity distribution price control. Tools for cost assessment (4 March 2013)
10. Assessment of RIIO-ED1 business plans and fast-tracking (22 November 2013)
11. RIIO-ED1 business plan expenditure assessment – methodology and results (6 December 2013)
- 11A. Northern Powergrid, Our business plan 2015-23. Executive summary (March 2014)
12. RIIO-ED1: Draft determinations for the slow-track electricity distribution companies. Overview (30 July 2014)
13. RIIO-ED1: Draft determinations for the slow-track electricity distribution companies. Business plan expenditure assessment (30 July 2014)
14. RIIO-ED1: Draft determinations for the slow-track electricity distribution companies. Detailed figures by company (30 July 2014)
15. RIIO-ED1: Final determinations for the slow-track electricity distribution companies. Overview (28 November 2014)
16. RIIO-ED1: Final determinations for the slow-track electricity distribution companies. Business plan expenditure assessment (28 November 2014)
17. Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators (28 November 2014)
18. RIIO-ED1: Final determinations for the slow-track electricity distribution companies. Detailed figures by company (28 November 2014)
19. Statutory consultation on proposed modifications to special conditions of the electricity distribution licences held by the slow-track licensees (17 December 2014)
20. Northern Powergrid response to statutory consultation on proposed modifications to special conditions (19 January 2015)
21. Attachment to Northern Powergrid response to statutory consultation on proposed modifications to special conditions (19 January 2015)
22. RIIO-ED1 modifications to amend the special conditions of the electricity distribution licences held by the slow-track licensees (3 February 2015)
23. Schedule 2A to 3 February 2015 decision: RIIO-ED1 slow-track CRC licence changes
24. Schedule 2B to 3 February 2015 decision: ED1 price control financial handbook