

**BEFORE THE COMPETITION AND MARKETS AUTHORITY**

**22 APRIL 2015**

**IN THE MATTER OF AN APPEAL UNDER SECTION 11C OF THE ELECTRICITY  
ACT 1989**

**BRITISH GAS TRADING LIMITED**

Appellant

**-v-**

**THE GAS AND ELECTRICITY MARKETS AUTHORITY**

Respondent

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**RESPONSE TO THE NOTICE OF APPEAL**

**ENERGY LICENCE MODIFICATION**

**NON-CONFIDENTIAL VERSION**

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## INTRODUCTION

1. This is the Response of the Gas and Electricity Markets Authority ("**the Authority**") to the Notice of Appeal submitted to the Competition and Markets Authority ("**the CMA**") on 2 March 2015 by British Gas Trading Limited (the "**Appellant**" or "**BGT**").
2. BGT appeals under section 11C of the Electricity Act 1989 ("**EA89**") the Authority's decision of 3 February 2015 under section 11A of the EA89 ("**the Decision**") to modify the electricity distribution licences of 10 Distribution Network Operators ("**DNOs**"), representing all the DNO groups in Great Britain save Western Power Distribution ("**WPD**"). The Decision gave effect to the electricity distribution sector price control, RIIO-ED1. By a decision dated 30 March 2015, the CMA granted BGT permission to appeal on the terms set out in its permission decision.
3. In this Response:
  - (a) Where the Authority does not expressly respond to a paragraph of the Notice of Appeal, it does not admit the same;
  - (b) Bare paragraph references are references to paragraphs of the Notice of Appeal unless otherwise indicated; and
  - (c) The Authority adopts the abbreviations used in the Notice of Appeal for convenience only without any admission to the contents thereof.
4. Section 1 of BGT's Notice of Appeal summarises the arguments raised in the later substantive sections of BGT's appeal. In order to avoid duplication, and in the interests of the clarity of cross-references, the Authority's Response principally refers to paragraphs of the later substantive sections of the Notice of Appeal, rather than to paragraphs of the summary at section 1. For the avoidance of doubt, this should not be taken to indicate that the Authority accepts their contents.

5. The remainder of this Response is structured as follows:
  - (a) Part I contains a general introduction to the role of Ofgem and the Authority;
  - (b) Part II contains the Authority's submissions as to the statutory framework and appropriate standard of review;
  - (c) Part III contains an overview of the regulatory context; and
  - (d) Parts IV-IX contain the Authority's detailed submissions in relation to each of the 6 grounds of appeal raised by BGT.

For the CMA's convenience, Parts I to III of this Response are materially the same as Parts I to III of the Authority's response to the appeals by Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) Plc (together "**NPg**").

6. Also, for convenience, a glossary of terminology relating to RIIO-ED1 is attached as Annex 1.
7. In this Response, a number of documents are referred to that are included in a Response Document Bundle. Those documents are referred to in the form **[RDB/x]**, where x is the tab number. In addition, a number of documents in the BGT bundle are referred to with the reference in the form **[BGa/b]**, where a is the volume number, b is the tab number.

## **PART I: THE ROLE OF THE AUTHORITY AND OFGEM**

8. The Authority is an independent regulator funded largely by the network companies which are licensed by the Authority to participate in the gas and electricity markets. The Authority consists of non-executive and executive members and a non-executive chair who oversee the work of, and provide strategic and policy direction for, Ofgem.
9. The Authority members are appointed by the Secretary of State at the Department of Energy and Climate Change ("**DECC**"). Non-executive members bring experience and expertise from a range of areas including industry, social policy, environmental work, finance and Europe. The Executive members of the Authority are Ofgem's Chief Executive, one Senior Partner and the Group Finance Director.
10. The Authority makes decisions on a wide range of regulatory matters. These decisions are based on work, for example gathering and analysing evidence, which is carried out on a day-to-day basis by Ofgem.
11. Ofgem is divided into five policy Divisions, namely Electricity Transmission, Smarter Grids & Governance, Markets, Sustainable Development and Ofgem E-serve. Each Division is headed by a Senior Partner. Below the Senior Partner in each Division are Partners and Associate Partners with particular areas of responsibility.

## PART II: THE STATUTORY FRAMEWORK AND STANDARD OF REVIEW

### *The statutory framework*

12. The appealed decisions were made by the Authority pursuant to s. 11A of the EA89 and subject to the statutory duties applying thereto, as set out below. By virtue of s. 11E(2) EA89, the CMA is in these appeals required to:

*"have regard, to the same extent as is required of the Authority, to the matters to which the Authority must have regard—*

*(a) in the carrying out of its principal objective under section 3A;*

*(b) in the performance of its duties under that section; and*

*(c) in the performance of its duties under sections 3B and 3C."<sup>1</sup>*

13. By s. 3A(1B) EA89 the Authority is required to perform its functions under s. 11A EA89:

*"... in the manner which ... the Authority ... considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors." (emphasis added)*

14. The principal objective is (s. 3A(1)):

*"... to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems."<sup>2</sup> (emphasis added)*

15. Section 3A(1A) provides further as follows.<sup>3</sup>

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<sup>1</sup> This provision defines matters to which the CMA must have regard. It does not serve to put the CMA in the shoes of the Authority. It does not follow that it is the CMA's function to substitute for the Authority's own judgment as to, for example, what is best calculated to further the principal objective.

<sup>2</sup> For the purposes of s. 3A the term "consumers" includes both existing and future consumers: s. 3A(6). The Authority agrees with NPg (at 3.20 of its Notice of Appeal), that consumers here includes end consumers of electricity.

*"(1A) Those interests of existing and future consumers are their interests taken as a whole, including—*

*(a) their interests in the reduction of electricity-supply emissions of targeted greenhouse gases;*

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

16. Article 36 of the Electricity Directive<sup>4</sup> provides as follows.

*"In carrying out the regulatory tasks specified in this Directive, the regulatory authority shall take all reasonable measures in pursuit of the following objectives within the framework of their duties and powers as laid down in Article 37, in close consultation with other relevant national authorities including competition authorities, as appropriate, and without prejudice to their competencies:*

*(a) promoting, in close cooperation with the Agency, regulatory authorities of other Member States and the Commission, a competitive, secure and environmentally sustainable internal market in electricity within the Community, and effective market opening for all customers and suppliers in the Community and ensuring appropriate conditions for the effective and reliable operation of electricity networks, taking into account long-term objectives;*

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<sup>3</sup> Section 3A(5B) provides:

*In subsection (1A)—*

*"emissions" has the same meaning as in the Climate Change Act 2008 (see section 97 of that Act);*

*"electricity-supply emissions" in relation to emissions of a targeted greenhouse gas, means any such emissions (wherever their source) that are wholly or partly attributable to, or to commercial activities connected with, the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors;*

*"targeted greenhouse gases" has the same meaning as in Part 1 of the Climate Change Act 2008 (see section 24 of that Act).*

<sup>4</sup> Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC

*(b) developing competitive and properly functioning regional markets within the Community in view of the achievement of the objectives referred to in point (a);*

*(c) eliminating restrictions on trade in electricity between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate electricity flows across the Community;*

*(d) helping to achieve, in the most cost-effective way, the development of secure, reliable and efficient non-discriminatory systems that are consumer oriented, and promoting system adequacy and, in line with general energy policy objectives, energy efficiency as well as the integration of large and small-scale production of electricity from renewable energy sources and distributed generation in both transmission and distribution networks;*

*(e) facilitating access to the network for new generation capacity, in particular removing barriers that could prevent access for new market entrants and of electricity from renewable energy sources;*

*(f) ensuring that system operators and system users are granted appropriate incentives, in both the short and the long term, to increase efficiencies in system performance and foster market integration;*

*(g) ensuring that customers benefit through the efficient functioning of their national market, promoting effective competition and helping to ensure consumer protection;*

*(h) helping to achieve high standards of universal and public service in electricity supply, contributing to the protection of vulnerable customers and contributing to the compatibility of necessary data exchange processes for customer switching."*

17. By s. 3A(1C) EA89 (together with the duty under s. 3A(1B) EA89, the **"principal objective duty"**):

*"before deciding to carry out functions ... in a particular manner with a view to promoting competition as mentioned in subsection (1B), ... the Authority shall consider—*

*(a) to what extent the interests referred to in subsection (1) of consumers would be protected by that manner of carrying out those functions; and*

*(b) whether there is any other manner (whether or not it would promote competition as mentioned in subsection (1B)) in which ... the Authority ... could carry out those functions which would better protect those interests." (emphasis added)*

18. In performing the principal objective duty, the Authority is required by s. 3A(2) EA89 to:

*"... have regard to*

*(a) the need to secure that all reasonable demands for electricity are met;*

*(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under [Part 1 of EA89], 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; and*

*(c) the need to contribute to the achievement of sustainable development." (emphasis added)*

19. In performing the above statutory duties, the Authority is further required to have regard (not exclusively) to the interests of four "*descriptions of consumers*", namely those who are disabled or chronically sick, of pensionable age, with low incomes, and those residing in rural areas: s. 3A(3).

20. By s. 132(2) of the Energy Act 2013 ("**EA13**"), the Authority must also:

- (a) "have regard to" the strategic priorities set out in a strategy and policy statement published by the Secretary of State pursuant to s. 131 of EA13<sup>5</sup>; and
- (b) "carry out [its] regulatory functions in the manner which ... the Authority ... considers is best calculated to further the delivery of the policy outcomes [set out in the strategy and policy statement]."

However, these duties (the "**EA13 duties**" and, together with the principal objective duty, the "**core statutory duties**") are subject to the application of the principal objective duty: s. 132(3) EA13.

21. Subject to the core statutory duties, the Authority is further required by s. 3A(5) to carry out its functions:

*"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;*

*(b) to protect the public from dangers arising from the generation, transmission, distribution or supply of electricity or the provision of a smart meter communication service;*

*(c) to secure a diverse and viable long-term energy supply,*

*and shall, in carrying out those functions, have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity or the provision of a smart meter communication service." (emphasis added)*

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<sup>5</sup> The strategy and policy statement has yet to be published. The consultation on the draft strategy and policy statement closed on 17 October 2014.

22. Section 3A(4) EA89 provides further that the Authority "may" (but is not required to) have regard to:

(a) the interests of consumers in relation to gas conveyed through pipes (within the meaning of the Gas Act 1986); and

(b) any interests of consumers in relation to—

(i) communications services and electronic communications apparatus, or

(ii) water services or sewerage services (within the meaning of the Water Industry Act 1991),

which are affected by the carrying out of [the Authority's] function.

23. In carrying out its functions in accordance with the above, the Authority must (s. 3A(5A) EA89) 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 him or, as the case may be, it to represent the best regulatory practice."*

24. Thus, the Authority is required to perform its functions under s. 11A EA89 within a complex, multi-layered legal framework that imposes upon the Authority a range of mandatory and discretionary duties, objectives and considerations. To the extent set out above, the hierarchy of those duties, objective and considerations is provided for by statute. Beyond that, it is incumbent for the Authority, acting within the statutory framework, to determine for itself the hierarchy of and weight to be attributed to various statutory considerations (*R v Director General of Telecommunications Ex parte Cellcom Ltd* [1999] E.C.C. 314, at [32]).

25. The interests of consumers are multiple and interrelated. When approached singly, they may be in tension with each other. The Authority is required to

take them "as a whole", balancing and reconciling individual interests, including those of existing and future consumers.

26. NPg purports (at paragraph 3.21 of its Notice of Appeal dated 27 February 2015) to identify what is required to protect the "*interests of consumers as end users of electricity*". Setting aside the fact that that is not the totality of the Authority's statutory obligations (see above), the interests asserted are overly simplistic and incomplete. The Authority does not dispute that consumers interests include those asserted there by NPg, but does not accept that the interests of existing and future consumers are limited to those asserted.
27. NPg (unsurprisingly) emphasises (at paragraphs 3.28 to 3.30) the adequacy of the remuneration that it receives and the financeability of its licensed functions. It is correct that the Authority is required to have regard to — among other things — the need to secure that licence holders are able to finance their licensed activities. Neither this nor any other relevant consideration of the adequacy of regulated remuneration is antithetical to the interests of consumers. It is not a case of consumers set against licence holders in diametric opposition. It is self-evident that consumers – both existing and future – have an interest in licence holders being adequately remunerated to be able efficiently to act in accordance with their interests, including in the adequacy and security of supply both now and in the future. It does not follow that the principal objective is synonymous with securing the financeability of NPg's licensed activities, nor that the Authority's task is merely to ensure the adequacy of the regulated remuneration. It is, however, also not the case, as BGT asserts (at paragraph 2.22(a) of its Notice of Appeal) that "*the DNOs' need to ensure finance ... is a subsidiary consideration, which arises only insofar as it is shown to be of relevance to the consumer interest.*" It is a matter that the legislature has determined to be relevant and to which the Authority must accordingly have proper regard in performing the principal objective duty. The (in some cases, competing) interests of consumers must be taken as a whole and the Authority must judge for itself what is best calculated in accordance with the entire statutory framework to protect those interests.

28. Any suggestion on the part of NPg (see paragraphs 3.27 and 3.30) that the Authority's obligation to have regard to the "need to secure" various matters amounts to a direct obligation on the part of the Authority to act so as to guarantee those matters is misconceived.<sup>6</sup>
- (a) In *R (Law Society of England and Wales v Lord Chancellor* [2012] EWHC 794 (Admin)), the court considered a similar obligation on the Lord Chancellor "*to have regard to the need to secure*" a provision of services under the Access to Justice Act 1999. The court held<sup>7</sup> that, if the Legislature had intended to secure the provision of services, "*one would expect it to have imposed a duty on the Lord Chancellor to secure that this need was satisfied. It did not do so, instead imposing the lesser duty to take that need into account*".
- (b) In *R (on the application of Baker) v Secretary of State* [2008] EWCA Civ 141, the Court of Appeal held that an obligation contained in the Race Relations Act 1976 to "*have due regard to the need to promote equality of opportunity and race relations*" was not "*a duty to achieve a result... it was a duty to have due regard to the need to achieve [the result]*". Due regard in this context was held to mean "*regard that is appropriate in all the circumstances*".<sup>8</sup>
29. In particular, if NPg is seeking to assert (at paragraph 3.30) that the Authority's obligation to "have regard to" the need to secure that licence holders are able to finance their regulated activities amounts to an obligation on the part of the Authority to ensure "*that DNOs are able to cover the reasonable costs of meeting the required Outputs and make reasonable returns on capital*", then that assertion is wrong. It is a matter to which the Authority must have regard. It has properly done so. Further, the matter to which the Authority must have regard in this respect is a licensee's ability to finance their regulated activities, not necessarily to make reasonable returns on capital in all circumstances.

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<sup>6</sup> As BGT states at paragraph 2.22(a)

<sup>7</sup> at paragraph 52.

<sup>8</sup> at paragraph 31.

30. NPg goes on to suggest at paragraph 3.32 that the Authority's duty (under s. 3A(5) EA89) to carry out its functions "*in the manner which ... it considers is best calculated ... to promote efficiency and economy*" is "less onerous" than its duty to have regard to the need to secure the matters referred to above. It is unclear what NPg means by this, but it should be noted that s. 3A(5) EA89 imposes a direct obligation<sup>9</sup> on the Authority, whereas s. 3A(2) EA89 imposes a number of mandatory relevant considerations to which the Authority must have regard.
31. The Authority's obligation under s. 3A(5) — and under the principal objective duty — is to act in the manner which "it considers" is best calculated to further or promote the specified objective. Contrary to BGT's and NPg's apparent positions, this formulation makes clear that it is for the Authority to determine for itself what it "considers" to be "best calculated". That reflects the reality that such a determination necessarily involves a judgment based on the evidence. NPg implicitly — and correctly — accepts at paragraph 3.32 that the Authority has a margin of appreciation in making that judgment. The assertion that that margin of appreciation does not extend to choosing an approach that is "clearly inferior" is uncontentious: such a choice would not meet the threshold test in the *Wednesbury* case.<sup>10</sup>

### ***The CMA's jurisdiction under s. 11E EA89***

32. These Appeals are brought under section 11C(1) of the EA89, which provides that an appeal lies to the CMA against a decision by the Authority to modify licences under s. 11A EA89.
33. The CMA's jurisdiction to determine such appeals is wholly statutory. Section 11E EA89 creates and defines the jurisdiction of the CMA under s. 11C EA89, including defining exhaustively the basis and grounds on which the CMA may allow an appeal.<sup>11</sup> Section 11E EA89 provides as follows.

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<sup>9</sup> Albeit subject to ss. 3A(1B) and 3A(2) EA89, and s. 132(2) EA13

<sup>10</sup> *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223, [230]: a decision may be challenged as unreasonable if it "*is so unreasonable that no reasonable authority could ever have come to it*".

<sup>11</sup> See *Anisminic Ltd v Foreign Compensation Commission* [1969] 2 AC 147.

*"(1) This section applies to every appeal brought under section 11C.*

*(2) In determining an appeal the CMA must have regard, to the same extent as is required of [the Authority], to the matters to which [the Authority] must have regard—*

*(a) in the carrying out of its principal objective under section 3A;*

*(b) in the performance of its duties under that section; and*

*(c) in the performance of its duties under sections 3B and 3C.*

*(3) In determining the appeal the CMA—*

*(a) may have regard to any matter to which [the Authority] was not able to have regard in relation to the decision which is the subject of the appeal; but*

*(b) must not, in the exercise of that power, have regard to any matter to which [the Authority] would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so.*

*(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.*

*(5) To the extent that the CMA does not allow the appeal, it must confirm the decision appealed against...." (emphasis added)*

34. The present appeals are the first under s. 11C EA89 (such appeals hereafter referred to as "**energy licence modification appeals**"). Neither the CMA nor its predecessor, the Competition Commission ("**CC**"), has considered its jurisdiction under s. 11E EA89. It is a matter for the CMA in the first instance to determine its jurisdiction.<sup>12</sup>
35. It is common ground that:
- (a) the CMA's jurisdiction is a question of law that the CMA must determine in order to conduct the appeal;<sup>13</sup>
  - (b) the grounds of appeal are not co-extensive with judicial review grounds of illegality, irrationality and procedural impropriety<sup>14</sup> (see BGT Notice of Appeal, at paragraph 2.18; NPg Notice of Appeal, at paragraph 3.8); and
  - (c) the statutory grounds of appeal in energy licence modification appeals are substantively identical to the statutory grounds in appeals under s. 173 and 175(4) of the Energy Act 2004<sup>15</sup> ("**Energy Act appeals**").<sup>16</sup>

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<sup>12</sup> *Anisminic*, at pages 206-215, per Lord Wilberforce.

<sup>13</sup> *ibid*, per Lord Wilberforce.

<sup>14</sup> Although these grounds and those contained in s. 11E EA89 are not the same, it should be noted that judicial review, at least in the High Court, is a flexible mechanism arising from the Court's original jurisdiction and not merely statute. See, for example, *IBA Healthcare v OFT* [2004] EWCA Civ 142, at paragraph 100. This may include a consideration of the merits of a decision, where the circumstances of the case require. For example, see *Wilkinson v Broadmoor Special Authority* [2001] EWCA Civ 1545 and *T-Mobile (UK) Ltd and Telefonica 02 UK Ltd v Ofcom* [2008] EWCA Civ 1373 ("**T-Mobile**").

<sup>15</sup> Section 175(4) of the Energy Act 2004 provides:

*The CMA 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 [the Authority] failed properly to have regard to the matters mentioned in subsection (2);*

*(b) that [the Authority] failed properly to have regard to... the purposes for which the relevant condition has effect... [this ground is analogous to s. 11E(4)(d) EA89 ("the modifications fail to achieve... the effect stated")]*

*(c) that [the Authority] 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;*

Accordingly, the CC's consideration of its jurisdiction in Energy Act appeals in *E.ON UK Plc and GEMA and British Gas Trading Limited: Decision and Order of the Competition Commission ("E.ON")* is highly relevant: see paragraphs 49 *et seq* below.

### ***Telecoms appeals***

36. Both Appellants seek to rely<sup>17</sup> on comparisons with the appellate jurisdiction of the Competition Appeal Tribunal ("**CAT**") under ss. 192 and 193 of the Communications Act 2003 ("**CA 2003**") ("**Telecoms appeals**"), and the CMA's role on reference in appeals thereunder relating to price control decisions. Although there are some similarities (as there are with judicial review<sup>18</sup>), the comparisons drawn are misconceived and disregard the fundamental differences between Telecoms appeals and the CMA's statutory jurisdiction in these Appeals. BGT's assertion at paragraph 2.17 that ss. 11C and 11E EA89 provide for a "*full appeal on the merits*" is unfounded and unsustainable.
37. If the legislature had intended to provide a form of statutory judicial review, the statute would have said so;<sup>19</sup> it did not. If the legislature had intended to provide for an appeal on the merits, it would have said so; it did not. It is a fundamental principle of statutory construction that the words of the legislation should be given their natural meaning unless to do so leads to absurdity.<sup>20</sup> Where the legislature has chosen different words, it is to be presumed that a different meaning and effect was intended. There is no basis on which to assert that s. 11E EA89 was intended to create a right of appeal of a similar

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*(e) that the decision was wrong in law.*

<sup>16</sup> See BGT Notice of Appeal, at paragraph 2.18-2.19; NPg Notice of Appeal, at paragraph 3.5).

<sup>17</sup> BGT, at paragraph 2.20 of its Notice of Appeal, states that the CC's approach in Telecoms appeals "accords with" the approach taken in E.ON, without further explanation. NPg, at paragraph 3.11 of its Notice of Appeal, states that the CC's approach in Telecoms appeals is "also relevant", without providing further explanation as to why this is the case.

<sup>18</sup> For example, both Appellants argue, and the Authority agrees, that the relevant statutory ground that the decision is wrong in law (s. 11E(4)(e) EA89) includes the public law concept of procedural unfairness/natural justice.

<sup>19</sup> See, for example, the CAT's jurisdiction under Schedule 8 to the Competition Act 1998 and s. 317 CA 2003.

<sup>20</sup> Known as the "Golden Rule" of statutory interpretation; see, for example, *Grey v. Pearson* (1857) 10 E.R. 1216.

nature to one provided for in wholly different terms. To the contrary, the two statutory jurisdictions are fundamentally different.

*The CAT's jurisdiction*

38. A right of appeal against certain decisions of the Office of Communications ("**Ofcom**") lies to the CAT under s. 192 of the CA 2003.<sup>21</sup>
39. Section 192 of the CA 2003 provides as follows.

*"[...]*

*(3) The means of making an appeal is by sending the Tribunal a notice of appeal in accordance with Tribunal rules.*

*[...]*

*(5) The notice of appeal must set out—*

*(a) the provision under which the decision appealed against was taken; and*

*(b) the grounds of appeal.*

*(6) The grounds of appeal must be set out in sufficient detail to indicate—*

*(a) to what extent (if any) the appellant contends that the decision appealed against was based on an error of fact or was wrong in law or both; and*

*(b) to what extent (if any) the appellant is appealing against the exercise of a discretion by OFCOM, by the Secretary of State, by the CMA or by another person.*

*[...]"*

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<sup>21</sup> Sections 192 to 196 CA 2003 implement Article 4 of Directive 2002/21/EC on the common regulatory framework for electronic communications networks and services (the "**Framework Directive**").

40. Section 195 CA 2003 sets out how the CAT must dispose of an appeal under s. 192 CA 2003.

*"(1) The Tribunal shall dispose of an appeal under section 192(2) in accordance with this section.*

*(2) The Tribunal shall decide the appeal on the merits and by reference to the grounds of appeal set out in the notice of appeal.*

*(3) The Tribunal's decision must include a decision as to what (if any) is the appropriate action for the decision-maker to take in relation to the subject-matter of the decision under appeal.*

*(4) The Tribunal shall then remit the decision under appeal to the decision-maker with such directions (if any) as the Tribunal considers appropriate for giving effect to its decision.*

*[...]"*

41. It is notable that, by contrast to the CMA in these Appeals:

- (a) the CAT is required to decide the appeal on the merits;<sup>22</sup>
- (b) the CAT's jurisdiction is not limited to finding the decision wrong on one or more specified grounds; and
- (c) the CAT is required to dispose of the appeal by reference to the grounds set out in the notice of appeal but the appellant is not constrained in its notice of appeal to specific grounds of the sort provided for in energy licence modification appeals.<sup>23</sup>

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<sup>22</sup> Section 192(2) CA 2003; cf. s.11E EA89 which provides that 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 [statutory] grounds". The CC in *E.ON* (at paragraph 5.12) held that s. 11E EA89 does not give the [CMA] jurisdiction to conduct a full rehearing of the reasons for the decision, but rather to provide a check on the process by which the Authority came to make its decision, including whether the Authority failed to properly have regard to its duties, erred in fact or erred in law.

<sup>23</sup> Sections 192(6) and 195(2) CA 2003.

42. These provisions of the CA 2003 implement (in part) the UK's obligations under Directive 2002/21/EC<sup>24</sup> (the "**Framework Directive**"). Article 4(1) of the Framework Directive provides:

*"Member States shall ensure that effective mechanisms exist at national level under which any user... who is affected by a decision of a national regulatory authority has the right of appeal against the decision to an appeal body that is independent of the parties involved... Member States shall ensure that the merits of the case are duly taken into account..."* (emphasis added)

43. By contrast, the provisions for energy licence modification appeals under EA89, as amended, implement the UK's obligations under Directive 2009/72/EC<sup>25</sup> (the "**Electricity Directive**"), which provides, at article 37(17) that:

*"Member States shall ensure that suitable mechanisms exist at national level under which a party affected by a decision of a regulatory authority has a right of appeal to a body independent of the parties involved and of any government."*

There is no requirement in the Electricity Directive that member states enact domestic legislation that establishes an appeal mechanism that "takes into account" the merits of the original decision, as in the Framework Directive.

44. It should be noted that even the Framework Directive requirement to provide for an appeal taking account of the merits does not require a full merits appeal before the CAT; it can be – and indeed in some instances is – met by judicial review.<sup>26</sup> Thus, the Telecoms appeals mechanism goes beyond that which is required by the Framework Directive, in respect of some – but not all – decisions by Ofcom that are subject to the Framework Directive's requirement for an appeal taking account of the merits.

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<sup>24</sup> Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services.

<sup>25</sup> Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC.

<sup>26</sup> *T-Mobile UK Limited v Ofcom* [2008] CAT 15, at paragraph 42, approved in the Court of Appeal in *T-Mobile* ([2008] EWCA Civ 1373), at paragraph 10.

45. BGT relies (at paragraph 2.19 of its Notice of Appeal) on the Government Response to the Department of Energy and Climate Change's consultation on the 'Implementation of the EU Third Internal Energy Package', January 2010 [BG2/1]:

*"... 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."*

That statement is not disputed. It lends no support to any false proposition that what was intended or implemented by s. 11E EA89 amounts to an appeal on the merits. It does not.

*The CMA's role*

46. Telecoms appeals are conducted in accordance with the Competition Appeal Tribunal Rules 2003 (the "**CAT Rules**"), the CAT's stand-alone rules on procedure.<sup>27</sup> Where the decision of Ofcom appealed against concerns the setting of price controls, the CMA is required by s. 193 CA 2003 and rule 3 of the Competition Appeal Tribunal (Amendment and Communications Act Appeals) Rules 2004 to refer any price control matter<sup>28</sup> raised by the appeal to the CMA (formerly the CC) for determination, and to apply the CMA's determination when deciding the appeal. Pursuant to s. 193(2) CA 2003, the CMA's determination must be made:
- (a) in accordance with the CAT Rules;
  - (b) in accordance with any directions given by the CAT; and

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<sup>27</sup> SI 2003/1372

<sup>28</sup> "Price control matter" is defined in s. 193(10) CA 2003 as an imposition of any form of price control authorised by ss. 87(9), 91 or 93(3) of the CA 2003.

- (c) subject to the CAT Rules and any such directions, using such procedures as the CMA considers appropriate.

The CMA has no independent power to go beyond the legal framework within which the appeal is to be determined by the CAT.

- 47. Nevertheless, to the extent that the Appellants seek to rely on the CMA's role in Telecoms appeals, the Authority acknowledges that there are similarities in the subject matter before the CMA in such cases and in the present appeals, and fully acknowledges the choice of the legislature to give both tasks to the CMA, a specialist body with appropriate expertise in regulatory and price control matters.
- 48. It is, however, to be noted that the CMA's role in each is deliberately distinct. In energy licence modification appeals, the CMA is the appellate body, charged with finally disposing of the appeal before it in accordance with its statutory jurisdiction. In Telecoms appeals, the CAT is the appellate body performing that function. The CMA's role in Telecoms appeals is prescribed by the CAT pursuant to the statutory scheme and its conclusions are subject to the CAT's endorsement and implementation in its decision.

***Energy Act appeals: the CC's observations in the E.ON case***

- 49. It is not in dispute that the statutory grounds of appeal in Energy Act appeals are substantively identical to the statutory grounds of appeal in these Appeals and therefore the CC's comments on its jurisdiction in Energy Act appeals in *E.ON* is relevant to the CMA's determination of its jurisdiction in the present appeals. The Appellants have referred to the CC's decision in *E.ON* but have not fully reflected the CC's reasoning.
- 50. In particular, the CC, when considering its jurisdiction, found that, as an appellate body, its jurisdiction could usefully be compared to that of appellate courts when reviewing decisions of trial judges under CPR 52, where the threshold for allowing the appeal is also whether the decision was "wrong".<sup>29</sup>

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<sup>29</sup> *E.ON*, at paragraph 5.4.

51. CPR 52, to the extent that is relevant for present purposes, provides that "[t]he appeal court will allow an appeal where the decision of the lower court was (a) wrong... [subsection (b) is not relevant]". The White Book commentary on CPR 52<sup>30</sup> provides that "'wrong' presumably means that the court below (i) erred in law or (ii) erred in fact or (iii) erred (to the appropriate extent) in the exercise of its discretion". Accordingly, an appellate court may allow the appeal against an impugned decision under CPR 52 where the decision was wrong by virtue of one or more of these types of errors. The approach taken by the courts in relation to an impugned decision will depend on the nature of the purported error.
52. In *E.ON*, the CC also adopted this approach, first considering its jurisdiction in relation to the Authority's exercising of its discretion (paragraphs 5.5-5.14), then errors of fact (paragraphs 5.15-5.17), and, finally, errors of law (paragraphs 5.18-5.19), and applying the reasoning of relevant CPR 52 cases concerning the appropriate standard of review.
53. The CC's reasoning in *E.ON* is considered below. The Authority respectfully submits that the CMA should adopt the reasoning of the CC in *E.ON* in relation to the present appeals.

*Errors in the exercise of discretion*

54. In relation to errors in the exercise of discretion, the CC held in *E.ON* that the grounds of appeal set out in s. 175(4) of the Energy Act 2004, which are in materially identical terms to the grounds of appeal in the present appeals, clearly foresaw circumstances in which the CC might reach a different view from the Authority on the merits but in which it could not be said that the Authority's decision was "wrong" on one of the statutory grounds:

*"... we consider that [the Authority's] decision will require the exercise of judgment or discretion in applying [the] statutory and regulatory framework to what will often be complex facts... leaving to one side errors of law, it is not our role to substitute our judgment for that of [the*

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<sup>30</sup> at CPR 54.11.4.

*Authority] simply on the basis that we would have taken a different view of the matter were we the energy regulator."*<sup>31</sup>

55. NPg recognises, at paragraph 3.12 of its Notice of Appeal, that:

*"... there is a line that must be drawn in deciding whether a particular decision of [the Authority] is wrong on one (or more) of the statutory grounds... or whether the decision is one that the CMA might not have taken itself were it regulator, but which is not wrong on one (or more) of the statutory grounds..."*

56. NPg asserts that it has limited its appeal to areas in which it considers that the Authority has exceeded any margin of regulatory discretion such that the Authority's decision was "wrong". Where the line is drawn in relation to the "wrongness" of the Authority's decision is a question of law for the CMA. The Authority disagrees that NPg has drawn the line in the right place: in truth, NPg disagrees with discretionary judgments made by the Authority but cannot show that the Decision itself was wrong on one or more of the statutory grounds.

*Errors of fact*

57. In relation to errors of fact, the CC held that it should be slow to impugn findings of fact made by the Authority in Energy Act appeals, but that it had a clear jurisdiction in respect of factual errors, and would exercise that jurisdiction where it concluded that the Authority had based its decision on a plain error of fact.<sup>32</sup>

58. In doing so, the CC relied on the guidance set out in *Assicurazioni Generali Spa v Arab Insurance Group* [2003] 1 WLR 577, in which Clarke LJ drew a distinction between (a) conclusions of primary fact based on, or inferred from, oral and/or documentary evidence before the appellate body; and (b) "evaluations of the facts" which "involve an assessment of a number of different factors which have to be weighed against each other". As to the latter, Clarke LJ added, importantly: "This is...often a matter of degree upon

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<sup>31</sup> E.ON, at paragraph 5.10-5.11.

<sup>32</sup> E.ON, at paragraph 5.15-5.16.

*which different judges can legitimately differ. Such cases may be closely analogous to the exercise of a discretion and, in my opinion, appellate courts should approach them in a similar way*".<sup>33</sup> The appropriate approach to be taken in relation to different findings of fact will depend on:

*"... the weight to be attached to the findings of the judge and that weight will depend upon the extent to which, as the trial judge, the judge has an advantage over the appellate court; the greater that advantage the more reluctant the appellate court should be to interfere..."*.<sup>34</sup>

59. Clarke LJ referred in his judgment<sup>35</sup> to the Court of Appeal's judgment in *Tanfern Ltd v Cameron-MacDonald (Practice Note)* [2000] 1 WLR 1311, where Brooke LJ gave the judgment of the court and said this, at paragraphs 30 - 32:

*"The appellate approach: the general rule*

*As a general rule, every appeal will be limited to a review of the decision of the lower court. This general rule will be applied unless a practice direction makes different provision for a particular category of appeal, or the court considers that in the circumstance of an individual appeal it would be in the interests of justice to hold a rehearing: CPR r 52.11(1). The appeal court will only allow an appeal where the decision of the lower court was wrong, or where it was unjust because of a serious procedural or other irregularity in the proceedings in the lower court: CPR r 52.11(3).*

*This marks a significant change in practice, in relation to what used to be called 'interlocutory appeals' from district judges or masters. Under the old practice, the appeal to a judge was a rehearing in the fullest sense of the word, and the judge exercised his/her discretion afresh, while giving appropriate weight to the way the lower court had exercised its discretion in the matter. Under the new practice, the*

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<sup>33</sup> *Arab Insurance*, at paragraphs 14-16.

<sup>34</sup> *Ibid.*, at paragraph 15.

<sup>35</sup> *Ibid.* at paragraphs 8 – 9.

*decision of the lower court will attract much greater significance. The appeal court's duty is now limited to a review of that decision, and it may only interfere in the quite limited circumstances set out in CPR r 52.11(3).*

*The first ground for interference speaks for itself. The epithet 'wrong' is to be applied to the substance of the decision made by the lower court. If the appeal is against the exercise of a discretion by the lower court, the decision of the House of Lords in G v G (Minors: Custody Appeal) [1985] 1 WLR 647 warrants attention. In that case Lord Fraser of Tullybelton said, at p 652: 'Certainly it would not be useful to inquire whether different shades of meaning are intended to be conveyed by words such as "blatant error" used by the President in the present case, and words such as "clearly wrong", "plainly wrong", or simply "wrong" used by other judges in other cases. All these various expressions were used in order to emphasise the point that the appellate court should only interfere when they consider that the judge of first instance has not merely preferred an imperfect solution which is different from an alternative imperfect solution which the Court of Appeal might or would have adopted, but has exceeded the generous ambit within which a reasonable disagreement is possible'." (emphasis added)*

60. Having referred to Clarke LJ's guidance, the CC held in *E.ON*:

*"Applying these principles, our view is that [the Authority], as the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the advantage may be less than that which the trial judge has over the Court of Appeal, because [the Authority's] decisions are not based on the evidence and cross examination of witnesses. [The Authority] nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry..."<sup>36</sup>*

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<sup>36</sup> *E.ON*, at paragraph 5.16

61. The CC also considered that the words "*based... on an error of fact*" (emphasis added) in the relevant statutory ground should be interpreted as a materiality threshold, such that the appellant would need to demonstrate that the error was material to the outcome of the decision. Only if the error was material would the CC regard the decision as "*wrong*" under the relevant ground.<sup>37</sup>
62. The CC in *E.ON* applied the materiality threshold and afforded a degree of respect to the Authority in relation to its findings of fact, such that the threshold for establishing that the Authority's findings of fact were sufficient to render its decision "*wrong*" was a particularly high one.<sup>38</sup> The Authority respectfully submits that the CC was right to do so and the CMA would be right to do so in the Appeals, having particular regard to (a) the lengthy and resource-intensive process undertaken by the Authority and the expertise it has brought to bear in doing so and (b) the fact that the Authority's determination involved, in many material respects, "*evaluations of the facts*" which "*involve an assessment of a number of different factors which have to be weighed against each other*" such that the appropriate test on appeal is closely analogous to that which applies to an appeal against the exercise of a discretion.

#### *Errors of law*

63. The CC in *E.ON* held that the relevant ground that the decision was "*wrong in law*" incorporated the public law concept of procedural fairness/natural justice.<sup>39</sup> The Appellant argues, and the Authority agrees, that this is also the case in relation to the equivalent ground of appeal in the present appeals (s. 11E(4)(e) EA89). The Authority submits that it has complied with its public law duties in relation to the procedure that it adopted in reaching the Decision, as outlined in more detail below.
64. NPG's assertion that "*wrong in law*" also "*catches basic arithmetic errors*" is unfounded and unsupported by the case authority cited in support of it.

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<sup>37</sup> *E.ON*, at paragraph 5.17.

<sup>38</sup> In particular, in relation to errors of fact, the CC held at paragraph 7.15 that none of the errors it had identified in the Authority's cost-benefit analysis amounted to errors of fact.

<sup>39</sup> *E.ON*, at paragraph 5.18.

*Danae Air Transport v Air Canada* [2000] 1 WLR 395 concerned an order for costs made by arbitrators against the claimant in an arbitration on the basis that it had been awarded less than the defendant had previously offered as settlement. In fact, the claimant had been awarded more than had been offered by way of settlement; the arbitrators had made a simple mathematical error when calculating the amounts. The arbitrators refused to accept the error, despite lengthy argument, and justified their decision with written reasons. The claimant applied to the courts to have the award remitted to the arbitrators under s. 22 of the Arbitration Act 1950. The judge at first instance refused on the basis that the mathematical error was either an error of fact or of law and therefore the court had no jurisdiction to remit (under s. 1(1) of the Arbitration Act 1979 (the "**1979 Act**"). The Court of Appeal reversed the decision on the basis that the error was not an error of fact or of law; it amounted to a "procedural mishap", in respect of which the court had jurisdiction to remit despite s. 1(1) of the 1979 Act.<sup>40</sup>

65. In the entirely different context of the present appeals, basic arithmetic errors by the Authority in the process of making its decision could only properly be characterised as errors of fact.<sup>41</sup>

### ***The relevant context in the Appeals***

66. When determining whether the Authority's decision was "wrong" on one or more of the statutory grounds, the CMA should first determine whether the purported error is an: (a) error of law; (b) error of fact; or (c) error in the exercise of discretion. The CC's judgment in *E.ON* also makes clear that, when considering the appropriate degree of respect to be afforded to a specialist regulator, an appellate body should consider (a) the nature of the decision; and (b) the relative positions of the primary decision maker and the appellate body in assessing the evidence.<sup>42</sup> In particular, as set out above, in appeals brought in the context of a challenge to the Authority's "evaluation of

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<sup>40</sup> See, in particular, the case authorities cited at pages 402-403.

<sup>41</sup> As noted above in relation to errors of fact, whether such errors would be sufficient to render the decision "wrong" for the purposes of the relevant statutory ground is a separate question.

<sup>42</sup> See the citation from *Tanfern* above. Also see, in relation to the application of the standard of review in the context of CPR 52, *E I Dupont de Nemours & Co v S T Dupont* [2006] 1 WLR 2793, at paragraphs 82 – 98, where *Assicurazioni Generali Spa* and *Tanfern* were discussed and applied.

facts" the approach of the CMA will be closely analogous to that applicable to an appeal from an exercise of discretion.

67. These three types of error can be aligned with the five statutory grounds in the present appeals as follows.
- (a) It is clear that, where the Authority has made an error of fact or law, the relevant statutory grounds will be whether the decision challenged was "wrong" on the basis of that error of fact or error of law (s. 11E(4)(c) EA89 and s. 11E(4)(e) EA89, respectively).
  - (b) Where the Authority has made an error in the exercise of its discretion, the relevant grounds may be whether the decision challenged was "wrong" on the basis that the error in the exercise of discretion amounted to a failure to have proper regard or give appropriate weight to the Authority's statutory duties (s. 11E(4)(a) EA89 and s. 11E(4)(b) EA89, respectively).
  - (c) Both errors of fact and errors in the exercise of discretion may also be relevant when considering whether the decision challenged was "wrong" on the basis that the modifications fail to achieve, in whole or in part, the stated effect (s. 11E(4)(d) EA89).
68. In order for the CMA to be satisfied that the Authority's decision was wrong, the Appellants must show that the Authority erred sufficiently when making the decision so as to make the decision "wrong" on one of the statutory grounds. In making its decision, the Authority was required to weigh a number of competing factors and considerations in order to ensure that the decision complied with its statutory duties. The Authority was also required, by virtue of certain of its relevant statutory duties (such as promoting competition and protecting the interests of consumers), to approach its task in a holistic manner, taking account of all of the relevant factors and to make the decision as a whole. Under s. 11E(2) EA89, the CMA is required to have regard to the Authority's statutory duties to the same extent as the Authority when reviewing the Authority's decision under s. 11C EA89.

*The nature of the decision*

69. The decision under challenge in the present appeals is technically complex and is made up of a number of discrete but inter-connected determinations that together give rise to the decision itself. The Appellants' complaints do not go to all aspects of the decision, instead focussing on particular determinations, but not others. The Appeals can only be allowed on these specific complaints. However, the CMA is required to determine whether they render the decision itself wrong. It must do so by reference to the decision as a whole and be mindful of the distortive effects that may arise from artificially cherry picking aspects of the decision for reconsideration.

*The decision-making process*

70. As is clear from these submissions and the supporting evidence, the Authority's decision was a complex regulatory judgment, involving the balancing of many considerations, made from scratch on the basis of third party responses to the Authority's consultation and its own internal assessment, based on substantial amounts of data and expert consideration. In this respect, the context is somewhat different from that in the *E.ON* appeal, which concerned the adoption by the Authority of one of a number of competing third party proposals on the basis of recommendations by another body, evidence of which was available for review by the CC in *E.ON* (albeit that this involved considerable economic and regulatory assessment and judgment).
71. As a result of the decision-making process that led to the decision that is the subject of the present appeals, the decision is necessarily only a summary of the Authority's full determinations based on the available evidence and the expert consideration.

## **PART III: REGULATORY CONTEXT**

### ***Introduction***

72. This Part sets out the context to the Appeal. In turn, it briefly sets out in the following three subsections:
- (a) first, how the regulation of DNOs has developed since the privatisation of the sector in 1990;
  - (b) secondly, the principles that the Authority applied in adopting the RIIO framework of regulation, which was an updated form of regulation for gas and electricity network operators in Great Britain; and
  - (c) thirdly, how the Authority applied the new regulatory model to the electricity distribution networks in the specific context of RIIO ED-1.

### ***History and background to the development of regulation of DNOs***

73. As part of the process to bring about the privatisation of the electricity sector in Great Britain in 1990, 14 Public Electricity Suppliers were created, responsible for the supply and distribution of electricity in the areas covered by the 12 Area Boards in England and Wales and the 2 vertically integrated Scottish companies. To allay concerns that these private businesses might abuse their monopoly position, they had the charges they levied restricted through a form of revenue regulation known as "RPI-X", with separate controls for the distribution and supply parts of the businesses.
74. Subsequently, competition was introduced into the electricity supply market in phases up to 1999 and price controls were lifted for that part of the value chain. However, in recognition of the fact that the distribution networks were effectively natural monopolies, they continued to be subject to RPI-X regulation.
75. This section:
- (a) first, explains the RPI – X form of regulation and how it has evolved since privatisation; and

- (b) secondly, briefly sets out the key finding of a major review of the RPI-X regime that coincided with 20 years of its operation (and was known as RPI – X @ 20).

#### *RPI-X*

- 76. The RPI-X framework was first applied in 1984 to British Telecom at the time of its privatisation. It followed a report by Stephen Littlechild, then an academic economist, for the UK Government in 1983 that proposed a new approach for regulating private sector monopoly businesses. It was subsequently applied by the Director General of Gas Supply to the gas sector associated with the privatisation of British Gas in 1986. The Director General of Electricity Supply then applied the same approach in the context of the privatisation of the electricity sector (which also involved the privatisation of the transmission networks).
- 77. One of the key issues that Stephen Littlechild sought to address in establishing the RPI-X approach to regulation was to provide incentives for the regulated company to become more efficient and, in so doing, break the asymmetry of information between regulated company and the regulator. His solution was for the regulator to set, ex ante, the amount of revenue that the regulated operator was allowed to recover from its customers for a fixed period of time – typically 5 years. Over this fixed time period, the regulated operator was allowed to keep any differences between the actual costs it incurred in providing the services and the revenue allowance set by the regulator. This was expected to create strong incentives for cost efficiency – the lower the regulated operator's costs, the more profits it would generate. However, in so doing, it would reveal to the regulator the true level of costs it could deliver the services for. Hence, at the end of the fixed time period, the regulator could use this lower level of observed costs as the basis for setting the allowed revenue for the following five year period.
- 78. This approach of information revelation through incentive-based regulation has been central to the evolution of price controls for DNOs, and for energy network operators in GB more widely. The Director General of Electricity

Supply and subsequently the Authority applied this RPI-X approach to the electricity DNOs in five price control reviews (labelled DPCR1 to DPCR5) following the initial RPI-X arrangements which were part of the privatisation package. Over this period, the form of the price controls developed in the light of experience and the changing context.

79. The timing of the preparation of the fifth price control review, DPCR5, coincided with the Authority starting a review of RPI-X regulation, called the RPI-X@20 review (discussed further below). As a result, DPCR5 was a significant step towards the RIIO framework. It had an increased focus on outputs in some areas, provided funding for innovation trials, and placed greater emphasis on the role networks would need to play to facilitate the transition to a low carbon economy.

#### *RPI-X@20*

80. The RPI-X regime was generally regarded to have been very successful. However, in 2008 the Authority considered that it was timely to commence a review of the regulatory framework to consider whether it:
- (a) was still fit for purpose. The RPI-X framework was 20 years old, and there was a desire to analyse both the effectiveness and appropriateness of the model for future application.
  - (b) would meet new and emerging challenges – The energy networks were required to play a key role in moving to a low carbon economy, requiring significant changes and investment, and consideration needed to be given to whether the regulatory framework should change as a result.
81. Recognising these issues and the need to step back and consider holistically the appropriate regulatory framework, the Authority launched a comprehensive review of the way in which Britain's gas and electricity networks were regulated. This review was known as RPI-X@20 in recognition that it was taking place 20 years after the introduction of the RPI-X regime in energy.

82. The review concluded that RPI-X had delivered significant benefits for consumers, including reductions in network charges, improvements in operating efficiency, more efficient financing, improved quality of service and increased investment. However, several areas for development were also identified. These were:
- (a) stakeholders suggested the RPI-X framework led network operators to focus on the short term, and on Ofgem, rather than customers. They felt there was limited consideration of innovation and how best to deliver it, potentially limited appetite for risk, and a bias for 'capex' solutions rather than non-network options.
  - (b) such factors made RPI-X unlikely to facilitate the transformation to a low carbon economy and ensure security of supply in an efficient manner.
  - (c) there were concerns the regime had become complex making it difficult for stakeholders to understand, respond to and engage with.
  - (d) the process of submitting cost forecasts which were reviewed by the Authority at the same time as developing the various incentives and financial components for the price control created uncertainty and disagreement. This made it more difficult to assess whether costs were efficient and it was not a transparent process for stakeholders; and
  - (e) the RPI-X framework led companies to focus on efficiency which could be at the expense of delivering on outputs (such as customer service) and the longer term health of the network.
83. The RPI-X@20 review also took into account the changes to the Authority's statutory duties that had been adopted at around the same time, including:
- (a) The Energy Act 2008, which clarified that the principal objective of the Authority to protect the interests of "consumers" related to the interests of "existing and future consumers"; and
  - (b) The Energy Act 2010 which made two clarifications which were:

- (i) first, when interpreting the Authority's principal objective of protecting the interests of existing and future consumers, there was a need to reduce greenhouse gas (GHG) emissions and ensure security of supply; and
- (ii) second, to consider alternative types of solutions to protect consumers instead of, or alongside, measures to promote competition.

### ***RIIO principles***

- 84. In October 2010 the Authority published its RPI-X@20 decision document. It detailed a new regulatory framework, known as the RIIO model. RIIO involves setting Revenue using Incentives to deliver Innovation and Outputs. The Authority also published a 'Handbook for implementing the RIIO model' ("**RIIO Handbook**") which provides a comprehensive explanation of all elements and principles of RIIO.
- 85. RIIO was designed to apply to all four energy network sectors (gas and electricity transmission and distribution), but acknowledging that variations would arise across sectors in how the principles were applied. The first RIIO price controls for gas and electricity transmission and gas distribution took effect in 2013, and accordingly, the Authority and DNOs have had opportunities to learn from the process in the design and implementation of the first RIIO price control for electricity distribution (RIIO-ED1).
- 86. The following paragraphs set out the principles and main features of the RIIO model; the building blocks of how allowed revenues are set under RIIO; and makes some observations on lessons learned by the Authority and DNOs from applying the RIIO model prior to RIIO-ED1.
- 87. A chronology of the work undertaken in developing RIIO-ED1 is attached as Annex 2.

*Principles of RIIO*

88. The overriding objective of the RIIO model is to encourage energy network companies to:
  - (a) play a full role in the delivery of a sustainable energy sector
  - (b) deliver long-term value for money network services for existing and future consumers
  
89. These objectives are of course interrelated. In particular, to meet the demands of moving to a low carbon economy there needs to be significant investment in the networks. In planning this investment DNOs need to demonstrate to consumers that the latter are getting value for money over the longer term.
  
90. Some of the major changes between RPI-X and RIIO are:
  - (a) Increased role of stakeholders in the process. DNOs are expected to engage proactively with consumers and other stakeholders on an ongoing basis.
  - (b) Increased transparency and predictability. The review results in a clear 'contract' of what the companies are required to deliver. The framework for the review is developed (and consulted upon) early. Company business plans have been published for the first time, and consulted and discussed with stakeholders.
  - (c) Extended price control period from 5 years to 8 years. This enhances companies' abilities to manage more effectively the uncertainties they face in the move to a low carbon economy, promotes longer-term thinking and encourages network companies to identify ways of delivering better value for money over the longer term. It also allows the companies more scope to realise the benefits of initiatives such as innovation.
  - (d) Clearly defined outputs that the companies have to deliver, reflecting expectations of existing and future consumers. These outputs fall into six primary output categories (customer satisfaction; reliability and

availability; safety; conditions for connection; environmental impact and social obligations). The outputs were developed in consultation with stakeholders and are set out in a strategy document early in the RIIO process in order to inform the business plans (see below). DNOs are held to account on their output delivery.

- (e) The companies submit business plans, rather than cost forecasts as was previously the case. These plans explain what a company intends to deliver for consumers over time and how, and hence what revenue it needs. These plans are based on the Authority's strategy document, although companies can seek to justify alternatives. The onus is on network companies to justify their view of required expenditure. They are 'public facing' documents, which the companies are expected to use and maintain throughout the price control period. Companies have to demonstrate how stakeholder engagement has been taken into account in their business plans and provide robust reasons for any failure to address stakeholder concerns.
- (f) Proportionate treatment and fast-tracking. The business plans are initially reviewed with a view to assessing the level of scrutiny required. Elements of a company's plan that are deemed to be particularly high quality may receive lighter touch regulatory scrutiny. If a plan is judged by the Authority to be of sufficiently high quality and provides good value overall, it is considered for fast-tracking. This means the business plan is accepted as submitted and the company's price control review is concluded early. This plainly incentivises the companies to submit their best business plan early in the process. Fast-tracking provides reputational benefits to the DNO (recognising that price controls are a "repeated game") and enables the DNO to start preparing for the forthcoming price control early (for example, by negotiating contracts). It also encourages companies to reveal information earlier in the process which in turn can drive efficiencies and improve proposals for delivery from the companies remaining in the process. This staged price control process under the RIIO model draws out information from

DNOs, which can be taken into account by the Authority to refine its decision-making based on evidence as the process continues.

- (g) Innovation. Many elements of the RIIO framework encourage the companies to innovate: such as well justified business plans with long-term justifications, longer price control periods and clear outputs to deliver. However, recognising that the incentives in the price control may not be sufficient to deliver the type and scale of innovation needed to deliver a sustainable energy sector, RIIO also includes a time-limited innovation stimulus which provides funding for research and trials. These stimulus-packages built on the DPCR5 innovation mechanisms and are included in RIIO-ED1 (as with RIIO-T1 and GD1).
- (h) Financeability. The RIIO framework, in accordance with the Authority's duty "*to have regard to the need to secure that licence holders are able to finance the activities [which are the subject of obligations on them]*", sets out clear principles that efficient network companies should be able to secure financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations. This is in the interests of consumers. These principles are designed to ensure that the framework does not provide excessive returns, reward inefficiency or 'bail-out' a company that has encountered financial distress as a result of its own behaviour. Principles include i) a longer-term view of financeability; ii) allowed return based on the weighted average cost of capital (WACC); iii) cost of debt element of the WACC based on a long-term trailing average, providing a good estimate of the cost of debt and updated annually within the price control; iv) asset lives underpinning the depreciation policy to reflect expected economic life; v) an onus on companies to manage short-term requirements and provide equity where necessary, and vi) return on regulatory equity (RORE) analysis to check if the price control package fits together appropriately.

*Setting allowed revenues under RIIO*

91. As with the RPI-X framework, RIIO is used to set a revenue cap whereby the Authority determines the maximum revenue a DNO can collect from its customers over the duration of the price control. Allowed revenues are set to cover all aspects of a DNO's business except for services directly remunerated by customers (such as some types of connections to the network and legacy metering).
92. The price control is set using a 'building block' approach to assess allowed revenues, incorporating incentives to encourage network companies to deliver outputs and value for money over the long term.
93. As was the case under the previous regime, allowed revenues comprise:
  - (a) Remuneration for efficient expenditure broken into two components: 'fast' and 'slow' money. Slow money is remunerated as if it was capital expenditure and hence is incorporated into the company's Regulatory Asset Value (RAV) and depreciated over time. Fast money, by contrast, is remunerated as if it was operating expenditure and is recovered in the current price control period;
  - (b) An allowed profit (determined as WACC multiplied by average RAV); and
  - (c) A tax allowance.

Together, these determine the base revenue, to cover expected efficient costs.

94. Three types of adjustments are made to reflect the company's performance. These relate to:
  - (a) output incentives,
  - (b) efficiency incentives, and
  - (c) an innovation stimulus during the control period.

95. Adjustments are made during the control period for specified uncertainties that are considered to be outside the company's control but will have a significant impact on costs of delivery (e.g. compensation for changes in general price inflation in the economy) and changes to financial parameters that are updated during the period (e.g. annual adjustment to the cost of debt, pension adjustments). The allowed revenue is also adjusted each year for any over or under-recovery of revenues by the DNO in the previous year.

96. Each of these above four adjustments is described in further detail below.

#### *Output incentives*

97. In principle, output targets, cost allowances for delivering those targets and incentives around beating or not meeting those targets should be set in the round to reflect the level of output (service) that end consumers of the service are willing to pay for, taking into account the range of potential overall returns to the companies.

98. Determining willingness to pay of current and future consumers is not an exact science. This inevitably requires the exercise of judgements as to whether the evidence points to the outputs framework broadly providing value for money for consumers and as to whether the structure of the incentive reflects the degree of confidence in the underlying evidence.

99. The incentive schemes are designed such that companies that outperform, i.e. that efficiently over-deliver what their consumers value, earn above normal returns and those that underperform, i.e. fail to efficiently deliver what their consumers value, earn below normal returns. This reflects the aim for the RIIO control to effectively mimic what would be observed in dynamic competition in markets.

100. Under RIIO, companies are incentivised to take responsibility for delivering outputs at value for money. This requires them to demonstrate that outputs, and the costs of delivering them, are providing what their customers want, and to engage with their stakeholders to inform their understanding. This in turn

requires the Authority to provide a clear regulatory framework early enough in the process for such engagement to take place.

101. In order to facilitate this, Ofgem needs to make and commit to strategy decisions much earlier in the price control review than under RPI-X regulation. Commitment to these decisions is important for the business plan engagement process to be considered credible by both DNOs and their stakeholders. Retaining commitment during the process also sends important signals for future price control reviews. This does not mean that once strategy decisions are made they are set in stone irrespective of later evidence. Price control reviews are a discovery process. Where there are good reasons to do so in the consumer interest, changes are made, but only after taking into account a range of stakeholder views and the need to retain confidence in the overall process which itself benefits consumers.
102. The six primary output categories reflect the broad role that the network companies will play in delivering the RIIO objectives. A variety of incentive mechanisms are used to encourage companies to deliver these outputs.
103. In addition to these primary outputs, the RIIO model includes secondary deliverables, which are leading indicators of companies' performance and are intended to ensure that they take a long-term perspective to managing their networks.
104. If price controls were focused only on the delivery of primary outputs, network companies might be encouraged to deliver these at the lowest cost during the eight-year price control period, potentially at the expense of measures that could help reduce the costs of delivering primary outputs over the longer term. To protect against this, the Authority expects the network companies to focus on the longer term and consider whether it is appropriate to include costs in their business plans that are related to delivery of primary outputs in future price control periods and to long-term value for money.
105. Secondary deliverables hold companies "to account" to (a) the management of network risk and hence long-term delivery of primary outputs; and (b) the anticipation of future needs. For example, asset health indicators reflecting

risk and criticality may be a potential secondary deliverable target. Secondary deliverables are not the 'ends' relating to consumer experience of network services but are the longer term 'means to the end'. They are needed to ensure delivery of primary outputs over time and that long-term value for money is not put at risk.

*Efficiency incentives*

106. The business planning process and the Authority's assessment of base revenue in the price control review are key parts of the framework, designed to encourage network companies to seek to deliver outputs (and secondary deliverables) that are lowest cost over the longer term. The plan provides a helpful and reasonable basis on which to make assessments of forecast efficient costs. However, the Authority does not expect network companies to deliver exactly against their plans over the eight-year price control period. Rather, network companies are expected to evaluate the optimal way of delivering on an ongoing basis, taking account of new information, learning and potential changes in circumstances over time. It is in this context that the RIIO framework provides specific incentives for DNOs to seek out, over the duration of the price control, delivery solutions that provide better value for existing and future consumers.
107. The Information Quality Incentive ("IQI") is a mechanism in the RIIO framework designed to encourage companies to submit accurate expenditure forecasts during the price control review, and then spend efficiently during the price control period. More accurate expenditure forecasts enable the Authority to benchmark the DNOs comparatively and set efficient cost allowances for the price control period. IQI efficiency incentives, together with the efficient cost allowances, incentivise the DNOs to spend efficiently through RIIO-ED1. This enables the Authority to identify further efficiencies which can be recognised in future reviews.

*Innovation incentives*

108. Innovation is key to enabling network companies to deliver the objectives of the RIIO model, namely to play their role in the delivery of a sustainable

energy sector and to deliver long-term value for money for existing and future consumers. Such innovation could take many forms, including deployment of new "smarter" technologies and/or the implementation of new operational processes and commercial arrangements (such as demand side management).

109. Under the RIIO model, companies are encouraged to innovate by longer-term, outputs-led, incentive-based, ex ante price controls which give companies commitment around the potential rewards that they can earn from successful innovations and a commitment not to penalise them for unsuccessful innovations. It is also driven by stakeholder engagement, clearly defined outputs and the ability to justify expenditures over periods longer than the price control under review.
110. However, RIIO recognises that there are some circumstances where the benefits of innovation are uncertain, or unlikely to accrue to the network company. To take account of this, the framework includes an innovation stimulus package which provides partial financing for innovation related to delivery of a sustainable energy sector. This builds in the successful Low Carbon Networks Fund in DPCR5. Companies are required to share the learning from trials and projects funded through the stimulus with companies across the sector.

#### *Uncertainty mechanisms*

111. While a longer control period can encourage innovation, it can also potentially increase the uncertainties around future DNO outputs and expenditure requirements. The RIIO model includes mechanisms to ensure that risks are borne by the party best able to manage them efficiently. This includes setting out mechanisms under which DNOs' revenues are adjusted; the potential for disapplication of the price control; and a tightly-defined mid-period review of output requirements.

### ***The RIIO-T1 and GD1 reviews***

112. The RIIO model was first implemented in the RIIO-T1 and GD1 price control reviews in the gas and electricity transmission sector and the gas distribution sector respectively. These reviews started in April 2011 and were implemented from 1 April 2013.
113. The Authority drew on the experience it had gained from those processes to inform its approach to the design and implementation of RIIO-ED1 as described below. The Chronology set out at Annex 2 provides further details of the Authority's process.

### ***RIIO-ED1***

114. The RIIO-ED1 price control set the outputs that the 14 DNOs need to deliver for their consumers and the associated revenues they are allowed to collect during RIIO-ED1. This period runs for the eight years, from 1 April 2015 to 31 March 2023.
115. There were three stages to the RIIO-ED1 price control review: Stage 1: Strategy consultation and decision ("strategy decision"); Stage 2: Business plans and proportionate treatment ("fast-track"); and Stage 3: Revised business plans and detailed assessment ("slow-track"). Each is outlined briefly below.

#### ***Stage 1: Strategy decision***

116. In Stage 1, the Authority developed the key elements of the regulatory framework ("strategy") for RIIO-ED1 so that DNOs were in a position to develop, consult upon and justify business plans for the RIIO-ED1 period which met the needs and requirements of existing and future consumers at good value.
117. The strategy was developed over an eight month period, with input from a range of stakeholders, including consumer and environmental groups, industry and government, as well as the DNOs. Eight policy specific working

groups<sup>43</sup> were established (comprising DNOs and other stakeholders), together with a Price Control Review Forum (comprising a broad range of stakeholder representatives) and a Consumer Challenge Group.<sup>44</sup> The Authority consulted on the RIIO-ED1 strategy in September 2012 [BG2/8] and published its Strategy Decision in March 2013 [BG2/10].

118. The Strategy Decision addressed: the outputs that companies would be expected to deliver and the associated incentive mechanisms; the process for assessing the companies' business plans; proposed mechanisms for handling uncertainty; proposed mechanisms for encouraging innovation; and Ofgem's approach to financeability. It set out the five core criteria against which the business plans would be assessed, namely: whether the DNO had followed a robust process; whether its plan delivered the required outputs; whether its costs of delivering the outputs were efficient; whether its proposed financing was efficient; and whether the plans dealt well with uncertainty and risk.
119. The Authority confirmed that it would retain its 'toolkit' approach to cost assessment, similar to that used in RIIO-T1 and GD1, and would apply it at both fast track and slow track.
120. For RIIO-T1 and GD1, the Authority had adopted a four stage assessment process. At fast-track it had provided licensees with high level feedback on their submitted plans (termed the 'initial sweep') and gave them an opportunity to improve their plans before taking its decision on proportionate treatment. In applying this approach in the RIIO-T1 review the Authority allowed the two Scottish transmission companies to address resolvable issues to their plans to enable them to meet the standards necessary for fast tracking.
121. For RIIO-ED1, however, the Authority made clear in the Strategy Decision that it expected the DNOs to have learned, from observing the RIIO-T1 and GD1 process, what was expected from them at the fast-track stage under RIIO. It therefore made clear that it believed that *"a three stage assessment process*

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<sup>43</sup> Flexibility and capacity; Environment; Innovation; Reliability and safety; Connections; Customer and social issues; Finance; Cost assessment.

<sup>44</sup> This comprised a range of consumer experts, to act as a 'critical friend' to Ofgem and provide an external perspective on whether elements of the price control settlement were in the best interests of existing and future consumers.

*[was] sufficient and there [was] therefore no need for an additional 'initial sweep' stage."* **[RDB/47]**

*Stage 2: Fast track*

122. The DNOs produced business plans on the basis of the Strategy Decision and submitted them to the Authority on or before 1 July 2013 for fast track assessment. The Authority also required the DNOs to publish their business plans on their websites, providing a significantly greater amount of information for public scrutiny than in previous electricity distribution price control reviews. The Authority sought views on these plans in its open letter on RIIO-ED1 business plans **[BG2/11]**.
123. The Authority assessed the submitted plans in accordance with its approach in the Strategy Decision and applied a traffic light system to identify those elements of each DNO's plans that were acceptable (green) and those that required further attention (amber and red). This included a detailed comparative cost assessment using the toolkit approach. The Authority used three comparative cost assessment models, analysing costs at a total expenditure (totex) level using two different totex models and on a cost activity level basis using disaggregated activity-level modelling. It used 13 years' of data including available DPCR5 data and DNO cost forecasts.
124. The Authority used three models in recognition of the fact that there is no definitive answer for assessing comparative efficiency. It expected the models to yield different results. There are advantages and disadvantages to each approach. Totex models internalise operational expenditure (opex) and capital expenditure (capex) trade-offs and are relatively immune to cost categorisation issues. They give an aggregate view of efficiency. The bottom-up, activity-level analysis has activity drivers that can more closely match the costs being considered.
125. Having assessed the plans in the round, the Authority published its assessment on 22 November 2013 **[BG2/16]**. It proposed that Western Power Distribution's ("**WPD's**") four licensees be fast-tracked, recognising that

WPD's business plans were, overall, of sufficiently high standard that it was in the interest of consumers to accept its submitted plans in full.

126. WPD was the only DNO group to score "green" in all assessment categories. The other DNOs' plans scored green in some areas, but had areas requiring further work and so were consequently not considered suitable for fast tracking.
127. On 12 November 2013 the CC published its provisional determination for Northern Ireland Electricity ("**NIE**") [**RDB/50**], in which it proposed a cost of equity allowance and resultant overall weighted average cost of capital ("**WACC**") materially lower than that proposed by the DNOs (which in turn were broadly similar to those set in the previous RIIO reviews). This prompted the Authority to re-consult on its approach to assessing the DNOs' cost of equity allowances, which it did on 6 December 2013 [**BG2/18**]. In its decision of 17 February 2014 [**BG2/22**] it concluded that it should reduce the baseline assumption for an efficient cost of equity and invited WPD to accept a specified reduction as a condition to being fast tracked, to which WPD agreed.
128. On 28 February 2014 the Authority decided to fast track the WPD DNOs [**BG2/23**]. It gave notice of its proposal to modify the WPD DNOs' licences so as to implement its decision in accordance with section 11A(2) of the EA89 on 28 March 2014 [**RDB/32**]. In the light of responses it received to this consultation and its earlier RIIO-ED1 consultations, it decided to proceed with the modification as consulted upon, subject to minor drafting corrections [**BG2/28**]. No party appealed this decision.
129. The potential to be fast-tracked appears to have achieved its intended purpose in that, in the view of the Authority, the quality of the DNO submissions showed a marked improvement to that of previous price control submissions. All plans scored "green" in at least one assessment category and demonstrated strong stakeholder engagement. Further, the plans showed efficiency savings of more than £2 billion compared to previous forecasts. [**BG2/16**]

*Stage 3: Slow track*

130. In Stage 3, the 10 DNOs that were not fast tracked were required to submit revised business plans in March 2013. DNOs published their modified plans on their websites and the Authority consulted on them. **[BG2/25]** Consistent with its Strategy Decision the Authority focused its attention at slow track on those elements of the DNOs' plans that it assessed to be in the amber or red categories at fast track.
131. The slow track DNOs' revised plans included justifications and output packages at lower cost, with a £700m reduction in forecast expenditures versus their fast-track plans.<sup>45</sup> Most DNOs did not change their business plans for elements that were rated green at fast-track.
132. None of the slow track companies was judged to have demonstrated that their proposed costs (including their proposed savings from the use of smart or innovative tools and techniques) were efficient at fast track. Consistent with the Strategy Decision, these were therefore assessed in detail. The assessment included a further comparative benchmarking exercise. This involved assessing the Authority's view of efficient costs and then applying IQI interpolation (75% of the Authority's view of efficient costs and 25% of the DNO's cost forecast) to reflect the fact that the Authority does not have perfect information.
133. As part of its submission to the CMA, NPG included a report by Frontier Economics ("**Frontier**") which contains a description of the Authority's cost assessment framework **[RDB/48]**. The Authority has reviewed this report and though for the most part it is factually correct, there are some minor errors and incomplete descriptions, as set out in the attached Annex 3.
134. On 30 July 2014, the Authority consulted upon its Draft Determinations for the slow track DNOs based on its assessment of their resubmitted plans. **[BG2/30]**

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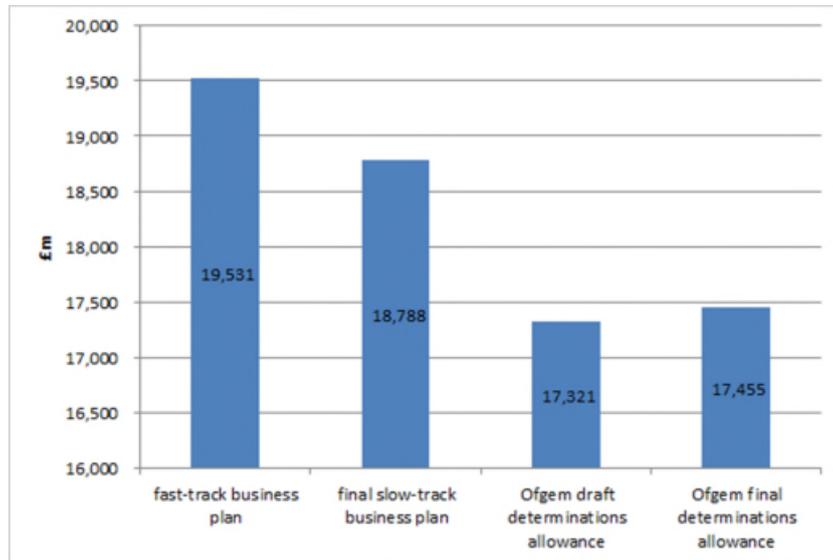
<sup>45</sup> All DNOs other than NPG reduced their cost proposals relative to their fast track plans.

135. In response to the Draft Determinations, some respondents claimed that the changes made to the assessment process between the fast-track and slow-track processes provided WPD with an unfair advantage at RIIO-ED2. The Authority disagrees with this contention. It estimates the financial benefit to WPD of being fast-tracked at around £250m **[BG2/35/A]**. The Authority considers that this £250m benefit is reasonable when balanced against the broader benefits of the fast-tracking approach (better initial business plans, a further £700m improvement across the sector between fast- and slow-track, and significantly better data for benchmarking DNOs at slow-track), which are greater than the benefits available to WPD. The Authority considers that the fast-track process has unlocked substantial value for consumers that would not have been possible otherwise.<sup>46</sup>
136. On 26 September 2014 the Authority consulted informally on its proposed licence modifications **[RDB/49]** and on 28 November 2014 it published its Final Determinations for the slow track DNOs. **[BG2/35]**
137. Overall, the Authority considers its Final Determinations are challenging for the DNOs to achieve, but fair, and represent good value for money for customers. They represent a £1.3bn (7%) reduction on the expenditure forecasts in the DNOs' slow-track plans. This is an 11% reduction from the fast track plans and 1% higher than Draft Determinations. This is shown in Figure 1.

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<sup>46</sup> Further, as explained at **[BG2/35/A]** the Authority does not consider that fast tracking provides WPD with an unfair prospective advantage for RIIO-ED2.

Figure 1. Slow-track DNO forecast and allowed total expenditures (2012-13 prices).



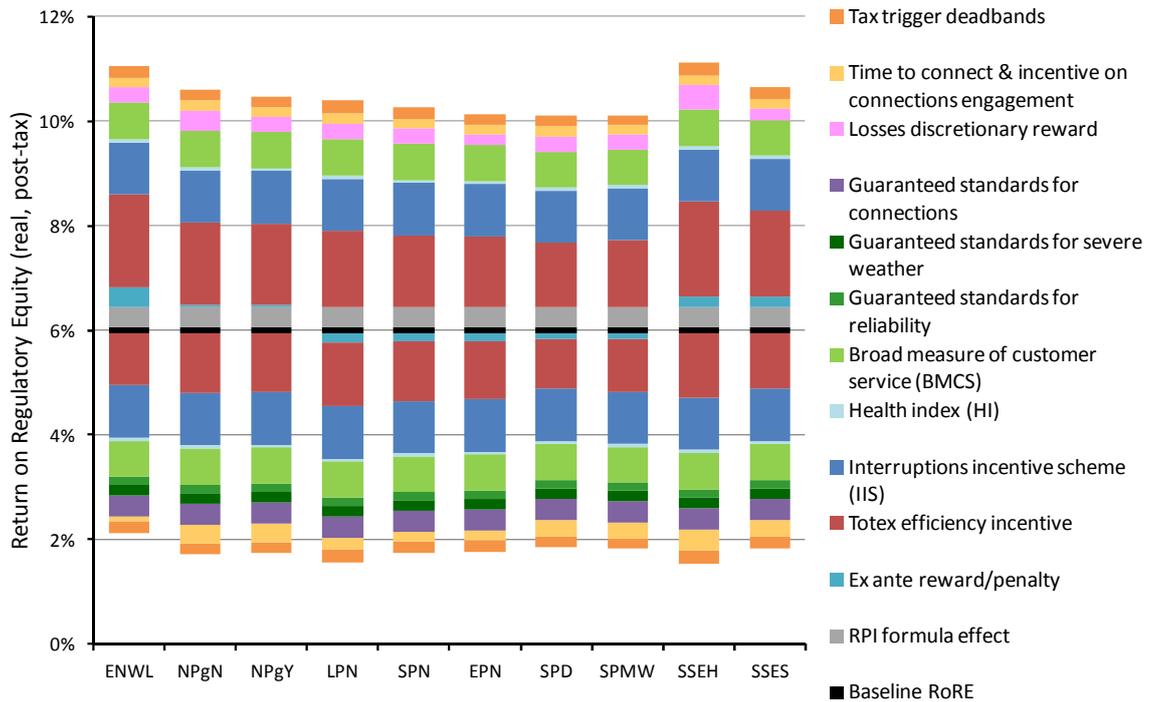
138. Table 1 below sets out the DNOs' total base revenues for the RIIO-ED1 period upon which allowed revenues are built.

Table 1. Base revenues for slow-track DNOs in the DNO licences.

£m 2012/13 prices	ENWL	NPg	UPKN	SPEN	SSEP D	Total
Final Determinations without updated pension deficit funding allowances	2,892	4,598	10,027	5,156	5,864	28,539
Final Determinations with updated pension deficit funding allowances	2,887	4,559	10,092	5,250	5,862	28,650
Disposals and DRS9 Corrections (as per 17 December 2014 letter)	- 1	0	2	10	- 12	- 1
Further two corrections	1	0	0	0	7	8
<b>Base revenues included in the licence</b>	<b>2,887</b>	<b>4,559</b>	<b>10,094</b>	<b>5,260</b>	<b>5,857</b>	<b>28,656</b>

139. The Authority also assessed the Final Determinations as a package, and their impacts on DNOs' financeability by considering plausible ranges of Return on Regulatory Equity ("**RoRE**") for each slow track DNO for the RIIO-ED1 period, as described in Figure 2. The RoRE ranges shown in the chart are broadly consistent with the Authority's Strategy Decision that outperforming DNOs could potentially earn RoRE above 10% while RoRE for underperforming DNOs could be below the cost of debt.

Figure 2 - Ranges for RoRE over RIIO-ED1 period



140. In the Authority's view, this analysis indicates a package of risk and reward calibrated to provide strong incentives for DNOs to deliver the outputs existing and future consumers need and require at efficient long-term cost. The Authority does not consider that DNOs will earn rates of return in excess of the fair rate of return (cost of capital) included in the Final Determinations, or as high as or higher than the returns achieved in the past. As already mentioned, the RIIO-ED1 Final Determinations are challenging for DNOs. The Authority has set tight cost allowances, an efficient cost of capital, and has tightened incentive mechanisms in a number of ways compared to DPCR5. It has also set an incentive in the licence under which DNOs suffer a penalty in RIIO-ED2 if they fail to deliver specific improvements to their asset base, without justification **[BG1/2]**. The potential scope for outperformance in RIIO-ED1 has also been reduced relative to DPCR5 because the Authority has had better access to information due to the fast-track process.

141. On 17 December 2014 the Authority gave notice of its proposal to modify the slow track DNOs' licences so as to implement its Final Determinations in accordance with section 11A(2) of the EA89 **[BG2/36]**. Taking account of all

of the evidence obtained during the RIIO-ED1 process, up to and including responses to the final round of consultation, on 3 February 2015 the Authority decided to proceed with the modifications set out in the notice, subject to the correction of minor errors as referred to in Table 1. **[BG1/2]**

142. While the Final Determinations were the conclusion of the RIIO-ED1 price control review for each of the slow-track DNOs, where certain elements had not changed since the Strategy Decision, these were not explained again in detail. This is why the modification notice referred to both documents. There are some instances where, in the process of developing draft and Final Determinations, some elements changed from the position set out in the strategy decision. Where this was the case the Authority made it clear in the determinations, and consulted on its reasons for doing so. It also noted in the Strategy Decision that certain values, such as the financial values for incentive caps and collars could not be set until Final Determinations, as they were based on the DNOs' base revenues.
143. The modifications comprise a suite of interrelated licence conditions which incorporate a detailed executable financial model (the Price Control Financial Model or PCFM) and related PCFM Financial Handbook. These facilitate annual updates of allowed revenues (the "annual iteration process") to enable specified financial adjustments to be made as close as reasonably practicable to associated expenditure rather than to be logged up for treatment only at the end of the price control period.

## **PART IV: GROUND 1 – ALLEGED INAPPROPRIATE MECHANISMS TO RETURN DOUBLE-RECOVERED COSTS FROM THE PREVIOUS PRICE CONTROL PERIOD**

### ***Introduction***

144. Ground 1 concerns the Authority's arrangements for the return of certain costs which the DNOs had double-recovered from consumers during DPCR5. In summary, the intention in DPCR5 was that certain services provided by DNOs (top-up, standby and enhanced security services, known collectively as "ES4" services), were treated as "excluded services" and excluded from the main revenue allowance for regulated Use of System Charges. DNOs were therefore allowed to charge for these services outside the main price control and were expected to charge for them using the same economic cost principles used for other Use of System Charges.
145. The Authority's price control decision for DPCR5, however, did not exclude forecast ES4 revenues, or alternatively the costs attributable to ES4 services, from the calculation of the main revenue allowance for Use of System Charges. This means that, if directly charged for, ES4 revenues represented a double recovery of costs.
146. Ofgem recognised this issue at the outset of the DPCR5 period and required DNOs to report on the basis that 85% of these revenues should be deducted from DNOs' regulatory asset value ("**RAV**") balances. This would have meant that 85% of the double recovered amount would be returned to consumers.
147. In the RIIO-ED1 decision, the Authority decided to return 100% of ES4 revenues by way of an adjustment to the relevant DNOs' RAV balances to be depreciated over 20 years.
148. BGT complains that that decision: fails to have proper regard to the interests of consumers and to principles of best regulatory practice insofar as a more immediate repayment to consumers would be appropriate; risks setting an inappropriate incentive for DNOs to double recover costs in the future; and was inadequately reasoned.

149. The Authority rejects those contentions. In summary, and as further explained below:

- (a) Both (i) return by way of an adjustment to the RAV and (ii) more immediate repayment, are neutral in net present value terms. Existing and future consumers taken together suffer no harm as a result of an adjustment to the RAV. All double-recovered costs will be returned to consumers.
- (b) A more immediate repayment to consumers would have had an adverse impact on key credit metrics of the DNOs and would have necessitated other adjustments in the financial package for at least one DNO to maintain its financial resilience at a standard considered appropriate by the Authority.
- (c) A more immediate repayment to consumers would have contributed to the savings to consumers in RIIO-ED1 arising as a result of the Authority's decision to move from a 20-year to a 45-year depreciation period for new assets, ie new additions to the RAV.
- (d) Return by way of an adjustment to the RAV was an established approach that had been reflected in DNOs' regulatory reporting in DPCR5. On BGT's case, the Authority's decision causes consumers in RIIO-ED1 to overpay by £32m as compared to the overall value of the combined slow track DNOs' settlements of £28 billion over that period. Even if the Authority's decision were flawed (which is denied), that amount is immaterial in the context of the value and complexity of the price control as a whole and disproportionate to the potential adverse perception of regulatory inconsistency that might be caused by a change to the method established in DPCR5 for repaying consumers.

### ***Background***

150. At paragraphs 4.8 to 4.11 of its NoA, BGT sets out the background to the Authority's decision and its approach. The Authority does not dispute BGT's account. By way of further background:

- (a) The Authority treated ES4 services as excluded services during DPCR5.
- (b) The Authority, however, had recognised during initial proposals for DPCR5 that it would be inherently hard for the DNOs to forecast costs in this area accurately and further proposed an adjustment to the RAV to return revenue in excess of forecasts. It stated:

*"Since DNOs would find it difficult to identify separately the costs involved in providing this service we propose to deduct DNOs' forecast revenues for this service (as a proxy for costs) from DPCR5 price control allowed expenditure and hence from allowed revenue. We propose that any revenue in excess of forecasts should be deducted from totex costs entering RAV for the year concerned."<sup>47</sup>*

- (c) The Authority had therefore envisaged that over-recovery in relation to ES4 services could be reimbursed by way of an adjustment to the RAV.
- (d) However, in DPCR5 final proposals, the Authority thought it inappropriate to make any deductions of DNOs' forecast revenues for ES4 services. It stated that *"[t]he corollary of this treatment is that the charges levied by DNOs for these services should be set on a cost recovery basis."<sup>48</sup> With the benefit of hindsight this decision was unclear as charging on a cost recovery basis would mean providing the services for free (since ES4 costs would be recovered through Use of System charges<sup>49</sup>) but this would not have reflected the costs of providing these services.*

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<sup>47</sup> Electricity Distribution Price Control Review Initial Proposals – Allowed Revenue and Financial Issues, §3.24, [AB1/AM1-2/26-27]

<sup>48</sup> Electricity Distribution Price Control Review Final Proposals – Allowed Revenue and Financial Issues, §3.9 [AB1/AM1-2/26-27]

<sup>49</sup> This problem arises because ES4 costs were included in the calculation of allowed revenues, which drives the annual Use of System revenue cap. ES4 revenues were outside that cap. Taken together, this means that ES4 costs are already recovered by Use of System revenues. Any ES4 revenues are therefore a double recovery.

- (e) Although during DPCR5 some DNOs chose to account for these services not as ES4 but within allowed revenues, other DNOs accounted for them as ES4 excluded services. They therefore double-recovered costs.
- (f) At the time, the Authority considered that a possible remedy for this potential double recovery would be to make adjustments to the RAV at the end of DPCR5 to remedy this (as it had originally envisaged in the DPCR5 initial proposals mentioned above). In the DPCR5 Regulatory Instructions and Guidance ("RIGs"), the Authority published the details of a RAV calculation which would ensure that ES4 costs were not double-recovered. The Authority decided that revenues should be used as a proxy for costs and that 85% of the revenues recovered from ES4 services should be removed from the RAV. This percentage represented the proportion of expenditure generally added to the RAV in DPCR5.
- (g) In the RIIO-ED1 review, the Authority proposed at Draft Determinations to recover these double-recovered sums through the RAV as anticipated in the RIGs, but recovering them at a rate of 100% rather than 85%. Following consultation, including consideration of BGT's views, the Authority in RIIO-ED1 Final Determinations decided:

*"[w]e believe it is correct to make a 100% adjustment in relation to top-up and standby revenues that some DNOs treated as excluded services during DPCR5. The costs associated with these revenues were in our DPCR5 cost allowances. Adjusting for less than 100% would fund some DNOs twice.*

*"5.47. Whether we should make adjustments to the RAV or to RIIO-ED1 revenues has a neutral effect on consumers overall, taking existing and future consumers together. It does affect the balance between different generations of consumers. It also affects DNOs' shorter term cash flows and financial metrics. We think this is similar to other factors that have inter-generational*

*effects, including our implementation of revised asset lives. We think our proposals keep an appropriate inter-generational balance and also facilitate efficient financing for the benefit of consumers in the long-run.*<sup>50</sup>

***BGT's complaint that the decision fails to have regard to the interests of consumers***

151. At paragraphs 4.12 to 4.16 of its NoA, BGT develops its complaint that the failure to make an adjustment to allowed revenues to return double-recovered costs more quickly was not in the interests of consumers and contrary to best regulatory practice. The Authority denies that its decision was harmful to the interests of consumers for the following reasons:

- (a) Both an adjustment to the RAV and an immediate adjustment to allowed revenues have the same net present value effect. It is therefore incorrect to conclude that there is necessarily any overall harm to consumers. Taken together, existing and future consumers are no worse off.
- (b) By making an adjustment to the RAV, the Authority avoided contributing to the savings to consumers in RIIO-ED1 arising as a result of the Authority's decision to move from a 20-year to a 45-year depreciation period for new additions to the RAV. The Authority's separate decision to move to a 45-year asset depreciation period (explained further below in Part VII) resulted in a significant reduction of costs for consumers compared to the situation if a 20-year asset depreciation period (which the Authority adopted in DPCR5 and before) had continued. The Authority estimates that as a result of the change in asset depreciation period, overall, costs to RIIO-ED1 consumers will be reduced by £600m, even after applying the transitional arrangements. The Authority chose not to contribute to the significant benefits already conferred on these consumers by making an immediate adjustment to allowed revenues. In the first year of RIIO-ED1 alone, consumers will

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<sup>50</sup> Final Determinations – Overview, §5.46-7 [BG2/35] [AB6/35/48]

receive benefits by reason of the new asset lives policy which outweigh the total harm which BGT alleges will result from the Authority's approach to double-recovered costs (£32m).

- (c) In addition, consumers benefit as a consequence of facilitating financing as discussed below. In paragraph 246 below this Response explains the positive effect on credit metrics within the RIIO-ED1 period of adjusting the RAV rather than making a direct adjustment to allowed revenues. It also explains the potential disproportionately adverse perception of regulatory inconsistency and consequential perception of regulatory risk in the minds of investors that might be caused by a change to the method established in DPCR5 that would be the result of making a direct adjustment to allowed revenues. By facilitating finance in this way, the Authority will help create the environment for more efficient finance and lower assessments of the cost of capital than would otherwise be the case. Given the inherent present value neutrality of the method, this would be to the net benefit of consumers.

152. As regards paragraphs 4.19a and 4.19b of the NoA, at which BGT argues that considerations of intergenerational equity do not support an adjustment to the RAV:

- (a) While BGT is strictly correct to assert with respect to (i) the Authority's adjustment to the RAV, and (ii) the Authority's inclusion of a transition period for the move to a 45 year asset life policy, that "*[b]oth of these effects work in the same direction*", its analysis overlooks the wider implication of the change to a 45 year asset life policy. As explained above, the effect of the move to a 45-year asset life policy is to reduce costs for RIIO-ED1 consumers by £600m even with a transitional period. BGT itself broadly *accepts* that the Authority's new position in relation to asset lives will have such an effect.<sup>51</sup>
- (b) BGT is wrong to state that the Authority has not explained why the approach strikes the right balance between present and future

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<sup>51</sup> Notice of Appeal, §4.82

consumers. The Authority laid out clearly in its letter to BGT of 3 February 2015 the issues associated with the move to a 45-year asset depreciation policy, and the relevance of those considerations to the issue of ES4 double-recovered costs.

153. The Authority further denies that the decision to make an adjustment to the RAV did not accord with best regulatory practice as BGT alleges at paragraphs 4.12 and 4.15 of the NoA. BGT's allegation that principles of best regulatory practice dictate that over-recovered revenues should be returned to consumers promptly oversimplifies the context of such decisions in a complex price control settlement. The Authority must have regard to the interests not only of existing but also of future consumers. In many decisions it takes, there are issues that affect future consumers, through inter-generational equity or by affecting potential investor perceptions of risk, which it must balance. In any event, even if it were consistent with best regulatory practice to return double-recovered costs promptly absent good reasons to the contrary, the Authority had such good reasons, as stated above.

***BGT's complaint that financeability is not a relevant consideration***

154. BGT complains that the Authority has failed to demonstrate: that financeability is a relevant consideration; and how its approach would facilitate efficient financing. As to this point:
- (a) By making an adjustment to the RAV, the Authority has spread the repayment to consumers over a 20-year period as opposed to requiring it immediately. In proportion to the relatively small value of the issue, the positive impact on DNOs' cash-flows and financial metrics is therefore clear. For the reasons stated above, the adjustment to the RAV will contribute to the efficient financing of the DNOs.
  - (b) Return by way of an adjustment to the RAV was an established approach that had been reflected in DNOs' regulatory reporting in DPCR5. On BGT's case, the Authority's decision causes consumers in RIIO-ED1 to overpay by £32m. As set out above, even if the Authority's decision were flawed (which is denied), that amount is

immaterial in the context of the value and complexity of the price control as a whole and disproportionate to the potential adverse perception of regulatory inconsistency and consequential perception of regulatory risk in the minds of investors that might be caused by a change to the method established in DPCR5 for repaying consumers.

- (c) Given the Authority's duty to have regard to issues of financeability, this was among the relevant considerations to which the Authority was obliged to have regard in reaching this decision.
- (d) Although the adjustment to the RAV would not be expected to have a material impact on the financeability of the DNOs in general, principally due to the small value of the issue itself and subject to the disproportionality of the issue referred to in subparagraph (b) above, the impact was more significant for some DNOs.<sup>52</sup> These were relevant financeability considerations to which the Authority was not only entitled but in fact required to have regard.

***BGT's complaint as to inappropriate incentives***

155. At paragraphs 4.12b and 4.17 of its NoA, BGT complains that the Authority's decision will set an inappropriate incentive on the DNOs to double-recover in future. The Authority rejects that complaint:

- (a) The double-recovery of ES4 revenues was an isolated incident which is unlikely to arise again. The Authority remedied the lack of clarity over the correct approach to charging for ES4 revenues in DPCR5 explained in paragraph 144 above by modifying the RIIO-ED1 licence. It now states specifically that top up and standby charges may only be treated as directly remunerated services to the extent that they relate to an agreement for the recharge of direct expenditure. For RIIO-ED1, over-recovery for such excluded services is therefore specifically structurally

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<sup>52</sup> ENWL in particular, represents 45% of the total ES4 revenues. The Authority judged that ENWL's financial resilience was constrained and required an adjustment to the financial package: Draft Determinations – Financial Issues [BG2/30C] [AB5/30C] at §3.25-3.33. Repaying consumers more quickly would have an adverse impact on the financial resilience measure, PMICR<sub>G</sub>, and would logically have necessitated a further adjustment.

eliminated.<sup>53</sup> As such, even if there was an incentive for the DNOs to double-recover for the costs of excluded services again, it is clear that they would have no opportunity to do so.

- (b) The incentives would in any event be absent in economic terms. As stated above, both an adjustment to the RAV and an immediate reduction to allowed revenues are neutral in net present value terms. There would therefore be no net gain to DNOs were they to double recover with a view to having an adjustment to the RAV imposed. Moreover, the sums involved in double-recovery with respect to ES4 services are relatively small (as BGT in effect concedes by alleging that the cost to RIIO-ED1 consumers will be £32m). It is therefore unlikely that DNOs would double-recover with a view to obtaining "*financing... over a 20-year period*" as BGT suggests.
- (c) The Authority accepts that it has not required interest to be paid by the DNOs on the sum of double-recovered costs, as BGT complains at paragraph 4.17 of the NoA. However, the amount of any such interest would be trivial and insufficient to create an inappropriate incentive of the kind alleged by BGT.
- (d) In any event, BGT ignores the fact that the Authority indexes the RAV by the RPI. During DPCR5, the RPI percentage change exceeded the interest rate that would have been applied for over-recovery payments during DPCR5 (roughly 2%). Therefore, the amount that consumers gain by way of an adjustment to the RAV exceeds the interest payments that would be payable on the sum of double-recovered costs if there was an immediate adjustment to allowed revenues.

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<sup>53</sup> See Draft Determinations – Overview, p. 45, §5.44: "*For RIIO-ED1, we propose to amend DNOs' licences to specify that top-up and standby charges are only directly remunerated if they relate to an agreement for the recharge of direct expenditure. All other expenditure that might be attributable to top-up and standby will be in general totex and funded through allowed revenues. Most top-up and standby income will therefore be in DNOs' allowed revenues.*" [BG2/30] [AB5/30/45]

***BGT's complaint as to inappropriate procedure***

156. At paragraph 4.20 of its NoA, BGT contends that the Authority has failed to engage with it on this topic and has failed to give adequate reasons for its decision. The Authority rejects that complaint:
- (a) The Authority most recently explained its reasoning in its letter to BGT of 3 February 2015, in which it set out the considerations of intergenerational equity which suggested that an immediate reduction to allowed revenues would not serve the interests of present and future consumers taken together.<sup>54</sup>
  - (b) In the same letter, the Authority explained how its approach to the issue of asset lives supported its approach to the return of double-recovered costs. Moreover, as further explained below at paragraph 303 *et seq*, the effect of moving to a 45-year asset life policy on the costs to consumers was explained by the Authority publicly on many occasions.
  - (c) The Authority further explained its approach in Final Determinations, as noted above.<sup>55</sup>
  - (d) The issues were discussed in a meeting between Ian Rowson of Ofgem and Andrew Manning on 28 May 2014 following email correspondence between Ofgem and BGT. At the meeting, Ian Rowson explained the approach of the Authority described above.

***Conclusion***

157. For all the reasons set out above, the Authority did not err in setting the mechanisms to return double-recovered costs associated with ES4 services.
158. In particular, the decision:
- (a) Served the interests of existing and future consumers;
  - (b) Had regard to principles of best regulatory practice;

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<sup>54</sup> Letter from Ofgem to BGT, 3 April 2015 §40 p. 11 [BG2/39] [AB6/39/11]

<sup>55</sup> Final Determinations – Overview, §§5.46-7 [BG2/35] [AB6/35/48]

(c) Gave proper weight to all considerations, including that of financeability; and

(d) Was supported by adequate reasoning.

159. There are therefore no grounds on which the CMA should intervene as requested by BGT at paragraph 4.23, or at all.

## **PART V: GROUND 2 – ALLEGED INAPPROPRIATE INCENTIVE TARGETS FOR INTERRUPTIONS INCENTIVE SCHEME AND BROAD MEASURE OF CUSTOMER SERVICE**

### ***Introduction***

160. The Interruptions Incentive Scheme ("IIS") and Broad Measure of Customer Service ("BMCS") are incentive schemes for the Customer Service and Reliability outputs of the RIIO-ED1 price control. Under the RIIO model, the Authority committed itself to providing clear and comprehensive outputs that the network companies are required to deliver. Without clear outputs and incentives in these areas, companies would have a strong incentive to focus only on reducing costs, without taking sufficient account of the long term health of the network or customer service. The incentive mechanisms are designed so that DNOs can earn higher returns by delivering higher than target outputs, which for these particular mechanisms means further reductions in interruptions or improvement in customer service. The incentives have been considered as part of the overall incentive package, in terms of the potential range of return on regulatory equity (RoRE) available to the DNOs in RIIO-ED1 [Strategy Decision Financial Issues §3.22 [BG2/10-F] [AB4/10-F/27].
161. Both incentives were designed with input from industry and stakeholder working groups.

### ***(A) Interruptions Incentive Scheme***

162. Ground 2 (a) concerns the IIS. The IIS provides incentives to DNOs relating to reliability of supply. Ground 2(a) refers specifically to the component of the IIS that provides incentives on managing unplanned interruptions.
163. The IIS contains two performance measures for unplanned interruptions: (i) the number of unplanned customer interruptions per 100 connected customers ("CI") and (ii) the number of customer minutes lost ("CML") as a result of such interruptions.

164. The IIS has been in place over a number of price controls, and has driven a significant reduction in the number of, and length of, interruptions as explained in the first witness statement of Miss Rossington at paragraph 16.
165. In RIIO-ED1 the Authority amended the scheme to include improvement factors in the calculation of the targets.
166. BGT complains that the Authority based the targets for unplanned interruptions on out of date data, in particular that the Authority did not take into account performance data for 2013/14 when setting targets; and that the targets are calibrated in such a way that DNOs generally will obtain substantial rewards without corresponding benefits for consumers.
167. In summary:
- (a) The reason that the Authority did not use 2013/14 data when setting the targets was that the data were not available when the Authority made its decision on how targets would be set in March 2013 – and in fact the data have still not been finalised. It was important to make clear the process by which the targets would be set and to give a clear indication of what the targets would be early in the process, so that DNOs had clarity before making their business plan submissions and so that they could engage meaningfully with stakeholders. When formulating business plan submissions, the DNOs would have had a clear idea of where the targets would be and so could share this information. Stakeholders could then express views on whether or not the targets were set at the correct level and the DNOs could have incorporated this information into their business plan submissions (for example, by proposing tougher targets). The Authority explained this in the Strategy Decision in March 2013:

*"[we] have decided to set targets up front in accordance with the method which was discussed in the consultation document. We feel that this is a prudent approach to adopt as it will provide clarity for stakeholders on the targets that their DNO has and will enable stakeholders to easily interact with their DNO on their*

*performance. It also provides certainty for any investment decisions by DNOs that will be of benefit to their customers."*

**[BG2/10; AB 4/10]**

- (b) If the Authority had signalled at the time of the Strategy Decision that it intended to take into account 2013/14 data in setting targets for RIIO-ED1, this would have created a perverse incentive on DNOs to stop making improvements in that year so as to create an artificially lower and more achievable target in RIIO-ED1.
168. As a general point, the IIS has already led to better reliability of service for consumers, in line with the Authority's view of consumers' 'willingness to pay'. The Authority aligned incentive rates for RIIO-ED1 with those used for RIIO-T1 (Strategy Consultation – Reliability and Safety, §4.8, **[BG2/8-C; AB3/8-C/19]**). The Authority's view was that using the RIIO-T1 incentive rates would result in rates similar to those used during DPCR5 (Strategy Consultation – Reliability and Safety, §4.13, **[BG2/8-C; AB3/8-C/19]**). Before the Authority decided on the price controls for DPCR5, it conducted research through consultants, Accent, on the extent to which consumers were willing to pay for improvements in reducing the number of interruptions and their duration. This research was used as the basis for selecting incentive rates for DPCR5 which were in line with consumers' willingness to pay. Further research, carried out for the Authority by Reckon for RIIO-ED1, did not suggest that Accent's quantitative valuation of consumers' willingness to pay fell outside Reckon's view of the cost to consumers of being without a supply. In addition, the DNOs gave Ofgem no feedback from its stakeholder engagement which suggested that the incentive rates for RIIO-ED1 went beyond consumers' 'willingness to pay'.
169. Paragraphs 4.24 and 4.27 of the NoA correctly set out high-level features of the IIS scheme.
170. At paragraph 4.26 of the NoA BGT argues that the Authority's explanation of the IIS is opaque. The Authority disagrees and notes that it set out its general approach in the Strategy Consultation **[BG2/8-C; AB3/8-C/16-32]** and

Strategy Decision [**BG2/10-C; AB4/10-C21.33**]. It went into further detail in the correspondence of 9 February 2015 with BGT [**BG1/AM1-10; AB1/AM1-10**]; and 13 February 2015 [**BG1/AM1-11; AB1/AM1-11**]; [**BG1/AM1-12; AB1/AM1--12**]; [**AB1/AM1-15/1-5**]. The Authority is providing further, commercially confidential, information subject to a confidentiality ring, as indicated by the CMA.

171. As regards paragraph 4.28 of the NoA describing the IIS:
- (a) The first and third sentences broadly describe how the target factors and improvement factors operate.
  - (b) The setting of targets is slightly different from the description given in the second sentence of paragraph 4.28: notional targets and improvement factors are set from years 2012/13 onwards. These are used to determine 'notional' targets for 2013/14 and 2014/15; improvement factors are then applied to these to produce the initial target for the first year of the price control period – 2015/16.
  - (c) The Authority set two improvement factors for CI – 0.5% for DNOs already meeting the benchmark<sup>56</sup>, and 1.5% for DNOs not meeting the benchmark.
  - (d) Separate CML improvement factors were set for the different voltage levels – HV, LV, EHV and 132kV.
  - (e) The Authority agrees with much of BGT's explanation of the way in which the initial target and improvement factors are set for each DNO in relation to CI and CML, set out in AlixPartners Report, §§5.1.5-5.1.23, subject to the clarifications and corrections set out in the first witness statement of Anna Rossington at paragraphs 25-52.
172. At paragraphs 4.25, and 4.29 - 4.32 and 4.36 BGT alleges that the design of the schemes is flawed in a number of respects, and is likely to lead to rewards

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<sup>56</sup> The CI benchmark is an aggregate benchmark of voltage-level CI benchmarks for each DNO. The calculation and use of this benchmark is explained in the first witness statement of Anna Rossington at paragraphs 28-30.

for DNOs without any substantive improvements in performance. In particular BGT alleges that, based on the 2014/15 forecasts, 10 out of 14 DNOs already achieve performance levels which would exceed the average target for RIIO-ED1.

173. BGT's analysis is flawed:

- (a) BGT's forecasts for 2014/15 are based on data produced by the DNOs as required under the Distribution Connection Use of System Agreement (DCUSA), for the purpose of enabling suppliers to understand likely future charges. The uncertainties underlying this data and assumptions that BGT will have needed to make mean that they should not be viewed as reliable forecasts.
- (b) The information available to the Authority from the Business Plan Data Templates provided by DNOs suggested that 2014/15 performance for unplanned interruptions would be *worse* than their performance in 2013/14; while the Authority accepts that this information is also unreliable – though more reliable than the DCUSA information – it demonstrates that little reliance can be placed on BGT's forecasts for 2014/15.
- (c) Even if BGT's 2014/15 forecasts were correct, however, if slow-tracked DNOs were to maintain the 2014/15 level of performance, there would be an *overall* penalty of £19m<sup>57</sup> over the course of RIIO-ED1. Therefore, even on BGT's view, it is incorrect to say that there will be systematic unearned rewards during RIIO-ED1: were the relevant DNOs to maintain BGT's view of their current level of performance, there would be a net penalty during RIIO-ED1, not a reward.
- (d) In any event, the Authority does not agree that (even assuming that BGT's 2014/15 forecasts are correct) 10 out of 14 DNOs already achieve performance levels which exceed the average target set for

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<sup>57</sup> This figure includes the caps and collars that are applied to rewards and penalties above or below a certain level, and the total reward is multiplied by the IQI efficiency incentive, as per the scheme design.

RIIO-ED1. It is important to note that BGT refers not only to the slow-tracked DNOs but also to the fast-tracked WPD DNOs. Those licences are not the subject of this appeal, and those performance levels are entirely irrelevant to this appeal. The Authority considers that, even on the hypothesis that BGT's 2014/15 forecasts are correct, only 5 out of the 10 relevant DNOs (ie the DNOs whose licences are the subject of this appeal) would earn a reward by maintaining those *forecast* levels of performance.

- (e) As regards paragraph 4.31 of the NoA, it is correct that on the basis of the 2013/14 *provisional* data, 8 out of 14 DNOs already exceed the Authority's average targets. However the 2013/14 data are still only provisional. Further, 4 of the 8 DNOs who may exceed the average targets are fast-tracked DNOs whose licences BGT has not appealed; those DNOs' performance levels are therefore irrelevant to this appeal. Of the slow-tracked DNOs (ie the DNOs whose licences are the subject of this appeal), only 4 out of the 10 relevant companies would exceed the Authority's average targets, on the basis of the *provisional* data.
- (f) In any event it is not safe to rely on purported performance in 2014/15 as indicating that DNOs will be able to earn rewards under either the CI or CML schemes without making any improvements over the next 8 years. Even if the actual data for 2014/15 shows that a DNO already exceeds the target, performance in any one given year is not necessarily indicative of underlying performance. There is an inherent volatility in the data which makes it difficult to predict outperformance in future years. Good or indeed poor performance in any year may be attributable to factors other than genuine improvements such as benign or adverse operating conditions. On several previous occasions, CI performance has deteriorated rather than improved in comparison with the previous year. Moreover, the Authority considers that some of the recent improvements in performance have come about as a result of changes in ownership leading to improvements in efficiency, and of the effectiveness of incentives in DCPR5. Looking at recent improvements

in performance may not result in realistic targets or improvement factors; improvements that have resulted from one-off structural changes will not necessarily be repeated. The Authority exercised its judgement in the light of this evidence so as to set challenging, but realistic targets to provide an effective incentive to maintain and improve performance.

- (g) Moreover, those DNOs which *are* already performing at the target level will still have to continue to maintain their current level of performance. Given that most performance improvements appear to be driven by operational changes rather than one-off investments, there is likely to be a cost to the business associated with maintaining a particular level of performance that is not funded by its customers.
- (h) In any event, the Authority does not agree with BGT's assertion at paragraph 4.32 of the NoA that total rewards that would accrue to the DNOs which already outperform their average target amount to £424.4mn, of which £146.2mn is paid to slow track DNOs (on the basis of 2014/15 forecasts;) or £342mn, of which £126mn will be paid to slow track DNOs (on the basis of 2013/14 data). As set out above, the Authority does not accept the 2014/15 forecast as correct or reliable; further the 2013/14 data is still provisional. Even if these data were correct, however, and if the Authority accepted BGT's assertions, the Authority estimates the figures for slow track DNOs at £119.6mn on the basis of 2014/15 forecasts; and £108.2mn<sup>58</sup> on the basis of 2013/14 provisional data. (The Authority also disagrees with BGT's estimate of rewards for fast track DNOs, but these are not relevant to this appeal.)

174. Moreover, the scheme represents good value to consumers, contrary to BGT's contention at paragraph 4.33 of the NoA.

175. BGT makes a number of specific criticisms of the scheme from paragraph 4.34 onwards.

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<sup>58</sup> Using 2013/14 prices

176. At paragraph 4.34 BGT allege that the targets did not take account of actual performance data for 2013/14. This was for the simple reason, set out above, that the data were not available when the Authority made public its decision on how the targets would be set (and indeed they have still not been finalised). It was important to set the indicative targets early in the process, in the Strategy Decision March 2013, to provide clarity to DNOs and stakeholders during the price control consultation about what was required.
177. In addition, as set out above, if the Authority had signalled to DNOs in the Strategy Decision March 2013 that it intended to defer target setting in order to take into account 2013/14 data, this would have created an incentive to DNOs to stop making improvements in performance in that year in order to ensure that the RIIO-ED1 targets were lower than otherwise.
178. At paragraph 4.35, BGT complains that the impact of using the data from 2013/14 is significant, since the average CI performance is 3.2% better for the 4 year period 2010/11 to 2013/14, and the average CML performance is 6.1% better for that period, than if the 2009/10 data set is used. BGT complains that these rates of improvement are much higher than the average annual improvement factor assumed by the Authority when deriving the initial CI and CML targets for 2015/16, of 0.3% for CI, and 2.6% over 3 years for CML. As to this:
- (a) the Authority reiterates that the 2013/14 data are still not finalised, so these conclusions are in any case provisional.
  - (b) In any event, as set out above, perceived improvement in 2013/14 does not necessarily mean that DNOs have made improvements to the extent that they will be able to outperform targets in RIIO-ED1.
  - (c) Further, BGT's approach of considering 4 years of recent data alone, and determining possible improvements on this basis, is not one that the Authority adopts or with which it agrees. As further explained in the first witness statement of Anna Rossington at paragraphs 63-65, the Authority looks at a longer period of data in order to derive improvement factors given the inherent volatility in the data.

Moreover, the Authority disagrees with BGT's assertion in the second half of paragraph 4.35 of the NoA that the Authority assumed annual improvement factors of only 0.3% over three years for CI and 2.6% over three years for CML. The Authority derived the CI target by applying 0.5% (for DNOs meeting the CI benchmark) and 1.5% (for underperforming DNOs) improvement factors. This means that the annual CI improvement is assumed to be around 1% on a weighted average basis; even on an unweighted basis the annual improvement would be greater than 0.5%. The CML target is set using voltage level improvement factors, 1% for LV, EHV, and 132kV and 3% for HV. BGT's estimates may have been based on their comparing against different historical data from that used by the Authority.

179. At paragraph 4.36 of the NoA BGT complains that the position is even more stark when account is taken of the 2014/15 data; and that adopting an initial target based on a four year average means that companies will in any event be expected to outperform. The Authority disagrees:
- (a) As set out above, the forecast data for 2014/15 must be treated with caution, but in any event the Authority considers that using 2014/15 data derived from Business Plan Data Templates results in a *reduction* in the amount of IIS rewards versus 2013/14.
  - (b) BGT's point at paragraph 4.36 (b) is broadly correct – adopting an initial target based on an average of some years will mean that companies would in any event be expected to outperform the index *if* one assumes a downward trend in interruptions over time. However the Authority does not consider that the *average* downward trend in interruptions over recent years (which not all DNOs have shown) is a useful indicator for future performance. In any event, there is no preferable alternative to using an average taken over some years. The same objection that BGT has made would apply to its own proposal to use a rolling average; and moreover a rolling average would mean that if performance deteriorated in one year, future targets would be *softer*. Using a single year is inappropriate because of the inherent volatility in the data.

180. At paragraph 4.37 of the NoA BGT makes various complaints about the Authority's letter of 3 February 2015:

- (a) BGT asserts that DNOs' investment decisions depend on the marginal incentive rate, and therefore that DNOs did not need to know the specific targets or improvement rates set by the Authority. However, while the Authority broadly agrees that in principle investment decisions depend on marginal incentives, in practice DNOs desire clarity about the exact point that they need to reach in order to earn a reward and benefit from this clarity in holding discussions with stakeholders. DNOs provide this information in their discussions with investors and stakeholders. Ofgem and the DNOs discussed the importance of clarity for stakeholders in working group discussions on 17 May 2012 (see para 3.2 of the minutes) [**RDB/11**]
- (b) BGT complains that the Authority, in using data only up to 2012/13, used data that was more out of date when setting RIIO targets than it did when setting DPCR5 targets:
  - (i) The RIIO approach differs from that taken in DPCR5. First, the strategy stage of the RIIO process focuses on setting out key elements of the price control up front to provide the DNOs with a framework on which to base their business plans. By contrast, during DPCR5, the Authority did not set all policy prior to the submission of costs forecasts. Where policy subsequently changed, this could require a revision of costs forecasts. Secondly, the RIIO approach includes a fast track process, designed to incentivise DNOs to submit well-justified business plans early in the review. In order to be eligible for fast-track treatment DNOs have to develop a well-justified plan in consultation with stakeholders, meaning that the DNOs needed to know the arrangements for incentives early on. The Authority made a commitment to providing DNOs with a consistent and transparent regime to facilitate such a dialogue and thereby greater focus on consumers' interests in DNOs' business plans

and price control settlements. It would have been inconsistent with that to change the approach subsequently and take into account the 2013/14 data set when setting targets for the slow track DNOs.

- (ii) In addition, there were an unusually high number of exceptional events in 2014, ie storms (three times the usual average number). The calculation of the IIS requires the data to be adjusted to remove the effect of these events, and this process is still continuing. The final data are therefore still not available.
- (c) BGT argues that in any case the Authority's Strategy Decision did not contain the initial targets to be applied by the Authority, and that DNOs did not have the actual data for 2012/13 when they prepared their business plans. It is correct that the Strategy Decision in March 2013 did not contain the initial targets as the data were not available for 2012/13. However:
- (i) At that time the Authority presented indicative targets, using finalised data up to 2011/12; and made clear that targets would be based on 2012/13 data when this became available.
  - (ii) The Authority had also explained the target setting models through the Reliability and Safety Working Group **[RDB/15]**. These models had been shared with the DNOs so that they could be verified.
  - (iii) The data for 2012/13 became available in April 2013; although they were not the finalised data, they were clearly indicative, which would have enabled DNOs to prepare their business plans and calculate their targets for 2015/16 to a high degree of certainty. Further, even before April 2013, each DNO had a good view of its own level of performance in 2012/13, which would have been able to inform its view of likely targets.

- (iv) Since all the slow-tracked DNOs accepted the target setting methodology in their business plan submissions, it seems likely that they engaged with that methodology and conducted analysis in order to determine their 2015/16 targets in this way.
- (v) Accordingly, even though the DNOs did not know the precise data for 2012/13 when they submitted their plans, they had considerably greater certainty than they would have done if the Authority had intended to take into account 2013/14 data as well.

181. At paragraph 4.38 of the NOA BGT argues that the improvement factors set by the Authority were well below historical performance. It is important to note that improvement factors were included for the first time in RIIO-ED1 and seek to drive improved performance by the companies. Improved performance has costs for the DNOs which are paid for in large part through the IIS. The high levels of performance improvement delivered through DPCR5 are the result of the incentives that were in place over that period; as well as of changes in ownership which have resulted in efficiency improvements. It is clearly wrong to assume as BGT does that that sort of level of performance improvement could be achieved in future without funding from IIS.
182. It is broadly correct that the Authority applied a conservative rate of improvement to the CI target. The Authority broadly agrees with the figures shown at paragraph 4.38 (a) for averages recently achieved, save that the Authority calculates the 4 year average from 2009/10 – 2012/13 at 4.14% (not 3.9% as BGT asserts); and that it calculates the 4 year average for 2010/11 – 2013/14 at 3.03% (not 3.1% as BGT asserts). It is correct that the overall improvement target of 0.84% is lower than these four year averages. A conservative improvement target was justifiable, since improvements to CIs require greater investment than improvements to CMLs. More substantial improvements to the network are needed to reduce the number of interruptions.
183. The improvement factors for CML are close to historical improvement rates for HV and LV voltages; the data for EHV and 132kv are very volatile, and it is

difficult to observe a meaningful historical performance rate or improvement factor. (The Authority broadly agrees with the figures for annual rates of improvement set out at paragraph 4.38 (b), save that the average annual required improvement is 1.72% rather than 1.8%.)

184. In any event it cannot be assumed that recent rates of improvement (if confirmed by the finalised data) can be maintained; that is probably not the case. It is likely that it will get progressively harder for DNOs to reduce interruption durations beyond a certain point, given the steps involved in rectifying an interruption. For example, from receiving notice of the fault a DNO needs to:
- (a) Identify the rough location of the fault;
  - (b) Reach the site;
  - (c) Identify the specific location of the fault;
  - (d) Identify the type of fault;
  - (e) Have the personnel and equipment to restore supply – which may involve excavation work, in a city environment, to a depth of around a metre; or, in the countryside, may involve removing trees from a line which itself involves turning off the supply to the line.
185. The RIIO-ED1 targets for GB (weighted by customer numbers) start at 44 minutes and reduce to 39 minutes by the end of the period. Further improvements could probably not be achieved through operational measures (for example, organising personnel so as to be able to respond to interruptions as quickly as possible) but would require significant investment in the fabric of the network to make interruptions less likely or more easily remedied. It is therefore inappropriate to use recent improvements in performance as a formulaic guide to what DNOs should be able to achieve in the future. The targets therefore hold the DNOs, and the sector, to appropriate and achievable targets.

186. At paragraph 4.39 of the NoA, BGT complains that when the targets are considered against the range of performance achieved by the DNOs, they are much closer to the worst rate of historical performance than to the best rate, and are well below the upper quartile. However, while this is broadly correct as regards CI targets, it does not follow that, as BGT alleges, the regime provides scope for systematic outperformance and fails to penalise poor performance, to the detriment of consumers. The Authority relies on all the reasons set out above. In relation to CML, the Authority does not accept that the targets are much closer to the lowest rate of historical performance than to the highest rate. The LV target departed from historical performance rates (which suggested that CML performance had in fact worsened) and set a challenging target, as described in the first witness statement of Anna Rossington at paragraphs 47-48.
187. BGT's allegation at paragraph 4.40 - 4.42 of the NoA that initial targets for CML are asymmetric is incorrect:
- (a) The CML targets are calculated from voltage-level CML/CI and CI benchmarks, which are a mix of industry benchmark and DNO own performance. If the Authority had set the CML scheme such that DNOs were measured only against their own performance, this would have given these DNOs little incentive to improve their performance in the last years of DPCR5. This is particularly the case for better performers which might have chosen to forgo a year of outperformance in order to acquire easier targets for RIIO-ED1. This could have been achieved for instance by delaying further investment or operational improvements from DPCR5 into RIIO-ED1.
  - (b) DNOs which have performed below CML targets against the CML/CI benchmark value previously are *also* measured against the benchmarks described in (a) above.
  - (c) The Authority does not agree that the sector will systematically outperform; it expects that leading DNOs' performance will be offset by under performance of other DNOs. If the DNOs maintain the level of

performance indicated by the *provisional* 2013/14 data, there will be an overall penalty of £10mn in the first year of RIIO-ED1. The Authority does not agree that outperforming DNOs have earned £472mn in the first four years of DPCR5; taking planned and unplanned IIS together (the data BGT appears to have used), the Authority calculates that they have in fact earned £371mn. (The Authority's calculation uses the provisional 2013/14 data that has not yet been finalised).

188. Accordingly, the Authority's decisions on the IIS provided for clear and comprehensive targets for outputs on customer interruptions, providing DNOs with incentives to maintain the long term health of the network and customer service. In particular:

- (a) The Authority had regard to all relevant information available at the appropriate time during the price control consultations;
- (b) The Authority proceeded on the basis of all information that it was reasonable to take into account.
- (c) The Authority had proper regard to the interests of existing and future consumers in setting the targets.

On 15 April 2015, BGT disclosed to the Authority certain data underling the AlixPartners Report, namely: (i) the actual annual CI and CML unplanned performance used to derive the 2009/10 - 2012/13 average figures per DNO at Tables 5.1 and 5.2 (pages 32 and 34) of the AlixPartners Report; (ii) detailed calculations and resultant CI and CML unplanned performance figures by DNO for each year of RIIO-ED1 which feed into Table 5.6 figures of the AlixPartners Report; (iii) detailed calculations and resultant CI and CML unplanned targets per annum per DNO as described in paragraph 5.4.2 points (a) and (b) of the AlixPartners Report; and (iv) CI and CML specific calculations used to derive the values in Table 5.7 of the AlixPartners Report. The Authority was unable to conduct a full analysis of these data in the short time available to it (one week) before filing this Response and its evidence. The Authority reserves its rights to make detailed submissions with respect to these data in due course.

***(B) Broad Measure of Customer Service***

189. This ground relates to the Broad Measure of Customer Service scheme which provides incentives to DNOs for good customer service.
190. BGT alleges that the BMCS is flawed, in that the targets have been relaxed by comparison with those under the last price control, and/or set at a level that is too low, when assessed against DNOs' recent performance. In particular BGT complains that the Authority did not take into account the 2013/14 performance data when setting the targets.
191. The Authority submits that it adopted an approach which was both reasonable and justified and accordingly that BGT has failed to demonstrate any relevant flaw in the approach adopted.

*Introduction*

192. The Authority's objectives for the BMCS are to ensure that DNOs provide a good customer service and that they improve their performance where it falls short of an acceptable level. It introduced the scheme as part of the DPCR5 price control, which comprises three elements – a customer satisfaction survey, a complaints metric and a stakeholder engagement incentive. The DNOs' performance in each element is subject to a separate financial incentive. The Authority applied the experience it had gained of the operation of the scheme during DPCR5 to make changes aimed at refining and strengthening the incentive for RIIO ED1. The Authority consulted extensively with stakeholders before adopting the new arrangement.
193. The Authority disagrees that the BMCS is flawed, or that targets may be expected to lead to systematic unearned rewards at the sectoral level without any corresponding improvements in performance. In summary:
  - (a) Historical performance data is not a good indicator of future performance. This is because of the evolving nature of customer satisfaction, and the fact that the scope of the BMCS has changed in RIIO-ED1, so that higher performance levels are required:

- (i) Consumer expectations change over time. What consumers regarded as good customer service in previous years will not be the same as what consumers regard as good customer service in RIIO-ED1. For example, consumers now expect to be able to engage with DNOs using the internet or social media. DNOs have therefore had to invest in new systems and processes to deliver this, and to keep pace with consumers' requirements. Past good customer service therefore does not guarantee future good customer service. Similarly, the expectations of our stakeholder engagement incentive panel of "good" stakeholder engagement will also change over time.
  - (ii) In RIIO-ED1, the customer satisfaction survey component of the BMCS includes a new measure based on the number of calls which consumers attempt to make to DNOs but which are not answered ("unsuccessful calls"). This could significantly reduce the rewards that DNOs receive, or increase penalties.
  - (iii) The customer satisfaction survey will also now include interviews with customers to whom the DNOs have not previously been incentivised to provide a good service. These customers include those who have been proactively contacted about a power cut and those who have engaged with the DNOs through any medium (eg email or social media).
  - (iv) In RIIO-ED1, the stakeholder engagement incentive will also now include an assessment of how well the DNOs address consumer vulnerability.
- (b) BGT's allegation implies that the Authority should have focused solely or primarily on data relating to DNOs' historic performance in designing the BMCS. In principle, the Authority disagrees with this approach. The Authority has looked at data outside the electricity distribution industry in designing the BMCS to ensure that DNOs' customer service is good when compared to a national standard. If the Authority were to have

adopted the approach implicitly advocated by BGT, the DNOs might have competed to perform better than each other but performed poorly when compared to other industries. Consumers could have ended up paying for what was in absolute terms a poor level of service.

- (c) BGT's concern that the design of the BMCS will lead to systematic unearned rewards appears to be premised to a large extent on WPD's historic performance levels. BGT, however, has not appealed WPD's licence. When one considers the slow-tracked DNOs alone, whose licences are the subject of this appeal, under the Authority's methodology the slow-tracked DNOs would earn a penalty in RIIO-ED1 if all they did was maintain the levels of performance achieved in 2013/14.
  - (d) The further reason that the Authority did not use the BMCS data for 2013/14 is that the data were not available at the time when the Authority set the targets, in December 2013. As with other incentives the Authority set targets early to give the slow-track DNOs visibility ahead of submitting their revised business plans, and to allow them to engage with their stakeholders on an informed basis. Moreover, if the Authority had signalled in its working groups or consultations that it intended to use data from 2013/14 to set targets, this could have encouraged DNOs to perform more poorly for the remainder of that year.
  - (e) The aim of the BMCS is not in any case solely to incentivise improvements, but also to encourage DNOs to *maintain* good levels of customer service.
  - (f) In the case of the stakeholder engagement incentive, the Authority has not even yet determined precisely how stakeholder engagement will be assessed and rewarded. BGT is complaining about a component of the scheme that has not yet been finally decided.
194. By way of general background, it is worth noting that the BMCS has had a very positive impact on bringing the DNOs up to acceptable levels of service

on a more regular basis during DPCR5. Customer satisfaction levels have been improved, the proportion of complaints decided against DNOs by the Energy Ombudsman has fallen. There is also starting to be a cultural change in the way that DNOs engage with stakeholders. More information on this is provided in the witness statement of James Veaney at paragraph 29.

195. It should also be noted that:

- (a) The BMCS was designed following a thorough consultation process open not only to DNOs but also to other interested parties (the details of the Authority's consultation process with respect to BMCS are set out below at paragraph 298 *et seq*). BGT's complaints in the NoA, however, are largely new. BGT raised few concerns about the BMCS scheme during the consultation on the slow track licence; it neither criticised the approach that the Authority took to setting targets nor expressed its arguments in anything like the detail that it now does.
- (b) BGT did not attend any of the series of working groups on BMCS, which were open to all stakeholders, and minutes of which were regularly published online.
- (c) Nor did BGT respond to the specific consultation on the design of the BMCS. **[BG2/13; AB4/13] [BG2/17; AB4/17]**
- (d) Although BGT attended a Price Control Review Forum on 3 December 2012 and commented on its general concern about fixed targets for performance for the duration of RII0-ED1, and made similarly high level concerns in the response to the Strategy Decision Consultation **[BG2/9; AB4/9/11]**, it did not raise these detailed criticisms at any point.

196. BGT considers that across the sector the Authority's decision would lead to an additional £22 million of revenues for the slow track licensees if they maintained their 2013/14 performance. This would be equivalent to 0.08% of the total slow track revenue allowances of £28 billion. However BGT has made a number of errors in its calculations as set out in the witness statement

of James Veaney at paragraph 32. On the Authority's analysis even if the DNOs were to maintain 2013/14 performance in RIIO-ED1 the slow track licensees would actually incur a penalty of -£1.08m.

197. The Authority therefore disagrees with BGT's assertion that the BMCS incentives are likely to lead to unearned rewards across the sector. It considers that it has adopted a robust approach to designing the incentives and that, in its expert judgment, the arrangements are in consumers' interests because they will drive DNOs to achieve and maintain good levels of customer service. On no basis could they be considered "wrong".

*Complaint that the targets are set at a level that is too low when assessed against the DNOs' recent performance*

198. The Authority agrees with the summary of the different components of the BMCS set out at paragraph 4.43 of the NoA, namely the customer satisfaction survey, the complaints metric, and the stakeholder engagement incentive. However, it is important to note that BGT has misconstrued a number of detailed elements of the BMCS design wrong, as set out in the witness statement of James Veaney at paragraphs 19-21. It is important to note that the aim of the BMCS is not solely to incentivise improvements, but also to encourage DNOs to *maintain* good levels of customer service (see eg paragraph 5.3 Strategy Decision – Overview [**BG2/10-A; AB4/10-A**]).
199. In paragraph 4.45 of the NoA BGT argues that the targets have been relaxed compared to the last price control or set at too low a level compared to DNOs' recent performance. The Authority disagrees for the following reasons:
- (a) First, historical data is not a good indicator of how DNOs will perform in the future, since the scope of the BMCS and customer satisfaction survey in particular has changed, as set out above at paragraph 193(a). Since customers' expectations will evolve over time, the DNOs will need to make continuing improvements to maintain current performance levels.

(b) Second, as regards the general complaint that the Authority did not use the 2013/14 data, that is answered above at paragraph 192. In particular, the data were not available at the time that the Authority set the targets in December 2013. The targets were set early to give WPD certainty on the price control package and give the slow-track DNOs visibility ahead of submitting their revised business plans. Furthermore, to have signalled in working groups or consultations that the Authority intended to use 2013/14 data would have created a perverse incentive for the DNOs to perform poorly for the remainder of that period. In any event, BGT's complaint implies that the Authority should look only or primarily at historical performance when determining targets for the BMCS, which is incorrect. The Authority sets fixed targets which are based in part on other information about customer service, gathered from other industries. This avoids the risks of rewarding DNOs for a level of performance that, while better than other DNOs, is poor in comparison to other industries. The Authority based its targets in part on UK Customer Satisfaction Index data. The Authority made clear that it would take other industries into account in the Strategy Consultation paragraphs 6.17-19 [**BG2/8-B; AB3/8/60**]; the Strategy Decision, Outputs Incentives and Innovation paragraphs 6.41-42, [**BG2/10/B; AB4/10/B-69**].

200. As regards the specific complaint at paragraph 4.45a, BGT also alleges that under the previous price control only half of DNOs would have been rewarded for such performance; while under RIIO-ED1, 11 out of 14 DNOs will receive rewards simply by maintaining performance levels already achieved in 2013/14. As to this:

(a) While the customer satisfaction survey targets for interruptions and general enquiries have been set below the target and the average outcome for DNOs in 2013/14, (a) BGT ignores the changes to the scope of the customer satisfaction survey set out above at paragraph 193(a)(ii); and (b) BGT also ignores that the target for *connections* (which accounts for half of the financial exposure under the customer

satisfaction survey) is higher than the 2013/14 target and average outcome (and in fact, no slow-track licensee has ever performed above the target level of performance in this category).

- (b) The Authority does not agree that under the previous price control, half of DNOs would necessarily have been rewarded for such performance. Under the previous price control, those DNOs *above the industry average* were rewarded. Depending on the spread of DNO scores and where the average fell, more or fewer than seven DNOs could have been rewarded.
- (c) The Authority also disagrees that under the absolute targets, 11 out of 14 DNOs will receive rewards simply by maintaining 2013/14 performance levels. BGT appears to have reached this view by disregarding the effect of the adjustment for 'unsuccessful calls'. This is an integral component of the RIIO-ED1 BMCS which cannot be excluded. Moreover, BGT has included the fast track DNOs in this analysis. When the 'unsuccessful calls' adjustment is (properly) included, and only slow track DNOs are considered, only 3 out of 10 DNOs would earn rewards by maintaining 2013/14 performance levels. (The overall penalties earned by slow track licensees would far exceed their overall rewards (£22.47m in total over RIIO-ED1). It is therefore incorrect that underperforming DNOs in 2013/14 could further deteriorate in their performance and still earn positive rewards under the scheme.
- (d) The effect of the "unsuccessful calls" adjustment could be significantly to reduce the rewards or increase penalties for DNOs. For example, during 2013-14, approximately 15% of customers who wished to contact SSEH were 'unsuccessful' (based on the Authority's most conservative interpretation of the RIIO-ED1 definition of 'unsuccessful calls'). If that were to occur during ED1, SSEH's customer satisfaction survey reward or penalty would be reduced by over £500,000 annually. In total, if the slow-track licensees maintained the percentage of

unsuccessful calls in 2013-14, they would be penalised by the unsuccessful call adjustment £27.95m in total over RIIO-ED1.

- (e) In any event, even if DNOs outperform targets, the scheme still provides incentives to DNOs to improve in order to earn higher rewards. Only if DNOs reach the maximum reward level, will they have no further incentive to improve.

201. At paragraph 4.45 (b) which deals with the complaints metric, BGT complains that the target has been set at a less demanding level than the 2012/13 and 2013/14 upper quartile performance (which DNOs needed to reach to avoid penalties under DPCR 5). However, while this is correct, penalties for *underperformance* (set in the Authority's decision following the specific consultation on Customer Services and Connections on 2 December 2013 [BG2/17; AB5/17/1-6] are significantly higher than during DCPR5. Under DCPR5, a DNO only earned the maximum penalty if its overall score on the complaints metric reached 70 (a higher score on the metric indicating a worse performance). Under RIIO-ED1 a DNO earns the maximum penalty if its overall score reaches 14.84. Penalties under RIIO-ED1 for scores of less than 14.84 on the complaints metric are also higher than for the equivalent score under DPCR5. If the Authority had set the score at which the DNO incurs their maximum penalty using 2013-14 data, rather than 2012-13 data, then the RIIO-ED1 arrangements would actually be more relaxed, as the performance of worst DNO deteriorated from 14.84 in 2012/13 to 17.87 in 2013/14. Further information about the complaints metric scoring method is set out in the witness statement of James Veaney at paragraphs 16 and 20.

202. At paragraph 4.45c of the NoA BGT makes various complaints about the stakeholder engagement incentive. As to this:

- (a) The Authority has not yet even determined precisely how stakeholder engagement will be assessed.
- (b) The DNOs' licences state that the Authority will draw up Stakeholder Incentive and Consumer Vulnerability Guidance which will make provisions for: the appointment of persons who will assess the

stakeholder submissions and make recommendations based on key assessment criteria; the key assessment criteria; and the manner and process by which the stakeholder engagement submissions will be assessed and rewards allocated.

- (c) BGT's complaint, about a scheme which has not yet even been finalised, is therefore misconceived.
- (d) In any event, even if it were the case that the stakeholder engagement incentive had been finalised, it would not be correct to assume that DNOs would outperform during RIIO-ED1 for the following reasons:
  - (i) The scope of the incentive has been widened for RIIO-ED1. Whereas previously, the incentive assessed only DNOs' engagement with stakeholders, it now also specifically assesses how well DNOs address consumer vulnerability (see Strategy Decision – Outputs, incentives and innovation, §§6.4, 6.17, 6.27, 6.54 [**BG2/10/B; AB4/10/B-63, 65-66, 71**]).
  - (ii) The expectations of the panel of persons who will assess the stakeholder submissions will continue to evolve over time. By way of example, in 2013-14, the panel appointed as part of the stakeholder engagement for DPCR5 noted that although all submissions demonstrated progress from the previous year, the panel's expectations had also increased (see Report on the Stakeholder Incentive Engagement Incentive 2013-14 – Electricity Distribution Network Operators, §4.1, [**RDB/46**]).

203. For the reasons set out above the Authority submits that the approach that it adopted in setting the various aspects of the BMCS incentive was fully justified. The Authority's judgment was that the different aspects of the scheme would provide appropriate incentives on the DNOs to maintain and improve service and that the DNOs would not be earning unjustified rewards. That judgment was a perfectly rational and appropriate one and in no sense could be considered "wrong".

*Complaint as to the absence of improvement factors in the scheme*

204. At paragraph 4.46 of the NoA BGT argues that the Authority has not incorporated any improvement factors into the BMCS. The Authority disagrees and maintains that, it has in effect incorporated improvement factors in the absolute targets under the BMCS where necessary as set out below:
- (a) In the case of the customer satisfaction survey, the requirement for improvement is effectively built-in to the absolute targets, insofar as customers' expectations change over time. The level of service that consumers regard as good could be expected to change over the course of RIIO-ED1. It was acknowledged during the course of the consultation that consumers' expectations are becoming more demanding. It is therefore unnecessary to set further improvement factors.
  - (b) For the same reasons, the stakeholder engagement incentive, once finalised, will have a requirement for improvement effectively built-in to the absolute targets insofar as the panel's expectations will change over time (as set out above).
  - (c) In the case of the complaints metric, the Authority's policy was to maintain the best performing DNOs at their current level of performance, but encourage the worst performing DNOs to improve. The complaints metric was set so that a DNO performing at the level of the worst performing DNOs would receive the maximum penalty, to ensure that the worst performing DNOs will make efforts to improve.
205. For the reasons set out above the Authority submits that the approach that it adopted in setting this aspect of the BMCS incentive was fully justified. The Authority's judgment was that the scheme design overall would provide appropriate incentives on the DNOs to maintain and improve service. That judgment was a perfectly rational and appropriate one and in no sense could be considered "wrong".

*Complaint as to asymmetry in the scheme*

206. At paragraph 4.47 of the NoA, BGT criticises alleged 'asymmetry' in the scheme. As to this:
- (a) It is correct that if a DNO exceeds the target it will earn a reward which is twice as large as the penalty that it would receive if it fell short of the target by 0.1.
  - (b) The Authority's approach was not to ensure that reward and penalty incentive rates were symmetrical, and there is no reason why it should have adopted that approach. Rather, the Authority took a view of the level of performance at which maximum rewards and penalties should be earned and imposed. Its approach was to set the maximum reward and penalty scores at 1.75 above and below the mean. This meant that any company that scored significantly higher or lower than an average performing company will incur the maximum reward or penalty.
  - (c) Indeed, if the Authority had adopted the approach suggested by AlixPartners (at §6.3.8 of their report), which appears to set the maximum levels symmetrically around the target), the score required to achieve the maximum reward could have been unrealistically high. This would be the predictable consequence of the maximum levels being set symmetrically around the upper quartile performance level as opposed to the mean performance level. The result would have been that the maximum reward and the maximum penalty, would have been asymmetrical, as the maximum reward score would barely be achievable. The Authority discussed this issue further in its decision of 2 December 2013 on Customer Service and Connections, following consultation [**BG2/17; AB5/17/1-6, part C**].

***Statutory grounds and relief sought***

207. Accordingly, the Authority's decisions on the IIS and the BMCS were rational and well within the Authority's permissible discretion and judgement. In particular, and contrary to paragraph 4.48 of the NoA:

- (a) The Authority had regard to all relevant information available at the appropriate time during the price control consultations.
- (b) The Authority proceeded on the basis of all information that it was reasonable to take into account.
- (c) The Authority had proper regard to the interests of consumers in setting the targets.

208. There are no grounds on which the CMA should intervene as BGT requests at paragraph 4.50 of the NoA, or at all.

## **PART VI: GROUND 3 – ALLEGED UNWARRANTED EX-POST CHANGE TO INFORMATION QUALITY INCENTIVES**

### ***Introduction***

209. Ground 3 concerns the Information Quality Incentive Scheme ("the IQI"). In summary, the IQI is a mechanism designed to encourage companies to submit accurate expenditure forecasts during the price control review, and then spend efficiently during the price control period. More accurate expenditure forecasts enable the Authority to benchmark the DNOs comparatively and set efficient cost allowances for the price control period. IQI efficiency incentives, together with the efficient cost allowances, incentivise the DNOs to spend efficiently through RIIO-ED1. This ultimately protects consumers through lower costs during the RIIO-ED1 price control period and by identifying further efficiencies which can be recognised in future reviews.
210. There are three components to the IQI:
- (a) An *ex ante* reward or penalty for each of the DNOs depending on whether their forecasts exceed or fall short of Ofgem's view of the efficient costs for that DNO.
  - (b) An efficiency incentive rate which incentivises efficient delivery. This is the proportion of any over or underspend that the DNO is exposed to. The lower the DNO's forecast of expenditure relative to Ofgem's view of efficient costs, the higher the efficiency incentive rate.
  - (c) The DNO's cost allowance is set through interpolation using a weighted average of 75 per cent of Ofgem's assessment of efficient costs and 25 per cent of the DNO's forecast.
211. The IQI is applied at a DNO group level and the three components combine to ensure that a DNO maximises its return by forecasting its expected level of expenditure. This feature of the IQI allows the Authority to have confidence in using the data for its comparative benchmarking and determination of cost allowances.

212. The three components of the IQI are set in such a way that there is a point at which a DNO will be expected to earn its weighted average cost of capital but receive no additional reward or penalty. This point is referred to as the 'break-even' point and is often referred to as a specific IQI ratio (where the IQI ratio is the DNO's forecast expenditure relative to Ofgem's view of efficient expenditure and can be shown as a percentage). If a DNO's forecast costs are below this break-even point it will earn additional reward under the IQI and a return higher than the WACC; if a DNO's forecast costs are above this point the company will face an additional penalty and therefore lower returns.
213. A critical and inherent element of the Authority's IQI design was that *some* DNOs would earn rewards for the submission of business plans which were more efficient than the Authority's view of efficient costs
214. This is because the Authority's view of efficient costs would be reached following a comparative benchmarking process whereby the Authority set its benchmark view at the upper quartile of DNOs' submissions. Given that the Authority's view was determined in this way, it necessarily followed that those DNOs whose cost efficiency was better than the upper quartile of efficiency would earn rewards. This component of the IQI was clear from the Strategy Decision – Overview, §6.22, as follows
- "We will set the break-even point in the IQI so that a DNO that forecasts in line with our view of the upper quartile and achieves that forecast would earn their cost of capital but not receive any additional reward under the IQI." (BG2/10-A, AB4/10-A/34)*
215. In summary, BGT's complaint is that after the DNOs had submitted their business plans in March 2014, the Authority changed the break-even point which determines what rewards are payable to DNOs, and what penalties are payable by DNOs. BGT contends that this increased cost to customers without any benefit in terms of improved information.
216. It is correct that the Authority did change the break-even point. However, it is important to note that this was part of a broader set of changes that together

(including the IQI adjustment) have delivered an overall reduction in allowed revenues of £372mn to the benefit of consumers over RIIO-ED1:

- (a) Initially, in the Strategy Decision, the Authority set the break-even point at 100% of the efficient costs baseline. This was based on setting the efficient cost baseline at the upper quartile level of efficiency.
- (b) Following the submission of DNOs' business plans, the Authority changed its approach to the assessment of Smart Grid Benefits ("SGBs")<sup>59</sup> and real price effects ("RPEs")<sup>60</sup>. Specifically the Authority concluded that the DNOs' cost forecasts for both elements were too high across all slow-track DNOs. This was because, in the case of SGBs, the savings that the DNOs had forecast did not go far enough in reflecting achievable efficiencies. In the case of RPEs the DNOs had not used latest data, and had over-estimated the potential increase in their input costs relative to inflation. Since these elements were too high across all DNOs, taking them into account when calculating the upper quartile would have meant that the Authority's measure reflected the DNOs' over-stated cost forecasts. The Authority therefore adjusted its cost assessment approach, to include the efficient cost of RPEs and additional SGB savings (above what was included in the DNOs' plans) *after* its calculation of the upper quartile.<sup>61</sup> The result of this adjustment was that *no* DNO appeared as efficient when compared with the Authority's new view of efficient costs. In reaching that new view, however, the Authority had departed from the policy of calculating an

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<sup>59</sup> SGBs are net cost savings which DNOs could reasonably be expected to achieve over the RIIO-ED1 price control period in respect of smart grid technologies and other forms of technological innovation.

<sup>60</sup> DNOs' allowances are indexed by the Retail Prices Index (RPI) as part of the price control framework. However, the Authority expects some of the costs faced by DNOs to change over RIIO-ED1 at a different rate than the RPI measure of economy-wide inflation. These differences in cost changes are referred to as RPEs. The Authority's view of total efficient cost includes an *ex ante* allowance based on its forecast of RPEs.

<sup>61</sup> In relation to RPEs, the Authority's approach was two-fold. First, the Authority forecast RPEs and applied the same assumption to each DNO. This approach was set out in the Strategy Decision and did not change between fast and slow track. Second, the Authority at Final Determinations applied this assumption *after* calculating the upper quartile of costs. This was a change in approach from the Strategy Decision, where it was stated that the RPE assumption would be applied *prior* to the upper quartile process.

overall upper quartile and had applied a tighter efficiency benchmark to the DNOs.

- (c) In the Draft Determinations for slow-tracked DNOs, the Authority therefore adjusted the break-even point in the IQI to 102.9% of its view of efficient costs. The result of the change was that a DNO which forecast costs of 102.9% of the Authority's view of efficient costs, and spent in accordance with this forecast, would earn its cost of capital and no more. Under this approach five of the slow-track DNOs would receive an ex-ante reward – ENWL, NPgN, NPgY, SSEH and SSES. The total ex-ante reward for these companies would be £42.4 mn, rather than a penalty which they would have received (in aggregate) absent the adjustment. The other DNO groups would incur a smaller penalty. This is aimed at addressing the effect of tightening of the efficiency benchmark on the IQI calculations.
- (d) The Authority did this in order to preserve the necessary component of its IQI policy described above that *some* DNOs receive rewards under the mechanism, to maintain the Authority's credibility for future price controls and therefore the ability to get good information from companies. It was inherent in the original IQI design that some DNOs would in fact earn an ex-ante reward for providing better information. The Authority's *ex post* changes to the IQI matrix threatened a situation in which no DNOs earned an ex-ante reward. By adjusting the breakeven point to 102.9%, the Authority ensured that some DNOs earned rewards as originally envisaged in the Strategy Decision. As the Authority recognised in Final Determinations paragraph 4.96, it considered that it was appropriate to reward companies that had provided information that assisted its comparative benchmarking.
- (e) Overall, revenues across RIIO-ED1 for the slow-track companies are reduced by £372m as a result of the treatment of SGBs, RPEs and the change in break-even under the IQI relative to our Strategy Decision; overall, consumers have therefore benefited from the changes that the

Authority has made (see paragraph 33 to 38 of the second witness statement of Anna Rossington).

217. In summary:

- (a) As set out above, under the IQI scheme originally proposed in the Strategy Decision, ex-ante rewards would certainly have been paid to some DNOs, if the Authority had not subsequently required much higher savings from SGBs and RPEs.
- (b) The change in the break-even point from 100% to 102.9% meant that ex-ante rewards were *still* paid to some DNOs; if there had been no change in the break-even point, *no ex ante* rewards would have been payable to DNOs at all.
- (c) The overall effect is that consumers benefit from the Authority's change in approach to the treatment of SGBs and RPEs, while DNOs are still able to earn rewards from the IQI scheme.

218. It should also be noted that:

- (a) Under the previous price controls – RIIO-GD1, RIIO-T1 and DPCR5 – licensees earned an *ex ante* reward of 2.5% of total expenditure if their forecast costs were in line with the Authority's view of efficient costs. Under the IQI proposed in the Strategy Decision, DNOs whose forecast costs were in line with the Authority's view of efficient costs would only have earned the cost of capital, and received no additional reward.
- (b) The IQI scheme proposed in the Strategy Decision therefore itself represented a significant reduction in the quantum of the benefits as compared to earlier price controls.

**BGT's complaints**

219. As regards paragraphs 4.51 and 4.52 of the NoA, BGT describes its view of the design and purpose of the incentive scheme:
- (a) Paragraph 4.51 is broadly correct<sup>62</sup>.
  - (b) However, as set out above, the incentives under the IQI are not *only* intended to incentivise the DNOs while they are preparing their business plans for the forthcoming price control; they also provide an efficiency incentive throughout the price control period to incentivise efficient delivery.
  - (c) The Authority's decision to change the baseline was not intended to incentivise the DNOs as regards the preparation of the business plans in this price control consultation; but to preserve the inherent component of Ofgem's original IQI policy of rewarding some DNOs which had forecast more efficient costs.
220. Paragraphs 4.53, 4.54 and 4.57 of the NoA are broadly factually correct. As set out above, the Authority adjusted the IQI so that a DNO that forecast costs at 102.9% of the Authority's efficient view – the efficient cost benchmark – will earn its cost of capital, in the light of the Authority's decision to apply additional efficiencies arising from most SGBs and RPEs after it had calculated the upper quartile of efficient costs. If the DNO forecast costs any lower than 102.9% of the efficient cost benchmark, it will receive an overall reward; if it forecast costs higher than that it will receive an overall penalty.
221. The Authority disagrees that the change is not well founded and is harmful to the interests of consumers, as BGT alleges at paragraphs 4.55 and 4.56 of the NoA, for the reasons set out above and expanded on below:

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<sup>62</sup> Although for completeness, the Authority's approach to setting RPEs did not rely on benchmarking across the DNOs. However, the Authority still expected DNOs to set challenging RPEs in their business plans.

- (a) Although this particular item of the price control regime gave rise to a higher cost to consumers in RIIO-ED1 than if the Authority had not changed the break-even point, the change must be seen in the light of the £750mn or so of cost savings to consumers achieved through the Authority's approach to RPEs and SGBs. Overall (including the IQI adjustment) the changes have led to a reduction in allowed revenue of £372m over the RIIO-ED1 period to the benefit of consumers.
- (b) The adjustment to the break-even point was intended, as set out above, to preserve the Authority's policy intent of rewarding some DNOs which forecast more efficient costs, in light of the Authority's new approach to RPEs and SGBs. This is important to maintain the credibility of the incentive with DNOs and other network operators subject to it for later price controls.
- (c) This adjustment to the break-even point will also encourage the submission of good information in future price controls. If DNOs perceive that the Authority may change its assessment of costs and 'move the goalposts' in such a way as to eliminate any rewards for provision of good information, there will be less incentive to provide high quality forecasts. If on the other hand DNOs are aware that the Authority will, if it changes the basis of cost assessment after DNOs have submitted business plans, be fair and change the IQI mechanism accordingly, they will be more likely to submit efficient bids and high quality information. Failure to adjust the break-even point would create an environment of regulatory uncertainty and risk to DNOs, and could weaken DNOs' confidence in the rewards system and increase the risk premium that would be paid by investors.

222. As regards BGT's criticisms of the Authority's reasoning at paragraphs 4.58 – 4.62, the Authority relies on the matters set out above. Moreover:

- (a) It was rational, and well within the Authority's area of discretion and judgment to:

- (i) adjust the break-even point to recognise the effect of its new treatment of SGBs and RPEs.
  - (ii) offset the additional £290mn of costs to consumers resulting from the change in the break-even point against the £700mn of cost savings which were achieved through the comparative cost assessment process (see the Authority's letter of 3 February 2015, which refers to that change of approach [**BG2/39/10; AB6/39/10, §26**]). The IQI encouraged the submission of more efficient costs in DNOs' business plans which in turn resulted in savings to consumers through the cost assessment. The Authority does not seek to *attribute* these savings to the change in the break-even point itself but rather to make the point that the IQI as a whole contributed to the savings; and
  - (iii) conclude that the change was needed in order to encourage the submission of better information in future price controls, as set out at paragraph 4.60 of the NoA, for the reasons set out at paragraph 221(b) above.
- (b) It is correct that the Authority's intention was initially to confer rewards upon the DNOs in the upper quartile of its efficiency benchmark, as set out at paragraph 4.61 (a) of the NoA. In Draft Determinations the Authority adjusted the IQI break-even point to 102.9% to ensure that this was achieved. At Final Determinations the Authority retained the same break-even point. Based on the cost assessment at Final Determinations, three DNO groups received an ex ante reward under the IQI.
- (c) It was rational and well within the Authority's area of judgment and discretion to ensure that some DNOs could benefit from the IQI scheme, even after the Authority had introduced its new approach to the treatment of SGBs and RPEs. As set out above, the original design of the IQI set out in the Strategy Decision ensured that *some* DNOs would benefit from a reward.

- (d) The change in the Authority's treatment of SGBs and RPEs would have meant that *no* DNO obtained an ex ante reward if the Authority had not adjusted the break-even point. That would have been contrary to the purpose of the IQI.
- (e) Paragraph 4.62 (a) is broadly factually correct insofar as it sets out which DNOs will receive rewards and which DNOs will receive lower penalties than otherwise. It is incorrect insofar as it suggests that the Authority has sought to argue that the overall effect of the change in the IQI break-even point was to benefit only the four DNOs with the best business plans. It was clear to the Authority that moving the break-even point to 102.9 advantaged *all* the slow-track DNOs as against the position if the break-even point had not been moved. It did so by providing either for rewards, or for reduced penalties. It is further inapposite to refer to the "*substantial performance-related benefits*" with which the fast-tracked DNOs have been rewarded. It was made clear in the Strategy Decision that the IQI would not be applied at fast-track, and would only be calculated for the slow-track companies. The Strategy Decision was clear that there would be an ex ante amount for any fast-tracked DNO, in lieu of an IQI reward. For slow-track DNOs, rewards would be available for those whose forecasts were better than the breakeven point in the IQI. Any rewards accruing to WPD as a result of being fast-tracked are entirely irrelevant to the current issue.
- (f) While it is broadly correct that the adjustment for SGBs reflected the fact that DNOs had underestimated the potential cost savings, if the Authority had (a) not changed its approach to SGBs and (b) made no change to the breakeven point, the DNOs which forecast more efficient costs than the Authority's upper quartile view would have earned rewards under the IQI. It was fair for the Authority to adjust the break-even point in the IQI, given this change in basis of the cost assessment after the business plans were submitted. This adjustment maintains the original intent of its incentive scheme. This preserves confidence in the

incentive and means that companies are more likely to submit efficient bids and high quality information for future price controls.

- (g) In the circumstances it was *a fortiori* rational, fair, and within the Authority's area of discretion and judgement to adjust the IQI break-even point to reflect the change in its approach to SGBs.
- (h) The Authority broadly agrees that the adjustment in the quantum of required SBG savings was conservative (although substantial). The Authority decided not to take other possible 'smart' benefits into account because it could not be confident that they were achievable, and in order to avoid potential double counting in its assessment.
- (i) As regards RPEs, while it is broadly correct that the DNOs were aware of their relevance to the consideration of expenditure and the IQI, it is important to note that the DNOs did not have access to the most recent data that the Authority used to set the RPE assumption when they produced their business plans.
- (j) In the circumstances, it was, again, *a fortiori* rational, fair and within the Authority's area of discretion and judgment to adjust the IQI break-even point to reflect the change in treatment of RPEs, given that this change in the basis of the cost assessment occurred after the business plans were submitted. Again, the adjustments will maintain the original intent of its incentive scheme, preserve confidence in the incentive and mean that companies are more likely to submit efficient bids and high quality information for future price controls.

223. At paragraph 4.62 f of the NoA, BGT complains that the change to the IQI break-even point is disproportionate. The Authority disagrees:

- (a) The reduction to DNOs' expenditure allowances arising from the change in the Authority's approach to SGBs and RPEs was approximately £750mn, as set out above.
- (b) This more than offsets the adjustment to the IQI break-even point, which resulted in the payment of rewards, and reduction in penalties,

amounting to a one-off benefit of some £290mn to DNOs compared to the position absent the IQI where they would have incurred significant penalties as a result of the Authority's revised approach to cost assessment. The Authority therefore disagrees with the assessment in the AlixPartners Report that the adjustment to the IQI increases DNOs' revenues by 17 times more than would be needed to compensate for the net impact of the adjustments.

- (c) As explained in the second witness statement of Anna Rossington at paragraphs 37-38 the Authority has calculated the overall impact on revenues of these changes using the models used in the review, to determine the effect of the changes in costs on overall revenue allowances. Overall the combined changes result in a reduction in the slow track DNOs' allowed revenue of £372m over RIIO-ED1, relative to continuing with the Authority's fast-track approach at Final Determinations, which is to the benefit of consumers.<sup>63</sup> In addition, to the revenue reduction during RIIO-ED1, the reduction in costs (including capital expenditure) of £750m over RIIO-ED1 reduces the DNOs' regulated asset base. This results in lower revenues in future price controls.

224. At paragraph 4.62 g, BGT refers to the fair bet principle and states that there is no justification for adjusting the index simply because the fair bet turns out to disadvantage the DNOs. As to this:

- (a) The Authority broadly agrees that it is to be expected that circumstances might change between the submission of business plans and the final Decision.
- (b) However, the Authority's decision to adjust the IQI break-even point was not as a result of changing circumstances, but as a result of the Authority's decision to change the way it calculated efficient costs.

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<sup>63</sup> The £372mn is a revenue reduction, while the £750mn value is an expenditure reduction. The approach to calculating the former value is set out in (see paragraphs 37-38 of the second witness statement of Anna Rossington).

- (c) In this case the effect of the treatment of SGBs and RPEs was of the magnitude of £750mn).
- (d) It is very unlikely that other factors unknown to the Authority operated to benefit the DNOs to the same extent.
- (e) The Authority considers that the 'fair bet' point should be set at the breakeven point at which DNOs will earn what the Authority considers is the cost of capital. During the price control process the Authority changed its view of efficient costs as set out above, to increase the savings required of DNOs as a result of its treatment of SGBs and RPEs. It was therefore fair and reasonable and well within the permissible area of the Authority's discretion and judgement to adjust the breakeven point.

225. For all the reasons set out above, the Authority therefore did not err in making changes to the IQI as alleged at paragraph 4.63 – 4.64 of the NoA.

226. In particular, the decision:

- (a) was rational, and did not take into account irrelevant considerations as alleged by BGT;
- (b) had proper regard to the interests of consumers;
- (c) was consistent and proportionate, in the light of the additional £750mn of savings required of DNOs arising out of the treatment of SBGs and RPEs; and
- (d) was an appropriate means of achieving the Authority's aim of ensuring that there are incentives to prepare well-justified business plans in future price controls.

227. There are therefore no grounds on which the CMA should intervene as requested by BGT at paragraph 4.65 of the NOA, or at all.

## **PART VII: GROUND 4 – ALLEGED UNWARRANTED TRANSITIONAL ARRANGEMENTS FOR CHANGE IN ASSET LIFE POLICY**

### ***Introduction***

228. Ground 4 concerns the Authority's decision to apply transitional arrangements with respect to its policy to move from a relatively accelerated 20-year asset depreciation period to a 45-year asset depreciation period that better reflects the economic lives of electricity distribution assets. In summary, the Authority has in previous price control periods adopted relatively accelerated depreciation periods for DNOs' assets, using a 20-year policy since 2000. For RIIO-ED1 (and indeed RIIO-T1 and RIIO-GD1), the Authority changed its approach and adopted a 45-year asset depreciation period. It has, however, not implemented that new approach immediately but has applied an 8-year transitional period (lasting as long as the RIIO-ED1 price control) whereby the depreciation period will be increased in equal increments each year of the price control from 20 years to 45 years.
229. BGT does not object to the Authority's decision to adopt a 45-year asset depreciation policy but rather to its decision to apply transitional arrangements to its introduction. BGT alleges that the transitional period: harms the interests of consumers insofar as it delays an economically efficient change; is inappropriately applied across the sector rather than case-by-case on the basis of demonstrated need; and is procedurally flawed.
230. The Authority rejects those contentions. In summary, and as further explained below:
- (a) The application of transitional arrangements serves the interests of present and future consumers taken together. Although the Authority recognises the advantages of a 45-year asset depreciation period, it also recognises that moving to this longer period will have the effect of reducing costs to consumers in the short term before prompting a sustained rise in costs to consumers in the long term. BGT does not dispute this effect. The fall and subsequent rise in costs unfairly distributes the burden of moving to a 45-year asset depreciation period

between generations of consumers. By applying transitional arrangements – whose effect is crucially neutral in net present value terms – the Authority has mitigated this issue of inter-generational unfairness and better balanced the interests of current and future consumers.

- (b) The issue of intergenerational inequity is one that will affect *all* consumers and therefore self-evidently applies in the case of every DNO. For this reason, the Authority was right to adopt transitional arrangements for every DNO.
- (c) Insofar as it affects the revenues and cash flows of the DNOs, moving to a 45-year asset depreciation period has a small but appreciable impact on the DNOs' credit metrics during the RIIO-ED1 period, and larger impacts thereafter. All DNOs requested transitional arrangements in their business plan resubmissions by reason of the impacts. In the light of these submissions and the changes to the price control package that the Authority had made since the business plan stage, the Authority considered that considerations of financeability justified the introduction of transitional arrangements for all DNOs.<sup>64</sup>
- (d) BGT's argument is premised on its analysis that under a 20-year asset depreciation period, consumers overpay for the use of assets. That analysis is flawed and artificial for the following reasons:
  - (i) Although current consumers will pay a higher depreciation cost in any given year with respect to a particular asset on a 20-year approach than on a 45-year approach, those consumers also enjoy the use of assets which have already been fully depreciated and paid for by previous consumers.

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<sup>64</sup> Where the Authority refers to financeability, it refers to the ability of companies to raise the finance they require, both through debt and equity, in a timely manner and at reasonable rates. It is clearly in the interest of consumers that DNOs should be able to finance themselves at reasonable rates. Further, as explained above in Part II, financeability is a matter to which the Authority must have regard in pursuing its principle objective.

- (ii) BGT ignores the fact that, even with the transitional arrangements, consumers during RIIO-ED1 will pay about £600m less than they would have done had a 20-year depreciation period been maintained<sup>65</sup> and will also pay less than consumers in *future price controls*. Absent transitional arrangements, £1.1bn of allowed revenues would be deferred from RIIO-ED1 consumers of slow-tracked DNOs to future generations of consumers.
- (iii) BGT artificially divides generations of consumers, suggesting that current consumers who pay the depreciation costs associated with a particular asset do not enjoy the use of that asset once it has been depreciated. That suggestion is unrealistic. In those circumstances, it would be more accurate to say that on a 20-year approach, consumers pay *more quickly*. Further, as explained above, the costs of paying more quickly are generally offset by the benefits of not having to pay at all for assets older than 20 years.
- (e) The Authority employed a full and proper procedure with respect to its decision on transitional arrangements. The analysis set out above was made public in these documents and in its letter to BGT of 3 February 2015.

### **Background**

- 231. At paragraphs 4.66 to 4.73, BGT sets out what it alleges has been the Authority's approach to transitional arrangements. The Authority's position with respect to those paragraphs is set out below.
- 232. As regards paragraph 4.66, although BGT is correct to state that a 20-year asset depreciation policy is accelerated relative to actually expected technical or economic asset lives, it is wrong to assert that since privatisation, DNO assets have been depreciated over 20-years only:

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<sup>65</sup> We calculate this figure by running the price control financial model as at Final Determinations but with the depreciation policy reverted to a 20-year basis and identifying the differences in revenues over the eight years of the price control for the Slow-tracked DNOs.

- (a) In DPCR2, Offer (the regulator at the time) set asset lives of between 11 and 20 years for the pre-privatisation asset value ("pre-vesting assets") and 33 years for assets which vested after depreciation ("post-vesting assets").
- (b) In DPCR3, Offer moved to a depreciation period of 20 years for new post-vesting assets. This depreciation period was maintained in DPCR4 and DPCR5.

233. At paragraph 4.67, BGT asserts that the result of the Authority's accelerated depreciation policy is that current consumers *overpay* for the use of assets to the benefit of future consumers. That analysis misinterprets the true position:

- (a) Although current consumers will pay a higher depreciation cost in any given year with respect to a particular asset on a 20-year approach than on a 45-year approach, those consumers also enjoy the use of assets which have already been fully depreciated and paid for by previous consumers. In particular, current consumers will enjoy the benefit of pre-vesting assets which have been fully depreciated. This was a point highlighted to the Authority in the consultation responses to its RPI-X@20 emerging thinking document and recommendations, and indeed it was suggested that existing consumers were *underpaying* :<sup>66</sup>
  - (i) Central Networks (now part of WPD) stated "*[c]urrent consumers receive a significant benefit from past customers as they utilise majority of assets which are fully depreciated.*"<sup>67</sup>
  - (ii) Central Electric (now NPg) stated that "*today's customers are paying too little of the costs of the assets that serve them today. This arises because the privatisation discount was followed by the acceleration of the depreciation of the pre-vesting assets so that many of the assets that are used to service customers today*

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<sup>66</sup> Paragraph 7.6, RIIO: A new way to regulate energy networks – Final decision, October 2010 [BG2/3] [AB3/3/p39]

<sup>67</sup> Central Networks, Response to the RPI-X@20 emerging thinking document, "Questions from the Embedding Financeability in a New Regulatory Environment document", p. 2 [RDB/2]

*have been fully depreciated and therefore do not appear in [the regulatory asset value]. Ofgem's treatment of the issues emphasises the intergenerational 'unfairness' that it supposes would arise from the continuation of the 20 year life without taking account of the distortion that is already locked into today's prices by the treatment of this subject since privatisation."*<sup>68</sup>

- (b) Further, when one assumes a constant level of investment and a constant depreciation period, there is no net overpayment at all. In the electricity distribution sector, a constant level of investment broadly reflects reality: there are few large one-off investments as there are in the transmission sector, for example.
- (c) BGT suggests that current consumers who pay the depreciation costs associated with a particular asset do not enjoy the use of that asset once it has been depreciated. That suggestion is unrealistic. It is clearly the case that many of the consumers who pay the accelerated depreciation costs associated with an asset would continue to have the benefit of its use once fully depreciated. In those circumstances, it would be more accurate to say that on a 20-year approach, consumers pay *more quickly*. The costs of paying more quickly must also be set against the benefits of not having to pay at all for assets that have been fully depreciated.
- (d) BGT ignores the fact that the effect of moving to a 45-year asset depreciation period with or without transitional arrangements is that a generation of current consumers will enjoy *lower* costs than i) consumers in previous price controls *and* (ii) consumers in future price controls. As further explained below, costs to current consumers will decline over a period of 20 years, before rising steadily to reach a steady state level which is higher than the current level. Further, even with the transitional arrangements, consumers will over the course of RIIO-ED1 pay £600m less than they would have done had a 20-year

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<sup>68</sup> Central Electric, "Response to Ofgem's RPI-X@20 Recommendation"s, 31 August 2010, p.20, §43 [RDB/6]

asset depreciation period been maintained. That cost is not saved for consumers overall as it is simply deferred for future consumers to bear.

- (e) Although, under a 20 year depreciation period, DNOs receive faster repayment of their capitalised expenditure (over 20 years rather than 45 years) the financial benefits of this are fully accounted for by the fact that allowed revenues are reduced because the RAV is lower (see further explanation below at paragraph 235). BGT's assertion that DNOs benefit from accelerated depreciation periods is therefore misleading. As a consequence of accelerated depreciation, consumers pay lower allowances for financing costs on the smaller RAV and DNOs do not benefit.

234. As regards paragraphs 4.68 to 4.70, BGT accurately describes the Authority's decision in March 2011 to move from a 45-year approach to a 20-year approach and to apply that policy to new assets only. The Authority considers that depreciation based on economic asset lives is appropriate. In reaching its decision, the Authority was supported by a paper prepared by CEPA, "The economic lives of energy network assets", December 2010 **[RDB/7]**. CEPA set out the available evidence on existing statutory, regulatory and technical asset lives for the electricity and gas networks in Great Britain and stated *"[i]deally, charges to customers should reflect the long run incremental cost of their use of the asset"*.<sup>69</sup> The report recommended that a depreciation period of 45 to 55 years would be appropriate in the electricity distribution sector. The Authority supports that conclusion and decided in March 2011 to adopt a 45-year depreciation period.<sup>70</sup>

235. CEPA further set out the long-term effect on revenues of a move to a longer depreciation period. CEPA's analysis explains that in a situation in which originally assets have been allocated a depreciation life of 20 years and the depreciation life is then doubled to 40 years, *"there is a significant drop in asset related cash-flows (depreciation and return) which then over time*

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<sup>69</sup> CEPA, "The economic lives of energy network assets", December 2010, p. 10 **[BG2/55] [AB9/4]**

<sup>70</sup> Decision letter on the regulatory asset lives for electricity distribution assets, 31 March 2011 **[BG2/5] [AB3/5]**

*recovers to reach a new equilibrium level higher than the original level.*"<sup>71</sup> The reason for this decrease in revenues is the temporary drop in 'depreciation allowances' to effect the change. The depreciation allowance is the adjustment to 'allowed revenues' which enables DNOs to recover from consumers the cost of their investment in an asset. If the depreciation period on an asset is 45 years rather than 20 years, that annual depreciation allowance will be correspondingly lower (1/45 rather than 1/20 of the cost of the asset) each year but over a longer period, and the DNO will be able to recover a correspondingly lower proportion per year of its investment in the asset. Effecting the change by applying the new asset life to new assets means it would take 45 years before depreciation allowances return to equilibrium levels, with depreciation allowances dipping to a minimum of 20 years' worth of depreciation at 1/45 towards the middle of that period. There is therefore a direct effect on the DNO's cash flows during that period.<sup>72</sup>

236. In addition, since assets are depreciated more slowly under a 45 year policy, the RAV is higher than under a 20 year policy. A higher RAV results in higher costs to consumers of servicing the RAV. This is because a) the new steady state level of annual depreciation will be 1/45 depreciation on 45 years' worth of assets, ie broadly the same annual cost as 1/20 depreciation on 20 years' worth of assets under the old policy; *but* b) the DNOs' revenue allowances for the WACC will be higher. Higher allowances will be needed to cover the annual cost of interest payable to lenders and the profits required by shareholders who, together, will have provided the finance on those 45 years' worth of assets (average depreciated value of about 22.5 years' worth). This compares with 20 years' worth of assets (average depreciated value of about 10 years) that would have been necessary under the old policy.
237. Thus DNOs' allowed revenue under a 45 year depreciation policy is eventually higher than it would have been if assets had continuously been depreciated

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<sup>71</sup> CEPA, "The economic lives of energy network assets", December 2010, pp. 35-37 **[BG2/55]**  
**[AB9/4]**

<sup>72</sup> The RAV is a core feature of price control regulation which represents the value of the company's assets on which it earns a return. The RAV is depreciated over time and allows DNOs to be repaid for and earn a return on the assets whose value it represents.

over 20 years; and consumers are required to pay more. Thus under the new 'steady state', costs to the consumer are higher than under the 20-year approach (under which the RAV was lower). The underlying difference in the RAV value is about 12.5 years' worth (the difference between the 22.5 and 10 referred to above) of assets. This is more than double the original RAV value (average depreciated value of about 10 years). The overall impact on the cost passed to consumers of financing the RAV is substantial.

238. As the CEPA report makes clear, the significant effect on cash-flows resulting from the move to a longer depreciation period can be mitigated by various transition options, which are not mutually exclusive.<sup>73</sup>
239. The first option is that the new longer depreciation period can be applied to new assets only. The result is still a fall in cash flows followed by a steady rise, but the fall is significantly smoother than if the new period is applied to all assets that have not yet been fully depreciated. The fall in cash flows occurs as follows. Where one assumes a steady level of investment (of, say one asset per year), one asset which was depreciated on the old short period (and therefore attracted a higher depreciation allowance) falls out of the asset base each year, being fully depreciated. That asset is then replaced by new assets which are depreciated on the new long period (and therefore attract a lower depreciation allowance). Each year, depreciation allowances which amounted to 1/20 of an asset's value are replaced with depreciation allowances which amounted to 1/45 of an asset's value. The result is a gradual decline in cash-flows. A low point is reached after 20 years, when all old assets have been fully depreciated and only 20 years' worth of assets are being depreciated at the new longer rate. Thereafter, cash-flows rise as the asset base gradually builds up. As explained above, costs to consumers when the new steady state is reached are higher than in the steady state under the shorter depreciation period, because the higher RAV leads to higher costs of servicing the RAV.
240. A second option is that a transitional period can be applied whereby the depreciation period does not immediately change from the shorter to the

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<sup>73</sup> CEPA, "The economic lives of energy network assets", December 2010, pp. 39-41, **[BG2/55]**  
**[AB9/4]**

longer period, but increases in gradual increments. This again does not prevent a fall in cash flows followed by a rise, but can mitigate the sharpness of the effect.

241. It was informed by the above considerations, and further concerns expressed by stakeholders regarding financeability, that the Authority decided to apply the new 45-year approach to new assets only, stating: *"we have had regard to our financing duty and the RIIO principles of not creating shocks or instability. These persuade us that in this case we should not apply the new asset lives to existing assets."*<sup>74</sup>

242. As regards paragraphs 4.71 and 4.72, the Authority agrees that it invited DNOs to justify transitional arrangements in their business plans, stating a preference for transitional arrangements managed over one price control period. The Authority's concerns regarding financeability were prompted by the effect on cash flows caused by the move to a 45-year asset depreciation policy set out above. In their slow track business plans all DNOs presented an analysis of the impact of a 45-year policy without transition on their financeability and credit metrics and on that basis proposed a straight-line 8-year transition period.

(a) [REDACTED]

(b) NPg referred to *"signs of financial stress as the effect of... the lengthening of regulatory depreciation... from 20 years to 45 reduces the operating cash flows."*<sup>76</sup>

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<sup>74</sup> Decision letter on the regulatory asset lives for electricity distribution assets, 31 March 2011, p. 4 [BG2/5] [AB3/5/4]. This decision was analogous to that made in the RIIO-T1 Strategy Decision – Financial Issues Annex, 2.33, at which the Authority stated *"on balance the need to meet our financing duty and to avoid sudden changes in cash flow persuade us that in this case we should not apply the new asset lives to existing assets."*

<sup>75</sup> [REDACTED]

<sup>76</sup> NPG slow track submission Section 3: Financing, March 2014, p.25 [RDB/26]

- (c) UKPN stated that "*[w]e believe that our combined depreciation and fast/slow money proposals produce the minimum acceptable level of forecast credit ratios over RIIO-ED1... Not all ratios in all years are above the thresholds, but on balance, we believe our business plan is consistent with our target rating.*"<sup>77</sup>
- (d) SP, the DNO group that had not proposed a transition arrangement in its fast track plans, argued that the removal of the 2.5% of additional expenditure that it had included in its fast track business plan submissions threatened its financeability and therefore supported transitional arrangements.<sup>78</sup>

***BGT's complaints as to consumer harm and the sector-wide approach***

243. At paragraphs 4.73 to 4.76 BGT develops its complaint that transitional arrangements harm the interests of consumers and should have been applied on a case-by-case basis. Although the Authority accepts the desirability of depreciation periods reflecting technical or economic asset lives, it rejects that complaint:

- (a) The Authority's adoption of transitional arrangements is neutral in net present value terms – in other words, taken together, consumers will not pay more by reason of the introduction of transitional arrangements. Overall, there is no harm to consumers.
- (b) The Authority must have regard to the interests of *future* as well as existing consumers. BGT's argument ignores the interests of future consumers and narrowly focuses on the situation of existing consumers (which it in any event over-simplifies, as it does not take account of the fact that those consumers benefit from existing fully depreciated assets). As the analysis presented above at paragraphs 238 and 241 makes clear, the move to a 45-year depreciation period for new assets

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<sup>77</sup> UKPN slow track submission, Business plan (2015 to 2023), Core Narrative, March 2014, p.93 [RDB/27]

<sup>78</sup> SP Energy Networks slow track submission, 2015-23 Business Plan, Updated March 2014, Annex: Financing our plan, March 2014, p.71 g.7.3. [RDB/29]

will result in lower costs for existing consumers and higher costs for future consumers. Absent transitional arrangements, over £1.1bn in allowed revenues would be deferred from RIIO-ED1 consumers to future generations of consumers. After accounting for the cost of financing higher RAV values, the costs to future consumers would be rather higher in real terms. Taken at its simplest, BGT therefore advocates a position where future consumers pay more so that existing consumers can pay less. This intergenerational unfairness is mitigated by the introduction of transitional arrangements: with these in place, only £600m in allowed revenues is deferred from RIIO-ED1 consumers to future generations of consumers.

- (c) It is further in the interests of consumers not to provoke shocks or instability to the revenues of DNOs, potentially creating an environment of regulatory uncertainty which can lead to higher financing costs in the long term.
- (d) BGT argues that there is a cross-subsidy moving from current consumers to future consumers. In reality, it is clear from the very analysis that BGT accepts, that future consumers will pay more than current consumers.
- (e) The effect on the costs to consumers described above is universal to all DNOs. It would therefore have been inapposite to apply transitional arrangements to some DNOs but not others, as BGT proposes.
- (f) BGT asserts that consumers have overpaid for assets historically. For the reasons stated at paragraph 233, that contention is flawed and over-simplifies the true position. Moreover, as set out in Mr Rowson's first witness statement at paragraphs 11-13, the assets were sold at a discount to replacement cost value at privatisation and the Authority consequently needed a policy of accelerating depreciation to avoid pricing at well below true network costs. The implication is that it has been only by accelerating depreciation that the Authority has been able to ensure consumers neither underpay nor overpay.

(g) In the light of the above considerations, it is clear that there was no requirement for the Authority to implement its 45-year asset life policy as quickly as possible, as BGT contends at paragraph 4.96. To the extent that the Authority was required to have "good reasons" to delay the implementation of a policy identified as the correct one, it had such reasons. The considerations of intergenerational equity and financeability (discussed further below), were more than sufficient to delay implementation of the policy.

244. At paragraphs 4.80 to 4.83, BGT argues that the Authority's concern in relation to severe future upward price pressure is misplaced. BGT's argument is unconvincing.

(a) BGT evidently accepts that the broad effect of a move to a 45-year depreciation period will be that described above. The analysis offered by AlixPartners (AlixPartners Report, §§8.2.5 – 8.2.15) broadly conforms to that of the Authority and CEPA.<sup>79</sup> Notwithstanding its acceptance that prices will rise for a long period from 2035/6, a situation which clearly creates the issues of intergenerational unfairness and intervening cash flow pressures for the DNOs described above, BGT attempts to maintain that the Authority's concerns are misplaced.

(b) BGT misunderstands the Authority's concern, alleging that the Authority foresees a severe upward pressure on prices only *absent transitional arrangements*. The Authority has never sought to suggest that the upward pressure on prices will only arise in a situation where there are no transitional arrangements (as BGT seeks to suggest). The Authority made it clear in its letter to BGT of 3 February 2015 that transitional arrangements "provided a better foundation for longer term financeability and would be in the consumer interest, taking existing and future consumers together". However, it also recognized that "even the transitional arrangements represent a shift of burden from existing

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<sup>79</sup> AlixPartners' analysis is hypothetical and premised on a number of assumptions. It therefore does not reflect the reality of the DNOs' situations.

*consumers to future consumers*" and explained that the effect of transitional arrangements would be to *mitigate* and not cancel the future upward pricing pressure.<sup>80</sup>

- (c) BGT is wrong to contend that *"the uncertain prospect of such increases... is better addressed in future price controls"* (at paragraph 4.83). The increases are not uncertain in the Authority's view but a logical economic consequence of the move to a 45-year depreciation period (endorsed by BGT itself). Further, given that the problem of future upward pressure on prices is evident and can be mitigated now, the correct and responsible regulatory approach is to take appropriate measures in this price control to mitigate its effects. It is to be noted that, as set out above, the Authority's approach in this respect is consistent with one of the options suggested by CEPA.

245. At paragraph 4.90, BGT argues that considerations of inter-generational equity do not support the introduction of transitional arrangements. The Authority notes that BGT does so notwithstanding its admission that *"an effect of the move from accelerated to economic depreciation for new assets is that (all else equal) current consumers will pay lower charges and future consumers will pay higher charges"*. As to this point:

- (a) It is not the case that lower charges for current consumers result from an unwinding of past over-payments by recent generations of consumers. That contention is premised on the view that current consumers have overpaid for assets prior to their being fully depreciated, which as explained at paragraph 233 above is an oversimplification. All recent generations of consumers, at least since privatisation in 1990, have benefited from the use of older assets that have been fully depreciated (or equivalently valued at a discount at privatisation). This means that the lower charges result from the effect explained at paragraph 239 above. The effect is an unwinding of the

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<sup>80</sup> Letter from the Authority to BGT, 3 February 2015 [BG2/39] [AB6/39/7-8]

discount at privatisation referred to in paragraph 15f rather than of overpayments by any recent generation of consumers.

- (b) Lower costs for existing consumers in each year represent a deferral of the amounts they pay for the economic cost of that years' worth of service capability (or asset) consumption for future generations to bear. Those future generations will experience that additional cost as the cost of financing a higher RAV value (than the value that would exist without the change in policy). As stated above, without transitional arrangements, the move to a 45-year approach results in £1.1bn in allowed revenues being transferred from RIIO-ED1 consumers to future consumers; with transition only £607m is transferred. By the end of RIIO-ED1, the transitional arrangements would lead to depreciation representing only about 87.4% of a year's worth of asset replacement.<sup>81</sup>

***BGT's complaint that transitional arrangements are not necessary to secure financeability***

246. At paragraphs 4.84-4.89, BGT argues that transitional arrangements have not been demonstrated to be necessary to secure financeability. As regards this point:

- (a) The Authority made it clear on several occasions (including in its consideration in the *"Handbook for implementing the RIIO model"*, October 2010, cited at paragraph 4.85) that transitional arrangements might be necessary. The necessity for transitional arrangements to mitigate the impact of cash flows was recognised in the CEPA report, as made clear above. Further, in its decision to introduce asset lives in March 2011, the Authority stated that *"we acknowledge that it may be appropriate to phase in the new asset lives over one or more price control periods... We are confident we can put in place transition arrangements to deal with short-term financeability concerns during*

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<sup>81</sup> Ibid.

*RIIO-ED1*.<sup>82</sup> Consequently, although BGT is right that the Authority proposed to adopt transitional arrangements only in cases of demonstrated need, it was alert to their possible necessity.

- (b) All slow-tracked DNOs presented an analysis to the Authority in their business plan resubmissions that transitional arrangements were necessary to secure financeability, as set out at paragraph 242 above.
- (c) The Authority recognised that, while the effects of transition on credit metrics within the control period (including the PMICR, as BGT correctly points out at paragraph 4.88a-b) were limited, they were nonetheless real. At fast track the Authority had said that it considered there was sufficient headroom in these metrics and that transitional arrangements were not justified. Further, subsequent to the fast track process, the Authority made a number of adjustments (such as the reduction of the cost of equity to 6.0%) to the companies' proposals which reduced cash flows by reducing DNOs' allowed revenues, and placed further pressure on certain credit metrics.
- (d) Even though there remained headroom in most of the affected credit metrics, in light of potential investor concerns around cash flows arising from the reduced cost of equity allowance, the Authority considered that an immediate transition to 45-year asset lives would have unnecessarily heightened such concerns. In the case of one company, ENWL, the Authority had identified a constraint in a credit metric the Authority uses to measure financial resilience, ie  $PMICR_G$ . This metric would be affected by an immediate transition to 45-year asset lives, indicating that further adjustments would have been required to secure an appropriate level of financial resilience for that company.
- (e) Consistent with the analysis set out in the business plan submissions of one group of DNOs, Northern PowerGrid, we recognised that there are material adverse longer-term impacts on DNOs' cash flows from the

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<sup>82</sup> Decision Letter on the regulatory asset lives for electricity distribution assets, 31 March 2011, **[BG2/5]** **[AB3/5/2-4]**. See further: Strategy Decision – Overview, p. 6 **[BG2/10]** **[AB4/10-A/6]**; RPI-X@20 Recommendations, pp. 46-48 **[RDB/5]**

change to new asset lives. The cash flow position of a company is driven in part by the relationship between depreciation allowances (which affect allowed revenues) and the RAV (or, specifically, the debt levels involved in financing the RAV). This relationship in particular affects an important group of DNOs' credit metrics that refer to 'funds from operations', or FFO. For example, Moody's, one of the three main rating agencies, places 12.5% weight (out of a total 40% weighting for credit metrics) on the FFO to debt metric in its rating assessments for regulated electricity and gas network operators<sup>83</sup>. The reductions in depreciation allowances described in paragraph 235 and the increases in the RAV described in paragraph 235 would make these metrics substantially worse. Assuming no change in gearing ratios, debt will increase as a result of the reduced cash flows from consumers, with the consequence that the FFO to debt metric will deteriorate. The Authority would estimate there would be a longer-term deterioration of some 8% in the FFO to debt metric<sup>84</sup>. Moody's assesses that a value of 11% for this metric is the minimum consistent with a company maintaining investment grade, and DNO levels at present are at or a little above 13%. An 8% deterioration is large relative to this benchmark. When the Authority considered the transition period, it was alive to the longer term financeability issues that arise and sought to mitigate those effects where possible.

- (f) When considering the price control package in the round, the Authority therefore considered that financial resilience could be undermined by an adjustment to asset depreciation lives without transitional arrangements. Taking this consideration together with those of inter-generational equity described above, the Authority considered that transitional arrangements further served the interests of consumers. Contrary to BGT's contention at paragraph 4.88c of the NoA, the Authority found this to be the case for every DNO.

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<sup>83</sup> Rating methodology – Regulated electric and gas networks, Moody's, November 2014 [Exhibit]

<sup>84</sup> This broadly reflects the change in the ratio of depreciation to RAV, being a reduction from 1/10 to 1/22.5 (steady state additions divided by the number of years' worth of additions in the RAV, see paragraph 235), divided by a gearing ratio of 65%.

- (g) In the light of the Authority's lengthy discussion of the possible desirability of transitional arrangements, and the analysis presented in the DNOs' business plans, the Authority does not consider that it was required to put forward the kind of analysis referred to by BGT at paragraph 4.88b of the NoA..
- (h) The issue of financeability was not one which it was appropriate for the DNOs to attempt to address themselves, as suggested by BGT at paragraph 4.89 of the NoA. The financeability issue arose from the Authority's alteration of the regulatory framework. In those circumstances, it was proper, responsible and in accordance with the Authority's duty to have regard to issues of financeability to apply transitional arrangements. Moreover, BGT is wrong to suggest that DNOs have benefitted from the past overpayment of consumers, for the reasons given above.

***BGT's complaint that the decision was procedurally flawed***

247. At paragraphs 4.77 to 4.79, and at 4.91c, BGT appears to allege that the decision to apply transitional arrangements was flawed procedurally by reason of inadequate consultation or inadequate reasoning. This complaint is misplaced:

- (a) The Authority's consultation in the area of asset depreciation periods was extensive.
  - (i) The Authority engaged with stakeholders at length during the RPI-X@20 process. The Authority invited and received responses on its new asset depreciation policy from a broad range of consultees in relation to both its January 2010 RPI-X@20 Emerging Thinking document and its July 2010 RPI-X@20 Recommendations. These consultation periods were 11 and 6 weeks respectively. The above documents set out and explained the Authority's concerns relating to the financeability

and the inter-generational equity issues which would arise from the move to a longer asset life.<sup>85</sup>

- (ii) The Authority conducted a specific consultation in relation to asset lives for the electricity distribution sector between January and March 2011. In this consultation, the Authority specifically referred to the possibility of transitional arrangements managed over one price control period.<sup>86</sup> Prior to this consultation, it made publicly available the report by CEPA,<sup>87</sup> which analysed: the cash-flow issues caused by the move to a longer depreciation period; and the mitigation of those issues by way of transition.
  - (iii) In its Strategy Consultation, the Authority again consulted on its preference for transitional arrangements managed over one price control period.<sup>88</sup>
- (b) The Authority's reasoning was made clear from the consultation and decision documents outlined above. The business plan submissions of the DNOs, also publicly available and open for consultation, further contained detailed reasoning on the impact of transitional arrangements on the financeability of the DNOs – which the Authority accepted in its slow track Draft Determinations.<sup>89</sup> The Authority further explained its reasoning in its letter to BGT of 3 February 2015, in which the Authority replied to BGT's response to the statutory consultation on the slow-track licence modifications.

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<sup>85</sup> RPI-X@20 Emerging Thinking, p. 36 [RDB/3] ; RPI-X@20, Emerging Thinking – Embedding financeability in a new regulatory framework, p. 8 [RDB/4]; RPI-X@20 Recommendations, pp. 46-48 [RDB/5]

<sup>86</sup> Open letter consultation on the regulatory asset lives for electricity distribution assets, 14 January 2011 [BG2/56] [AB9/5]

<sup>87</sup> CEPA, "The economic lives of energy network assets", December 2010, p. 5 [BG2/55] [AB9/4]

<sup>88</sup> Strategy Consultation - Overview, p. 6 [BG2/10] [AB4/10-A/6]

<sup>89</sup> Draft Determinations – Financial Issues, §3.52 [BG2/30] [AB5/30-C/25]

***Conclusion***

248. For all the reasons set out above, the Authority did not err in introducing transitional arrangements in relation to its change in asset life policy.
249. In particular, the decision:
- (a) Had regard to the interests of existing and future consumers;
  - (b) Was consistent with the Authority's duty to have regard to the principle according to which regulatory activities should be targeted only at cases where action is needed;
  - (c) Gave appropriate weight to considerations of financeability; and
  - (d) Was procedurally fair insofar as it was transparent, accountable, preceded by an extensive consultation, and supported by proper reasoning.
250. There are therefore no grounds on which the CMA should intervene as requested by BGT at paragraph 4.93, or at all.

## **PART VIII: GROUND 5 – ALLEGED UNWARRANTED CHANGE IN COST OF DEBT INDEXATION**

### ***Introduction***

251. The Authority's principal objective is to protect the interests of existing and future consumers (in relation to electricity conveyed by distribution or transmission systems). The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective and, in doing so, the Authority must have regard to the need to secure that licence holders are able to finance their activities. The cost of financing the capital intensive electricity distribution networks is a significant part of the overall cost to consumers. The Authority considers that interests of consumers are best served by creating a stable and predictable regulatory environment that secures the confidence of investors and permits lower cost financing. The Authority's long term strategy to this end, consistent with other regulators and recent decisions by the CC, has been to set allowances for financing costs that relate to the costs of debt that have been reasonably incurred by the regulated companies (embedded debt) subject to appropriate consideration of whether those costs had been incurred prudently and efficiently<sup>90</sup>.
252. Unlike other regulatory regimes, an innovation in the RIIO model is that it uses an index for the cost of debt based on a long-term trailing average of forward interest rates. This helps ensure that allowances are sufficiently sensitive to changes in the interest rate environment that cannot be known about at the time of a price review. It provides a regulatory commitment to investors, reducing regulatory risk, and also helps minimise forecasting error which has historically tended to benefit investors at the expense of consumers. The possibility of forecasting errors had previously required a degree of caution and prudence in making forecasts, which is no longer required under RIIO. Under RIIO the cost of debt used in calculating allowed revenues is updated mechanistically each year for changes in the index.

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<sup>90</sup> §13.58, Competition Commission, Final Determination Northern Ireland Electricity Limited, March 2014 [BG2/52-A/13-11; AB9/52-A/13-11]

253. Although the Authority has adopted a cost of debt index model, it adopted the principle that, at the time of a cost of debt index being introduced for the first time, it should relate to the cost of efficiently incurred embedded debt. The RIIO handbook referred to "*a commitment to remunerating efficiently incurred debt costs*".<sup>91</sup> This was reflected in the design criteria for establishing a cost of debt index developed with our advisers<sup>92</sup>. The Authority carried out analysis to this end in designing the cost of debt index for RIIO-T1 and GD1, and concluded that a 10 year simple trailing average index best matched the cost of debt for those companies. However, the analysis for the RIIO-T1 and GD1 decision did not include data pertinent to the DNOs. See RIIO-T1 and GD1 Strategy Decision - Financial Issues Annex §§3.41-3.48 **[RDB/10]**.
254. In our RIIO ED1 Strategy Decision the Authority decided at that stage that there was not sufficient evidence to move away from the 10-year index we had established for T1 and GD1. The Authority said that if a company could show in its business plan that this index was not appropriate for its circumstances it could propose modifications (RIIO-ED1 Strategy Decision §§2.14-2.40 **[BG2/10-F; AB4/10-F/10-15]**).
255. Although companies made representations that the 10-year cost of debt index would not cover their actual debt costs, all DNOs accepted the Authority's preferred index in their June 2013 fast track business plan submissions. But they made it clear that their proposals were made in the round and that upsides in their plans offset the downside in the cost of debt index.<sup>93</sup> These upsides may have been in the rewards they would have had for securing fast-track status<sup>94</sup>, but might equally have been in their cost of equity proposals or in the scope for outperformance in their cost proposals.

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<sup>91</sup> §12.13, Handbook for implementing the RIIO model, October 2010 **[BG2/4/108; AB3/4/108]**

<sup>92</sup> §7.7, The Weighted Average Cost of Capital for Ofgem's Future Price Control – Final Phase I Report, Europe Economics, 1 December 2010, stated "The indexation proposal should accurately reflect the cost of debt for an efficient company, including embedded debt. This criterion carries a high weight." **[RDB/8]**

<sup>93</sup> This is exemplified by the 'Key Message' introduction to Northern Powergrid's financing section in its June 2013 fast track business plan submission.

<sup>94</sup> Plans were prepared assuming the benefits of fast-track, including early settlement and an IQI additional income reward of 2.5% of Totex. See §§ 6.8, 6.12 & 6.13, Strategy decision for the RIIO-ED1 electricity distribution price control, Overview, March 2013 **[BG2/10-A; AB4/10-A]**

256. Following the Strategy Decision, the submission of initial plans and the fast-track consultation, the Authority undertook a consultation on the Equity Market Return and indicated it was minded to set cost of equity allowances for RIIO-ED1 at 6.0%, ie 0.7%-0.8% lower than any of the DNOs had proposed in their fast track business plans<sup>95</sup>. Those DNOs were also aware that the slow track review process would subject their cost forecasts to adjustments in light of our benchmarking analysis. They could no longer rely on there being the same upsides as they could have in the fast track process.
257. In their revised business plans, submitted in March 2014, the DNOs provided further evidence of the disparity between the 10-year cost of debt index and their forecast debt costs. A number of DNOs proposed alternative index designs that would better cover the costs of their embedded debt.
258. In parallel the Authority carried out an analysis – on the same basis as it had done for T1 and GD1 - looking at the implications of a 10 year index for the DNOs with their debt structure. It concluded there were concerns as to how well this covered the DNOs' actual cost of debt and it failed the test we had used for RIIO-T1 and GD1. The Authority's periodic analysis of the rates at which regulated companies issue debt against market benchmarks<sup>96</sup> led it to believe that across the industry as a whole the actual cost of debt compares well with the market benchmark and is therefore a reasonable indicator that it was efficiently incurred. While the Authority had not guaranteed that the index would always fully cover the costs of debt, it saw the levels of under-recovery shown by our analysis as material, particularly in light of its established test at the time of introducing a new cost of debt index.
259. In considering the options for extending the index the Authority noted that an immediate move to a 15 year index, as proposed by some of the DNOs, would lead to the DNOs over-recovering their cost of debt in the short term. Given the Authority's duty to protect the interests of consumers it considered this

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<sup>95</sup> In our equity market return decision, we identified a reduction of 0.4% arising from a structural change in the RPI index, and WPD accepted an amendment in its business plan submission to reflect this change.

<sup>96</sup> This is illustrated in Figure 28 in our October 2010 Handbook for implementing the RIIO model. [BG2/4/108; AB3/4/108]

would not be appropriate. At Draft Determinations the Authority proposed a trombone index extending from 10 to 20 years which meant that at the start of RIIO ED1 the cost of debt would be the same as originally proposed but provided the advantage that the Authority could be more confident that it would appropriately cover the efficiently incurred costs of debt over the period of the control. The Authority also noted that the DNOs would be less exposed to the interest rate uncertainties in forecasting debt markets, which it saw as beneficial while it also saw advantage for consumers in the resulting reduced scope for forecasting error.

260. The DNOs continued to argue strongly that the Authority was still under-providing for their cost of debt and that the Authority should move to a longer initial start point for the index (suggesting a 13 year start point if the 15 year index was unacceptable). The Authority considered these representations but decided to stay with the position set out at Draft Determinations.

261. In summary then, responding to BGT's grounds:

(a) The decision to move away from the 10 year index set out in the Strategy Decision was the result of the Authority's appropriately and properly taking account of the evidence put to it through the consultation process and further analysis that it conducted in the light of that new information. From this analysis, it was clear that the 10 year index would not fund the DNOs cost of debt under a variety of interest rate scenarios. The move to a 10 to 20 year trombone is a better solution in terms of costs to consumers than the DNO proposals - which involved an immediate move to a longer index;

(b) The 10 to 20 year trombone still under-provides for the DNOs cost of debt, but by a margin that the Authority considers is reasonable and justifiable. There is no basis on which this can be considered as being too generous and indeed the DNOs continued to argue strongly for a longer index.

(c) The fact that this change could be expected (though not guaranteed) to increase costs to consumers over ED1 does not mean that it was not in

consumers' interests. Consumers' interests have to be considered broadly and include the interests of existing and future consumers in maintaining investor confidence in a stable and predictable regime and the Authority's adherence to principles and commitments;

262. Alongside this general overview of the decision to extend the cost of debt index, the Response will now address each of BGT's points in turn.

***BGT's complaints***

263. BGT's assertion that the change in the cost of debt index will cost consumers £120m presents a misleading view of the impact. First, it overlooks the longer term effect of extending the period over which consumers benefit from today's exceptionally low interest rate environment for an additional ten years.
264. Second, setting a cost of debt index that materially underfunds efficiently incurred debt would have longer term adverse consequences for consumers. A large driver of the cost of financing for the DNOs is the market's perception of their riskiness. Underfunding debt would directly impact the market's view of regulatory risks, increasing the DNOs' overall perceived riskiness and ultimately increasing the cost of financing, which is recovered from consumers.
265. Furthermore, if the Authority sets a control with material underfunding of efficient debt, it risks damaging the energy network sectors' credit quality. The Authority's regulatory regime is especially highly rated by the credit rating agencies, creating confidence in the DNOs and again leading to lower financing costs. Moody's methodology ascribes a 15% weighting to its assessment of the stability and predictability of the regime, and this provides a material benefit to the ratings of the DNOs (and other network operators) which in turn helps DNOs to maintain sensible gearing ratios and helps minimise the overall cost of capital [RDB/39]. Underfunding efficient debt would also negatively impact on the DNOs' 'cost and investment recovery', to which Moody's methodology ascribes a further 15% weighting. Taken together, these factors represent 30% of the weighting in Moody's methodology. Although other rating agencies do not disclose their

methodologies in such detail, the Authority would expect them to have a broadly similar sensitivity to these issues. There would be further adverse consequences on credit metrics of under-remunerating the cost of debt that would tend to compound this effect on credit ratings.

266. As to BGT's argument that there will be no benefits to consumers realised during ED1, the Authority's duties extend to future as well as to existing consumers.
267. The Authority broadly agrees with the factual background set out at paragraph 4.94 and 4.96 of the NoA.
268. As regards paragraph 4.95 of the NoA, in which BGT refers to the Strategy Decision, the Authority did *not* state definitively in the Strategy Decision that it would use a 10 year trailing average. The Strategy Decision stated that the Authority would use a 10 year trailing average but that DNOs could make submissions in their business plans as to whether that would be inappropriate:

*"However, if a company can show in its business plan that the 10 year simple average index is not appropriate for its circumstances, it can propose modifications. We will consider the merits of such a proposal when evaluating the business plan and would need to satisfy ourselves that the adoption of a different approach is both robust and justified."*

**[BG2/10-F/10; AB4/10-F/10]**

269. As regards paragraph 4.97 of the NoA:
- (a) It cannot be said with any certainty that the change of approach creates significant additional costs for consumers, as BGT contends; the negative consequences of materially underfunding the sector's debt need to be taken into account, and so the consequence of not altering the index will likely outweigh the direct cost to consumers that BGT has calculated.
- (b) Even leaving aside the exclusion of these effects by BGT, BGT's estimated costs of £120m are by no means certain, relying on the actual outcome for the next 8 years of debt costs. BGT's forecasts rely

on the *known* cost of debt only up until September 2014; thereafter they rely on forecasts of debt costs.

- (c) The actual direct cost to consumers of the change to the trombone index will be determined by the actual costs of debt as measured by the index. In general, the higher the level of interest rates in the future, the lower the cost to the consumers of the change to the trombone index. The Authority tested the change to the trombone index on a range of interest rate forecasts as set out in the second witness statement of Mr Rowson at paragraphs 34-36.

270. Paragraph 4.98 of the NoA correctly sets out the part of the Strategy Decision cited by BGT on the reasons why the Authority was continuing with a 10-year trailing average at that point. The Authority stated, as set out above, that it would consider the merits of other proposals.

271. *After* the Strategy Decision had been published the Authority carried out further consultation:

- (a) Following a consultation on Equity Market Return, the Authority decided on 17 February 2014 to lower the assumed cost of equity to from the DPCR5 level of 6.7% to 6% [**BG2/22**; **AB5/22**].
- (b) This change occurred shortly before DNOs submitted revised business plans, which they had been instructed to prepare on the basis that the cost of equity would not change. The Authority's change in approach to the cost of equity, combined with the removal of the fast-track rewards prompted further submissions from DNOs on the appropriate measure of the cost of debt. Several DNOs, at the time of fast-track, had only accepted the cost of debt index as part of the wider package.
- (c) In their slow-track business plan submissions several groups proposed alternative indices; ENWL proposed a trailing average starting at 15 years and extending to 20 years based only on BBB rated bonds [**RDB/24**]; NPg proposed a longer trailing average starting at 17 years (since there would have been issues of data availability for any longer

period) **[RDB/30]**; UKPN did not propose an alternative cost of debt but suggested adjusting the capitalisation ratio in the light of the new cost of equity to achieve a similar result **[RDB/28]**.

- (d) The Authority gave further consideration to the appropriate measure of the cost of debt and concluded that the trombone index would better match forecast actual debt costs. The chosen index has the additional benefit of protecting the DNOs against interest rate volatility, because the period used in configuring the index is closer matched to the current profile of debt and the debt issuance strategy that the sector has adopted. This further increases investor confidence by reducing a risk and as such it is in consumers' interests. The decision was rational and correct, and well within the Authority's permissible discretion and judgement.

272. As regards paragraph 4.99 of the NoA which states that the Final Determinations and Decision fail to provide new evidence or reasoning:

- (a) The Authority provided sufficient evidence and analysis in the Draft Determinations – **(BG2/30-C; AB5/30-C/10-14)**.
- (b) In particular, the Authority set out the detailed analysis that it had carried out, and stated "*2.41 We found that trailing average periods that extend trombone like from a fixed starting point until they reach about 20 years provided the lowest sensitivity [in terms of the accuracy of the index] to interest rates. Fixed trailing average periods would expose investors to more uncertainty. We consider that a trombone index would therefore have significant advantages in terms of limiting investor risk and improving financeability.*"
- (c) In the Final Determinations the Authority, after considering consultation responses, confirmed the reasoning in the Draft Determinations **[BG2/35-A/40-43; AB6/35-A/40-43]**.

273. The Authority considers that the change is justified on the basis of two considerations set out at paragraph 4.100 of the NoA, namely:

- (a) The trombone index has the benefit of better aligning forecast interest costs and the cost of debt allowances; and
- (b) The trombone index has the additional benefit of better protecting DNOs from a mismatch in their exposure to market interest rate uncertainty and the debt profile of the sector, such that it makes the slight underfunding of the DNOs' cost of debt more acceptable.

274. Overall this is in consumers' interests for the reasons set out above. As such the decision was rational and well within the Authority's margin of discretion.

275. As regards paragraphs 4.101-105 of the NoA on the alignment of forecast interest costs and cost of debt allowances:

- (a) It is broadly correct that the Authority's policy is to allow a DNO to recover the costs of debt that is efficiently incurred.
- (b) The Authority's decision to move to an index for the cost of debt, based on wider industry interest rates, provides a basis for ensuring that the allowed cost of debt only reflects debt that is efficiently incurred, since individual issues have little impact on the overall index.
- (c) The Authority considers that the best basis available to it on which to calibrate the cost of debt index (in terms of the length and form of the index) is the sector wide actual debt costs. It further considers that this basis is reasonable because:
  - (i) The information available to the Authority did not suggest that the DNOs had incurred debt inefficiently. The Authority has carried out periodic reviews of debt coupons at issue against the current market yields, and has found no evidence of systematic inefficiency across the sectors. The reviews in 2010 and in mid-2012 are retrospective, so encompass the vast majority of DNO debt.
  - (ii) The Authority has found no reason to disqualify any relevant licensee debt on efficiency grounds from this analysis. It should

be noted the NWEN £180m 2013 bond that BGT refers to as being in particular erroneous to include is not a debt of the licensee, only of the finance company. It was therefore never in the analysis.

(iii) The DNOs have always been incentivised to issue efficiently. In past price controls, any debt issued above the fixed allowance was not fully funded by DUOS customers. Since the introduction of the index mechanism, this incentive has become stronger, because, issuing debt below the allowances means that the DNOs may keep the difference.

(iv) An alternative assessment method is to use comparative analysis to assess efficiency. However the DNOs do not issue new bonds each and every year so comparators are not always obvious or straightforward. Another obvious comparator, Northern Ireland Electricity, has been ruled out by the Authority, as the CC used GB DNOs as comparators to NIE when assessing NIE's efficiency. A reciprocal analysis would result in circular logic problems. It is therefore difficult to judge the efficiency of any DNO's bond issues using this method.

(v) [REDACTED]

276. As regards paragraph 4.106 of the NoA which states that a change in index was not required to fulfil the objectives set out in the RIIO Handbook:

(a) The objectives set out in the RIIO Handbook, and the explanation of how those objectives will be achieved, are set out at paragraph 84 *et seq* above. Paragraph 12.16 of the RIIO Handbook [**BG2/4; AB3/4**] in particular identifies an objective that the cost of debt index should

provide a reasonable estimate of the cost of debt. It was to meet this objective that the Authority changed the index.

- (b) It is incorrect that a fixed-length trailing average will effectively ensure that new debt financed at efficient rates will be fully funded, as BGT contends. As the Authority indicated in the Draft Determinations, a 10 year trailing index could have significantly *under* provided for DNOs' forecast costs of debt (Draft Determinations, Financial Issues, §2.42 – **[BG2/30-C; AB5/30-C/12]**). The trombone index avoids the risks of this significant underfunding, although there is a slight under-provision in that case as well (§2.44, **[BG2/30-C/12; AB5/30-C/12]**).
- (c) It is broadly correct that extending the index gives a higher effective weight to debt issued in the earlier years of the price control. However, the Authority's analysis, which Mr Rowson explains in his second witness statement at paragraphs 59-74, shows it is incorrect that this creates a risk that new debt, financed at efficient rates, will not be fully funded in the future as BGT asserts. The more important test is that the index is a reasonable estimate of the cost of debt and extending the index was necessary to meet this test.
- (d) At paragraphs 4.107 – 4.109 of the NoA, BGT contends in summary that the Authority should have considered whether the actual cost of debt was attributable to high levels of gearing (ie higher than the Authority's assumed level of gearing of 65%), and adjusted the 'efficient cost' to exclude that. The Authority broadly agrees that in principle such an adjustment may in certain circumstances be appropriate. However, it was not necessary to make such an adjustment in this case because it is not for the Authority to determine the appropriate level of gearing for a DNO. The only requirement that the Authority sets is that a DNO must maintain an investment grade credit rating. All DNOs have historically sat, and currently sit, within this criterion, with a mixture of A and BBB ratings. Within this, it is for the DNO to decide on its level of gearing, as part of the wider capital structure.

277. As regards the contention at paragraph 4.110 of the NoA that the Authority did not take proper account of the 'halo effect' (ie the effect by which market yields of DNOs' debts are below that of the benchmark of bonds of comparable credit ratings):

- (a) The Authority did consider the halo effect in the Draft Determinations – Financial Issues [**BG2/30-C; AB5/30-C/12-15**].
- (b) It was very difficult to determine the precise quantum of the halo effect. While AlixPartners assume that the halo effect is around 50 basis points, NERA (on behalf of the Energy Networks Association, an industry body funded by the gas and electricity transmission and distribution networks in the UK and Ireland) concluded that the quantum was roughly 5 basis points [**RDB/37**].
- (c) At the Final Determination the Authority reviewed its analysis in the light of the NERA report, and found that the halo effect was only around 0.2 percentage points, broadly enough to cover the Authority's assumed costs of issuance and other fees (Final Determinations – Overview Document – Appendix 8 – §1.4 [**BG2/35-A; AB6/35-A/92**]). In the light of this overall uncertainty, the Authority considered it proportionate not to provide an allowance to the DNOs to cover the costs of debt issuance fees (0.2%) because of the offsetting halo effect. However, the Authority considered it inappropriate to make any further adjustment for the halo effect in the cost of debt allowances. That decision was plainly rational and correct, and within the Authority's permissible discretion and judgement.

278. As regards paragraphs 4.111 – 4.114 of the NoA on the reduction of exposure to market interest rate uncertainty:

- (a) The Authority agrees that the use of the trombone index, by more accurately tracking the profile of DNO debt costs, reduces risk exposure by nearly tenfold, and that this is of value to investors (Draft Determinations: Financial Issues paragraph 2.44 [**BG2/30-C, AB 5/30-C/12**]).

- (b) As set out above, this reduction in risk will benefit consumers, with future financing costs lowered through maintaining investor confidence and regulatory regime certainty.
- (c) By tracking the sector more accurately, the trombone index further protects consumers from interest rate risk due to the longer period providing greater smoothing. The 10 year index would likely overact to changes in the interest rate environment, relative to the sector's actual debt costs.
- (d) Rather than representing a transfer of risk to consumers, the extended index protects consumers from interest rate uncertainty since it smooths changes in interest rates over longer periods. The 10-year index is inherently more sensitive to changes in interest rates. The Authority further considers that consumers will benefit from increased investor confidence resulting from the use of the trombone index. The greater the confidence that investors have in regulated utilities, the lower their overall costs of capital should be. An index that better matches the DNOs' debt profile will therefore help create the conditions for further reductions in the overall cost of capital in the longer term.
- (e) The Authority considered the cost of equity and the cost of debt together as part of an overall assessment of the WACC. The Authority concluded that the overall WACC was supported by the balance of evidence, a cost of equity of 6.0% remained appropriate and that the cost of debt index was a reasonable approximation to the efficient cost of debt (Draft Determinations – Financial Issues, paragraphs 2.9, 2.46 [BG2/30-C, AB5/30-C/7, 12]; Final Determinations – Overview paragraph 5.18 [BG2/35-A, AB6/35-A/42-43], Minutes of the meeting of the Gas and Electricity Markets Authority held on 13 November 2014 [RDB/38]).

279. For the reasons set out above, the Authority did not err in changing its approach to the assessment of DNOs' cost of debt as BGT contends at paragraph 4.115. In particular, the Authority:

- (a) had proper regard to the interests of consumers, including the balance of interests between existing and future consumers;
- (b) had proper regard to the principles under which regulatory activities should be transparent and accountable;
- (c) gave adequate reasons for its decision.

280. There are no grounds on which the CMA should intervene as BGT invites it to do at paragraphs 4.117-118 of the NoA, or at all.

## **PART IX: GROUND 6 – ALLEGED PROCEDURAL FLAWS**

281. Ground 6 concerns a number of complaints about alleged procedural flaws. In his permission decision of 30 March 2015, the CMA Inquiry Chair stated that he considered that this ground had no reasonable prospect of success to the extent that it consisted of a general complaint about the Authority's procedure. He therefore directed that CMA's consideration of ground 6 should be limited to a consideration of the matters identified at paragraph 4.128 of the NoA insofar as they relate to the complaints in the first five grounds of appeal.
282. The points made in this Part are also relied on in defence of the substantive grounds of appeal.

### ***The Authority's Duties***

283. The Authority agrees with BGT's observations that the Authority was under a duty to consult on the price control, and to give reasons for its decisions. The precise content of those duties will always depend on the factual circumstance of any particular case. As to the assertion that the Authority is under a duty to act transparently, the duty under the EA89 is to have regard to the principles under which regulatory activities should be transparent, rather than a duty to act transparently. Transparency is therefore one of the considerations to which the Authority must have regard (see *Lumsdon v Legal Services Board* [2014] EWCA Civ 1276 [2014] HRLR 29 at paragraph 84).
284. The Authority had due regard to the principles under which regulatory activities should be transparent; and it acted transparently and consulted extensively and properly. BGT was able to participate effectively in the consultation, and provide intelligent and realistic responses. The Authority's reasons for its decisions were adequate and intelligible.
285. The Authority intends to make legal submissions on the scope of its duties for the hearing. In this Response it is sufficient to state:
- (a) For a party to succeed in a challenge to a consultation, it is not enough to point to minor flaws. Clear unfairness must be shown. Moreover,

fairness must be assessed in the context of the consultation. The obligation on a consulting authority is to enable those with a potential interest in the matter to make an intelligent response. The scope of the duty of fairness will depend in part on the identity of those whom the authority is consulting (see *Moseley v Haringey London Borough Council* [2014] UKSC 56 [2014] 1 WLR 3947 SC). For example, a consultee with a considerable degree of expertise in, and knowledge of, the relevant matters will be likely to be able to respond satisfactorily to presentations of less specificity than will members of the public (see *Moseley* above at paragraph 26, per Lord Wilson JSC).

- (b) A public authority is not obliged to give detailed reasons for every aspect of its decision. As Lord Brown went on to state in *South Bucks District Council v Porter (No 2)* [2004] 1 WLR 1953, cited by BGT at paragraph 4.122 of the NoA, reasons can be briefly stated, and the degree of particularity required depends on the nature of the issues falling for decision; they need refer only to the main issues in the dispute, not to every material consideration. Moreover, "*Decision letters must be read in a straightforward manner, recognising that they are addressed to parties well aware of the issues involved and the arguments advanced*" (paragraph 36).

### ***Alleged Defects in the Authority's Procedure***

286. As a general point, and as BGT sets out at paragraph 4.123, the consultation process has been extensive, lasting around three years. The Authority involved and engaged with not only the DNOs, but also other stakeholders such as BGT, who had many opportunities to contribute to the process. The stages of the consultation were:

- (a) The open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1, dated 6 February 2012 **[BG2/6 AB3/6]**.

- (b) Two workshops on business plan guidance on 13 July 2012 and 25 July 2012 – the first open to all interested stakeholders, the second open to DNOs only **[RDB/14]**.
- (c) The strategy consultation, which ran from 28 September 2012 to 23 November 2012 **[BG2/8, AB3/8]**. The Authority received 49 responses to this including a response from British Gas and other non-DNOs.
- (d) The strategy decision following the above consultation, dated 4 March 2013 **[BG2/10, AB4/10]**.
- (e) An open letter consultation on the business plans submitted to Ofgem by the DNOs, which was addressed at other stakeholders such as British Gas – **[BG2/11, AB4/11]**. British Gas responded to this submitting three expert reports (on the WACC, on the incentives, and on the cost efficiency and expenditure assessment) **[BG2/12, AB4/12]**. This ran from 1 July 2013 to 2 August 2013.
- (f) A consultation on the customer service and connections incentive which ran from 4 September 2013 to 30 October 2013. Notwithstanding that BG now raises complaints about BMCS, it did not respond to this consultation **[BG2/13, AB4/13]**.
- (g) A consultation on the timing of a decision on DNOs revenues for 2015/16 – which ran from 4 October to 4 November 2013, **[BG2/14, AB4/14]**.
- (h) Draft Determinations for the fast tracked DNOs (WPD) – a consultation which ran from 22 November 2013 to 22 January 2014 **[RDB/19]**. British Gas responded to this – but did not raise all the concerns that it raises now. See below.
- (i) The RIIO-ED1 business plan assessment and fast tracked consultation which also ran from 22 November 2013 to 22 January 2014 **[BG2/16, AB4/16]**.

- (j) A consultation on methodology for assessing the equity market return for the purpose of setting RIIO price controls. This was published on 6th December 2013 and closed on 10th January 2014 [**BG2/17**, **AB5/17**].
- (k) Three informal consultation on fast-track licence drafting, two of which ran from 10th January 2014 to 7th February 2014 and one of which ran from 31<sup>st</sup> January 2014 to 28<sup>th</sup> February 2014 [**RDB/22**] and [**RDB/23**].
- (l) A consultation on the draft RIIO-ED1 Environment Report Guidance Document (ERGD). This was published on 7th March 2014 and closed on 4th April 2014 [**RDB/31**].
- (m) A statutory consultation on proposed modifications to special conditions of the electricity distribution licences held by the four licensees owned by Western Power Distribution plc (WPD). This was published on 28th March 2014 and closed on 29th April 2014 [**RDB/32**].
- (n) A statutory consultation on proposed modifications to the standard conditions of the electricity distribution licences. This ran from 28th March 2014 to 29th April 2014 [**RDB/33**].
- (o) An open letter consultation on revised RIIO-ED1 business plans. This ran from 31st March 2014 to 12th May 2014 [**BG2/25**], [**AB5/25**]. BGT's response can be found at [**BG2/27**], [**AB5/27**].
- (p) Draft Determinations consultation for the slow-track electricity distribution companies, running from 30th July 2014 to 26th September 2014 [**BG2/30**], [**AB5/30**]. BGT's response is at [**BG2/32**], [**AB5/32**]. BGT's response was one of 17 which the Authority received.
- (q) A consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators. This was published on 28th August 2014 and closed on 26th September 2014 [**BG2/31**], [**AB5/31**]. BGT's response is at [**BG2/33**], [**AB6/33**].

- (r) An informal consultation on slow-track licence drafting – Charge Restriction Conditions. This was published on 26th September 2014 and closed on 24th October 2014 **[BG2/34], [AB6/34]**.
- (s) The Incentive on Connections Engagement (ICE) Guidance Document consultation. This ran from 4th December 2014 to 5<sup>th</sup> January 2015 **[RDB/40]**.
- (t) The Stakeholder Engagement and Consumer Vulnerability (SECV) incentive consultation. This ran from 16th December 2014 to 16th January 2015 **[RDB/41]**.
- (u) The statutory consultation on proposed modifications to the standard conditions of the electricity distribution licences. This was published on 17th December 2014 and closed on 19th January 2015 **[BG2/36], [AB6/36]**. BGT's response to this is at **[BG2/38], [AB6/38]**.
- (v) A consultation on the assessment of benefits from the roll-out of proven innovations through the Innovation Roll-out Mechanism. This was published on 7th January 2015 and closed on 4th March 2015 **[RDB/42]**.
- (w) A consultation on the draft RIIO-ED1 Environment Report Guidance Document, which ran from 28th January 2015 to 25th February 2015 **[RDB/43]**.
- (x) Draft regulatory instructions and guidance for the electricity distribution networks. This consultation ran from 28th January 2015 to 25th February 2015 **[RDB/44]**.
- (y) Consultation on updates under CRC 4C Price control update provisions for WPD; Publication date 3rd February 2015; Closing date 17th February 2015 **[RDB/45]**.

287. In addition to the consultation referred to above, the Authority further engaged with DNOs and other interested parties through working groups and other discussion meetings from the outset of the RIIO-ED1 process, many of which

were directed at specific aspects of the development of the strategy decision. These principally comprised the following:

- (a) The Price Control Review Forum, which provided stakeholder representatives and DNOs with the opportunity to give input directly into the price control process. Price Control Review Forums were held on 29 May 2012, 3 December 2012, 30 July 2013, 23 April 2014 and 10 September 2014.
- (b) The Customer and Social Issues Working Group, at which issues including the BMCS were discussed. Several non-DNO parties participated in these including DECC, Consumer Focus, Fuel Poverty Advisory Group, Welsh Government and Age UK. BGT, however, did not participate.
- (c) The Connections Working Group. Again, non-DNO parties participated in these including DECC, Powercon, RWE Renewables, Large Users Group, Amey, GTC and the House Builders Federation.
- (d) The Flexibility & Capacity Working Group. Non-DNO participants included RenewableUK, Good Energy, DECC, RWE Renewables, London First, CHPA, Consumer Focus and West Coast Energy.
- (e) The Environment Working Group. Non-DNO participants included the Scottish Government, Council for Protection of Rural England, Greater London Authority, CNP, Wildlife Trust, DECC, Scottish Environment Protection Agency and the Renewable Energy Association.
- (f) The Reliability and Safety Working Group, at which details of the IIS were discussed at length but which was not attended by BGT.
- (g) The Innovation Working Group. This was a continuation of the working group created for RIIO-T1 and GD1 and included DECC, the Renewable Energy Association, the Energy Innovation Centre and a consultancy.
- (h) The Finance Working Group.

- (i) The Cost assessment Working Group which looked at the toolkit of methods to assess efficient costs in the business plans.

288. The Authority agrees that it is in the public interest that stakeholders on the purchasing side should also be able to engage effectively, and that major suppliers such as BGT are particularly well placed to do so. It is clear that BGT has had extensive opportunities to engage with the process. The Authority notes the following with respect to BGT's assertion that it is particularly well-placed to represent the interests of consumers:

- (a) As a supplier, BGT clearly has interests of its own which are not aligned directly with those of consumers. A representative consumer body such as Citizen's Advice has a clearer and indeed formal role as the advocate of consumers' interests.
- (b) The Authority established a Consumer Challenge Group for RIIO-ED1 which consisted of a range of consumer experts which acted as a "critical friend" to Ofgem and provided an external perspective on whether elements of the price control settlement were in the interests of consumers. Details of the composition and function of the Consumer Challenge Group were contained in notes dated April 2013 and December 2013 ([RDB/17] and [RDB/20]).

289. As further general points:

- (a) While BGT has made a number of submissions throughout the process, it has not sought every opportunity to engage with the consultation. For example, BGT did not attend any of the Customer and Social Issues working group meetings or the Reliability and Safety working group meetings - which were open to all, and whose minutes were published regularly on the internet. The working groups were described and advertised as open to all in the Authority's open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1, dated 6 February 2012 [BG2/6] [AB3/6/5]. They were further discussed at the Price Control Review Forum on 29 May 2012, which Mr Andrew Manning of BGT attended [RDB/13]. Moreover, some

of BGT's specific requests for information were made *after* the final licence modification Decision.

- (b) While the Authority has not always discussed BGT's submissions in detail in its public decision documents, it has made its reasoning and analysis clear. As set out above, a public authority is not obliged to give detailed reasons on every aspect of its decision.
- (c) Moreover, a very substantial number of stakeholders engaged with the RII0-ED1 process. The Authority received 49 responses to its Strategy Consultation from DNOs, National Grid, DECC, environmental groups, consumer groups and other stakeholders; 15 responses to its Draft Determinations for WPD; 29 responses to its Draft Determinations for slow track DNOs from DNOs, a transmission operator, a supplier, consumer groups and other stakeholders. Many of these responses annexed lengthy expert reports (ENA for example attached six expert reports in its response to the Strategy Decision). BGT attached three expert CEPA reports to its response to the Open Letter Consultation on DNOs' business plans.
- (d) In these circumstances the Authority takes into consideration all views, and gives reasons in its public documents. However, it is both wholly impractical, and in any event not required of it in a consultation of this magnitude, to respond in forensic detail to every point raised by every consultee, for instance with the type of analysis (for example of inter-general equity or financing issues) which BGT appears (mistakenly) to suggest is required. Even if the Authority had been able to respond publicly in forensic detail to every submission it received during the course of the price control process, this would have rendered its decision documents inaccessibly lengthy to many stakeholders.
- (e) While the Authority has expanded on its reasoning in correspondence such as its letter to BGT of 3 February 2015 [BG1/6], [AB2/6], its decisions were adequately reasoned in the Final Determinations.

290. In the circumstances, BGT has had numerous opportunities to engage, and in some cases has not raised concerns which it now raises in the appeal:
- (a) Its detailed complaints regarding BMCS are for the most part new. Whilst BGT noted some high level concerns during our RIIO-ED1 Strategy Consultation and has recently suggested that they expect the DNOs to perform well under the BMCS, at no point prior to its appeal has BGT raised the detailed concerns it now raises about the *design* of the BMCS. Most notably, BGT did not respond to our specific consultation about the design of the BMCS.
  - (b) It did not ask for details of the IIS analysis before February 2015, *after* the Authority had made its decision.
291. The Authority therefore does not agree that BGT has been unable to engage effectively.
292. As regards paragraph 4.127 of the NoA, it is incorrect that every significant policy change made by the Authority since the Strategy Decision has been either neutral or to the advantage of the DNOs. For example, the Authority's change in approach to RPEs, and to SGBs, referred to above, reduced the DNOs' proposed expenditure allowances by some £790mn. Moreover the Authority considers that all the policy decisions that it has taken have served the interests of consumers. Further, it would in any event be wrong to infer from the policy decisions made following the Strategy Decision that the process did not take into account representations made during the consultation.
293. BGT makes various statements about alleged lack of transparency at paragraph 4.128 of the NoA. As regards these:
294. **In the case of directly remunerated services in DPCR5:**
- (a) The Authority most recently explained its reasoning in its letter to BGT of 3 February 2015 [BG2/39], [AB6/39], in which it set out the considerations of intergenerational equity which suggested that an

immediate reduction to allowed revenues would not serve the interests of present and future consumers taken together.

- (b) In the same letter, the Authority explained how its approach to the issue of asset lives supported its approach to the return of double-recovered costs. Moreover, as further explained above, the effect of moving to a 45-year asset life policy on the costs to consumers was explained by the Authority publicly on many occasions.
- (c) The Authority further explained its approach in Final Determinations.
- (d) The issues were also discussed in a meeting between Ian Rowson of Ofgem and Andrew Manning on 28 May 2014 following email correspondence between Ofgem and BGT. At the meeting, Ian Rowson explained the approach of the Authority described above.

295. **In the case of IIS**, the Authority provided a full discussion of the scheme in:

- (a) Strategy Decision paragraphs 4.7-4.25 **[BG2/10], [AB4/10-B/32-35]**
- (b) Strategy Consultation chapter 4 **[B2/8 AB3/8-B]**
- (c) The Reliability and Safety Working Groups, which BGT did not attend (although stakeholders were invited to do so), and which contained further discussion of the details of the IIS. In particular, Ofgem presented its methodology at a meeting of the Reliability and Safety Working Group on 17 May 2012 **[not in appeal bundles – exhibit relevant slides and minutes.]** The relevant presentation was made publicly available on the Authority's website on 12 July 2012.

296. The Authority acknowledges that it gave incomplete information about the way in which CML improvement factors and targets were set insofar as it stated in its the Strategy Decision – Reliability and Safety, para 4.57, **[BG2/8-C] [AB3/8-C/28]**, that: "*[f]or the CML targets, the improvement factors are outlined in Table 4.5 below, these are based on assessing the CML/CI performance of the industry at each voltage level over the same number of years as is used in setting our proposed targets (under the up-front*

*approach*)". The omission was not significant overall, however. The reasoning at the consultation stage and in the Decision were sufficient to enable BGT to have a proper understanding of, and intelligent response to, the Authority's policy decision. Moreover, the complete and accurate picture was presented in the Reliability and Safety Working Group on 17 May 2012, the slides and minutes for which were publicly available on the Authority's website. BGT did not ask for detailed information on the scheme before 9 February 2015 – after the Authority had made its final decision. As for that further correspondence, the Authority has explained that it was unable to provide all the information requested because it was confidential under section 105 of the Utilities Act 2000. The CMA has now directed us to disclose such information, so that the Authority is now permitted under the Utilities Act 2000 to do so.

297. It should be noted that BGT did not appeal against the Authority's decision to modify WPD's licence in the fast track process, although the same IIS was applied to that modification, and information which they claim supports their case was available to BGT at the time that the Authority took that decision.
298. **In the case of BMCS**, the Authority set out its approach in:
- (a) Customer Service and Connections Incentive Decision 2 December 2013 **[BG 2/17], [AB4/10-B/62-71]**.
  - (b) Strategy Decision – Outputs, Innovation and Incentives, Chapter 6 **[BG2/10], [AB4/10-B/62-71]**.
299. Moreover, as set out above, BGT failed to take opportunities to engage with the Authority on this matter. BGT:
- (a) did not attend the Customer and Social Issues Working Groups at which BMCS was discussed; these were open to all and the minutes were regularly displayed on the internet;
  - (b) did not raise the issue in its 22 January 2014 response to the Authority's consultation on WPD (and, again, did not appeal);

- (c) did not raise the issue in its response to Draft Determinations 26 September 2014 **[BG2/32]**, **[AB5/32]**;
  - (d) did not respond to the consultation of 16 December 2014 on how to assess performance under the stakeholder engagement incentive **[RDB/41]**.
  - (e) did not raise the issue in its response of 19 January 2015 to the final statutory consultation **[BG2/38]**, **[AB6/38]**.
300. Moreover, BGT only made further enquiries on 17 February 2015, after the Authority had made the final decision. If BGT had failed to understand any of the detail of the scheme, it had many opportunities to ask for further information.
301. **In the case of the IQI**, the Authority explained its reasoning in:
- (a) Draft Determinations – Overview paragraphs 4.52-60 **[BG2/30]**, **[AB5/30/34-37]**.
  - (b) Final Determinations – Overview paragraphs 4.84 – 4.96, **[BG2/35]**, **[AB6/35/37-39]**.
  - (c) Letter to BGT 3 February 2015 **[BG2/39]**, **[AB6/39]**. This letter did not postdate the final licence modification Decision as BGT alleges; it was contemporaneous with, and part of, the Authority's decision. The Authority responded to points raised in BGT's response to the statutory consultation, as it is required to under section 11A(7)(c) EA 89 **[BG1/6]**, **[AB2/6]**.
302. Those reasons at (a) and (b) above were sufficient to enable BGT to respond intelligently. The Authority explained that the cost of the IQI should be set off against savings made through the comparative cost assessment. It was seeking to explain that the existence of the IQI had prompted significant savings at the cost assessment stage which far surpassed the cost to consumers of the change in breakeven point. It is not understood what further information BGT could have required as regards why the change to the IQI

would be expected to improve incentives to provide good quality information in future price controls; or why the underestimation of savings as regards SGBs and RPEs justified an adjustment to the IQI. There is no duty on the Authority to provide detailed supporting analysis to show the effects of the adjustments to the approach to SGBs and RPEs.

303. **In the case of the transitional arrangements for the change in asset depreciation policy** the Authority's consultation in the area of asset depreciation periods was extensive:

- (a) The Authority engaged with stakeholders at length during the RPI-X@20 process. The Authority invited and received responses on its new asset depreciation policy from a broad range of consultees in relation to both its January 2010 RPI-X@20 Emerging Thinking document and its July 2010 RPI-X@20 Recommendations. These consultation periods were 11 and 6 weeks respectively. The above documents set out and explained the Authority's concerns relating to the financeability and the inter-generational equity issues which would arise from the move to a longer asset life.<sup>97</sup>
- (b) The Authority conducted a specific consultation in relation to asset lives for the electricity distribution sector between January and March 2011. In this consultation, the Authority specifically referred to the possibility of transitional arrangements managed over one price control period.<sup>98</sup> Prior to this consultation, it made publicly available the report by CEPA,<sup>99</sup> which analysed: the cash-flow issues caused by the move to a longer depreciation period; and the mitigation of those issues by way of transition.

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<sup>97</sup> RPI-X@20 Emerging Thinking, p. 36 [RDB/3]; RPI-X@20, Emerging Thinking – Embedding financeability in a new regulatory framework, p. 8 [RDB/4]; RPI-X@20 Recommendations, pp. - 46-48 [RDB/5]

<sup>98</sup> Open letter consultation on the regulatory asset lives for electricity distribution assets, 14 January 2011 [BG2/56] [AB9/5].

<sup>99</sup> CEPA, "The economic lives of energy network assets", December 2010, p. 5 [BG2/55] [AB9/4].

- (c) In its Strategy Consultation, the Authority again consulted on its preference for transitional arrangements managed over one price control period.<sup>100</sup>
- (d) The Authority's reasoning was made clear from the consultation and decision documents outlined above. The business plan submissions of the DNOs, also publicly available and open for consultation, further contained detailed reasoning on the impact of transitional arrangements on the financeability of the DNOs – which the Authority accepted in its slow track Draft Determinations.<sup>101</sup> The Authority further explained its reasoning in its letter to BGT of 3 February 2015, in which the Authority replied to BGT's response to the statutory consultation on the slow-track licence modifications.

304. **In the case of cost of debt indexing**, the Authority explained the position at:

- (a) Draft Determinations: Financial Issues, pp 9-15 **[BG2/30]**, **[AB5/2/30]**.
- (b) Final Determinations – Overview, Appendix 8, **[BG2/39]**, **[AB6/39]**.

305. The Authority explained, contrary to BGT's assertion at paragraph 4.128 e, why the Authority considered it appropriate to remunerate efficiently incurred debt costs (see RIIO Handbook paragraphs 12.13 onwards **[BG2/4]**, **[AB3/4/108]**). Its Draft Determinations provided sufficient evidence and analysis to justify its change of approach on this issue. Moreover, in its letter of 3 February 2015, which was contemporaneous with, and part of, its Decision, the Authority explained the difficulties of carrying out an assessment of the efficiency of DNOs' debt costs (paragraph 16), and why it considered that the decision was in the consumer interest (paragraph 14). The Authority was not under a duty to address all of BGT's concerns in the Draft or Final Determinations. As set out above, the Authority had received numerous responses, on many issues; in those circumstances, there was no duty to address each and every submission made, either in those Determinations or in its letter of 3 February 2015.

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<sup>100</sup> Strategy Consultation - Overview, p. 6 **[BG2/10]** **[AB4/10-A/6]**

<sup>101</sup> Draft Determinations – Financial Issues, §3.52 **[BG2/30]** **[AB5/30-C/25]**

306. As regards paragraph 4.128 (f) of the NoA as regards the importance of price controls:
- (a) While the Authority acknowledges the importance of the price control decision, its scope of its duties to consult and to give reasons is defined in the context of the multiplicity of issues, the numbers of responses received, and the length of the decision.
  - (b) It would have been impractical to go into the amount of detail that BGT incorrectly says is required.
  - (c) The Authority must also have regard to the principle of proportionality; for example as regards the complaint regarding DRS which involved a relatively minimal sum, namely around £32mn).
307. In the circumstances, contrary to paragraph 4.130 of the NoA:
- (a) The Authority had due regard to the principles of transparency and accountability and acted in accordance with its duties;
  - (b) The Authority acted lawfully, fairly, and in accordance with its statutory obligations to consult and to give reasons.
308. The Authority does not accept that the present appeal requires an intensive scrutiny of the underlying merits of its decision, although it does consider that the appeal process is sufficient remedy for any of BGT's complaints. It intends to make further submissions on these legal issues at the hearing. As regards BGT's invitation to the CMA to issue guidance on the principles relating to transparency, we note that the CMA decided not to grant permission to BGT's wider process points.

## **CONCLUSION**

309. For all the reasons given above, the Authority invites the CMA to dismiss BGT's appeal. In the event that BGT's appeal is allowed in any part, however, the Authority reserves its right to make detailed submissions as to the remedy and licence amendments arising from the CMA's decision.

**STATEMENT OF TRUTH**

I, Maxine Frerk, on behalf of the Gas and Electricity Markets Authority, believe the facts and information stated in this Response to be true.

Signed: .....  
.....

Maxine Frerk, Senior Partner, Smarter Grids and Governance

Dated: ..... 22/4/15 .....

## Annex 1

### RIIO-ED1 Glossary of Terms

#### A

##### Administrative burden

Things that business must do or other administrative costs that businesses sustain due to a requirement from regulation. This may include keeping records or responding to information requests.<sup>102</sup>

##### Allowed revenue

The amount of money that a network company can earn on its regulated business and recover from customers through the distribution use of system charges. Allowed revenue comprises base revenue, incentive rewards or penalties and allowances from uncertainty mechanisms.

##### Arithmetic mean

A simple average. The sum of all observations divided by the number of observations.

##### Asset Replacement

An activity undertaken by the DNOs to remove existing assets and install a new asset. The driver for this replacement may be due to poor asset condition, obsolescence or environmental or safety liabilities.

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<sup>102</sup> <http://www.berr.gov.uk/whatwedo/bre/policy/simplifying-existing-regulation/administrative-burdens/page44061.html>

The principal assets replaced as part of a replacement project are captured as primary assets. Where associated assets are also replaced to facilitate the primary asset replacement, these are counted as consequential assets

### The Authority/Ofgem/GEMA

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

### Average time to connect incentive

A proposed new price control incentive for RIIO-ED1 that aims to improve the average overall time taken to connect customers to the distribution system.

## B

### Base revenue

The core amount of money that a network company can earn on its regulated business in order to recover the efficient costs of carrying out its activities. Base revenue includes allowances for operating costs, the return of capital (depreciation), return on capital, tax, pension deficit repair and any adjustments to previous allowances.

### Benchmarking

The process used to compare a company's performance (e.g. its costs) to that of best practice or to average levels within the sector.

## Better regulation and better regulation principles

Established principles of better regulation state that regulation should be transparent, accountable, proportionate, consistent, and targeted only at cases where action is required.

Ofgem has interpreted better regulation to mean only regulating where necessary whilst designing rules that support competition and protect the customer. As part of our better regulation work Ofgem develops an annual Simplification Plan to help reduce the burden of administration while ensuring consumer protection.<sup>103</sup>

## Black Start

The series of actions necessary to restore electricity supplies to customers following a total or widespread partial shutdown of the GB Transmission System. Black Start requires distribution substations to be re-energised and reconnected to each other in a controlled way to re-establish a fully interconnected system.

## Black Start Resilience

Refers to resilience of both the distribution network assets and the key telecommunications systems, essential to DNOs for the organisation and coordination of resources, to a prolonged loss of supply in order to implement restoration plans under Black Start conditions. The required level of resilience shall meet the recommendations of the Electricity Task Group sub-committee of the Energy Emergency Executive Committee (E3C).

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<sup>103</sup> Further details can be found at the following link:  
<http://www.ofgem.gov.uk/About%20us/BetterReg/Pages/BetterReg.aspx>

## Bond

A type of debt instrument used by companies and governments to finance their activities. Issuers of bonds usually pay regular cash flow payments (coupons) to bond holders at a pre-specified interest rate and for a fixed period of time.

## Broad Measure of Customer Satisfaction (BMCS)

A composite incentive consisting of a customer satisfaction survey, a complaints metric and stakeholder engagement. It was introduced for DPCR5 and is designed to drive improvements in the quality of the overall customer experience by capturing and measuring customers' experiences of contact with their DNO across the range of services and activities the DNOs provide.

## Building blocks approach

Building block reviews focus on determining appropriate values for each company's own capital asset values, weighted average cost of capital (WACC), capital expenditures and operating expenditures for the upcoming price control period.

## Business Support Costs (BSCs)

The indirect operating costs required to support the overall business. For more information on what this includes, see the Regulatory Instructions and Guidance (RIGs) Glossary:

[http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

## BT 21st Century (BT21CN)

21CN refers to the roll out of BT's next generation communications network which replaces Public Switched Telephone Network (PSTN) with a Digital Internet Protocol (IP). Whilst effectively changing the communications protocol used on the existing

network assets, it also accelerates the replacement of copper communications circuits with non-metallic optical fibre.

## C

### Call Centre

Responding and managing the main telephone lines for the business. Where reports or queries require further investigation by another division of the business these costs are not included except to the extent that a member of the Call Centre team responds after obtaining additional information.

### Capital Asset Pricing Model (CAPM)

A theoretical model that describes the relationship between risk and required return of financial securities.

The basic idea behind the CAPM is that investors require a return for the rate of interest, and a return for the level of risk in their investment.

### Capital expenditure (capex)

Expenditure on investment in long-lived assets. For more information on what this includes, see the RIGs Glossary: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

### Capitalisation policy

The approach that the regulator follows in deciding the percentage of total expenditure added to the RAV (and thus remunerated over time) and the percentage of expenditure remunerated in the year it is incurred.

## Carbon footprint

Total amount of greenhouse gas emission caused directly and indirectly by a business or activity.

## Chief Executive Officer (CEO) and Other Corporate Functions

Combines the activities of:

- Non-executive and group directors labour and Board meeting costs
- Management charges from Affiliates of a general non-specific nature
- Corporate communications/Community Awareness
- Legal services
- Company secretarial services.

For more information on what this includes, see the RIGs Glossary:

[http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

## CI- Customers interrupted per year

The number of customers interrupted per year (CI). This is the number of customers whose supplies have been interrupted per 100 customers per year over all incidents, where an interruption of supply lasts for three minutes or longer, excluding re-interruptions to the supply of customers previously interrupted during the same incident.

## CI/CML Schemes

Any discretionary schemes primarily aimed at improving CI and/or CML performance.

### Closely Associated Indirect Costs (CAIs)

The indirect operating costs that support the operational activities of the DNO. For more information on what this includes, see the RIGs Glossary: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

### CML- Duration of interruptions to supply per year

The duration of interruptions to supply per year (CML). This is the average customer minutes lost per customer per year, where an interruption of supply to customer(s) lasts for three minutes or longer.

### Competition Commission (CC)

An independent public body which conducts in depth inquiries into mergers, markets and aspects of regulation of the major regulated industries.

### Competition and Markets Authority (CMA)

The CMA is a new organisation bringing together the Competition Commission (CC) and the Office of Fair Trading (OFT). The CMA was created in a shadow form by the Enterprise and Regulatory Reform Act 2013 on 1 October 2013 and will take on its full responsibilities from 1 April 2014.

### Competition Test

The Competition Test involves an assessment of whether there is effective competition in a relevant market segment. It is set out in Distribution Price Control 5 Final Proposals – Incentives and Obligations and referenced in CRC12.

### Composite Scale Variable (CSV)

A method of combining a number of different cost drivers in to a single driver for regression analysis using fixed pre-determined weights.

### Connection Boundary

The connection charging boundary describes the split of connection costs between the DNO and the connecting customer. The costs allocated to the connecting customer are recovered via a connection charge and the costs allocated to the DNO will be recovered from all network users via use of system charges.

### Connection Quotation

The notice required to be given by an electricity distributor in accordance with section 16A(5) of the Electricity Act 1989.

### Connection Completion

The completion of electrical works to the point that, subject only to the fitting of an appropriate meter where necessary, energisation would be possible.

### Connections

Within the reporting for DPCR5, the term connection refers to the provision of exit points. All provisions of new exit points or upgrades of existing exit points should be referred to as connections within the annual reporting for connections.

### Consumer

In considering consumers in the regulatory framework we consider users of network services (for example generators, shippers) as well as domestic and business end consumers, and their representatives.

### Consumer Challenge Group

The consumer challenge group comprises of members appointed by Ofgem on the basis of their expertise in the interests of present and future consumers and energy sector knowledge. Their role in the price control review process is to provide Ofgem with advice on consumer priorities for the price control. To help achieve this the group seeks to identify the main questions that consumers have about the price control and what needs to be addressed in the various documents published by Ofgem in the price review process.

### Consumer First Panel

The Panel, set up by Ofgem, consists of 100 domestic customers, recruited from five locations across Great Britain. The Panel meets at least three times a year to discuss key issues related to energy. It was first established in July 2008.

### Contestable Activities

Connections activities that can be carried out by a non-affiliated third party with relevant accreditation.

### Control Centre

Operational management and control of the network, outage planning and management.

Relates to both the short term and long term outage planning and management that is carried within the Control Centre, at all voltage levels, prior to the undertaking of planned incidents.

### Cost of capital

This is the minimum acceptable rate of return on capital investment. It includes both the cost of debt to a firm, and the cost of equity.

### Cost of debt

The effective interest rate that a company pays on its current debt. Ofgem calculates the cost of debt on a pre-tax basis.

### Cost of equity

The rate of return on investment that is required by a company's shareholders. The return consists both of dividend and capital gains (e.g. increases in the share price). Ofgem calculates the cost of equity on a post-tax basis.

### Credit rating

An evaluation of a potential borrower's ability to repay debt. Credit ratings are calculated from financial history and current assets and liabilities. There are three major credit rating agencies (Standard & Poor's, Fitch and Moody's) who use broadly similar credit rating scales, with D being the lowest rating<sup>104</sup> (highest risk) and AAA being the highest rating (negligible risk). The companies regulated by Ofgem typically have a credit rating of BBB, BBB+, A- or A.

### Critical National Infrastructure (CNI)

Critical National Infrastructure (CNI) refers to sites designated as CNI by DECC.

### Criticality Index (C)

The Criticality Index (C) is a framework for collating information on the Consequences Of Failure of distribution assets and for tracking changes over time.

The Criticality Index is a comparative measure of Consequence Of Failure. For a particular asset, the Criticality Index is provided by:-

- the location of the asset within the Criticality Index Bands; and

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<sup>104</sup> The lowest credit rating on Moody's scale is C.

- the Average Overall Consequence Of Failure, for the relevant Health Index Asset Category

### Customer Contributions

Revenue recovered from specific customer for individual services via relevant charges.

## D

### De minimis

Any business conducted or carried on by the licensee, or by an Affiliate or a Related Undertaking of the licensee in which the licensee holds shares or other investments, other than:

- the Distribution Business
- any other business or activity to which the Authority has given its consent under paragraph 4 of standard condition 29 (Restriction of activity and financial ring-fencing of the Distribution Business).

### Dead-band

In the context of the tax trigger, the dead-band is a fixed percentage of base demand revenue outside of which, if positive, licensees will receive additional revenues, or, if negative, incur a clawback of base demand revenues that were set at the price control, arising from the activation of the tax trigger and the charge restriction conditions.

### Demand connection

A new or modified connection that enables the premise to receive a supply of electricity from the electricity distribution system.

### Demand side management (DSM)

Demand side management (or load management) is any mechanism (both social and mechanical) that allows a customer's demand to be intelligently managed in response to events on the power system. Such events would include lack of network capacity or insufficient generation.

### Department of Energy and Climate Change (DECC)

### Depreciation

Depreciation is a measure of the consumption, use or wearing out of an asset over the period of its economic life.

### Direct Activities

Those activities which involve physical contact with system assets. For more information on what this includes, see the RIGs Glossary: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

### Direct Expenditure

Expenditure incurred undertaking Direct Activities.

### Design Life

The period over which an asset is designed to last.

## Dismantlement

Dismantlement is the activity of de-energising, disconnecting and removing (where appropriate) network assets where the cost of dismantlement is not chargeable to a third party and no new assets are to be installed.

## Distributed Generation (DG)

Any generation which is connected to the local distribution network, as well as combined heat and power schemes of any scale. The electricity generated by such schemes is typically used in the local system rather than being transported across the UK.

Means an installation comprising any plant or apparatus for the production of electricity that is directly connected to the licensee's Distribution System or is connected to that system through one or more electricity networks (other than an onshore Transmission System) that is or are directly connected to it.

## Distributed Generation (DG) Forum

A series of regional events held by Ofgem in 2011 and 2012 to discuss explore the experience of connecting distribution generation to the distribution network.

## Distributed Generation (DG) Information Strategy

A strategy set out by the distribution network operator and approved by the Authority that outlines how the distribution network operator intends to ensure that all existing and potential DG connection customers of its distribution system are able to receive an adequate level of information and a satisfaction standard of service.

## Distributed Generation (DG) Connections Guide

A common set of documents produced by the DNOs and approved by the Authority that provides guidance on:

- The details of the statutory and regulatory framework (including health and safety considerations) that apply to DG connections
- The likely costs, charges, and timescales involved in the application process.
- The details of the arrangements and opportunities available for competitive activity in the provision or procurement of a connection.
- Engineering and other technical matters relevant to the commissioning, energisation, and maintenance of such connections.

### Distribution billing (DUoS)

For the purposes of the IT and Telecoms Systems Overview worksheet of the Cost and Revenue RIGs, are IT systems that assist with DUoS billing.

### Distribution Network Operators (DNOs)

Holders of electricity distribution licences. Licences are granted for specified geographical areas in Great Britain. Currently there are 14 DNOs owned by six different groups.

### Distribution Price Control Review 3 (DPCR3)

The price control review for the electricity distribution network operators covering the period from 1 April 2000 to 31 March 2005.

### Distribution Price Control Review 4 (DPCR4)

The price control review for the electricity distribution network operators covering the period from 1 April 2005 to 31 March 2010.

### Distribution Price Control Review 5 (DPCR5)

The price control review for the electricity distribution network operators covering the period from 1 April 2010 to 31 March 2015.

### Distribution network

The distribution system is a network of wires, transporting electricity from the transmission system or distribution connected generation to domestic, commercial and industrial electricity consumers.

The electricity distribution network includes all parts of the network from 132kV down to 230V in England and Wales. In Scotland 132kV is considered to be a part of transmission rather than distribution.

### Diversions (conversion of wayleaves to easement)

Costs involved in retaining assets by way of the purchase of land or easements and the cancellation of terminable agreements, for example in response to injurious affection claims.

### Diversions (non-fully rechargeable)

Diversions activity that is not fully recharged to any third party or agent.

### Diversions due to wayleave terminations

The raising or rerouting of a circuit and/or the relocation of plant following the termination of a wayleave or lease.

### Diversions for Highways

The raising or rerouting of a circuit or repositioning of plant associated with new roads or streetworks. Such costs represent the DNO proportion of the costs. The proportion that is charged to the customer is reported under ES2.

## Draft Determinations

Consult on the proposed DNO settlements for the price control period. In previous price control reviews, Draft Determinations were called Initial Proposals.

## E

### Early Retirement Deficiency Contributions (ERDC)

Cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

### Earthing upgrades

Where earthing, at a substation site with a primary voltage greater than HV, has been upgraded by the installation of additional earth electrodes to mitigate against a high earth potential rise (EPR) or step and touch potentials in excess of tolerable limits.

This excludes sites where earthing has been replaced due to fault or theft.

### Easements

An entitlement to retain assets in a location for a determined period of time or in perpetuity without risk of interference from the owner.

### Economic Life

The period over which an asset performs a useful function.

### EHV (Extra High Voltage)

Voltages over 20kV up to, but not including, 132kV.

### EHV end connection involving only EHV work

A demand connection at EHV level where the only voltage of the assets involved in providing such connection, and any associated works, is EHV.

### Energisation

The insertion of a fuse or operation of a switch that will allow an electrical current to flow from an electricity distributor's distribution system to the customer's installation, or from the customer's installation to that distribution system.

### Energy Ombudsman/Ombudsman Services (EO)

Ombudsman Services provides an independent dispute resolution service for the communications, energy, property and copyright licensing sectors.

### Engineering Management and Clerical Support

The office-based activities of engineering and clerical support staff (i.e. depot clerical staff, managers, work planners, etc) managing or assisting employees undertaking direct activities and wayleave administration.

### Equity beta

The equity beta measures the covariance of the returns on a stock with the market return. The weaker this co-variance, the greater the contribution that the stock could make to reducing the exposure to systematic risk, and hence the lower the return that investors would require on that stock.

### Equity risk premium

A measure of the expected return, on top of the risk-free rate, that an investor would expect for a portfolio of risk-bearing assets. This captures the non-diversifiable risk

that is inherent to the market. Sometimes also referred to as the 'market risk premium'.

### Excluded Market Segment

Any of the excluded market segments that are described in or determined in accordance with Appendix 1 of Charge Restriction Condition 12 (CRC 12). In DPCR5 Final Proposals Ofgem considered that competition was not viable in these market segments at that time or in the foreseeable future.

## F

### Fault

Any incident arising on the licensee's distribution system, where statutory notification has not been given to all customers affected at least 48 hours before the commencement of the earliest interruption (or such notice period of less than 48 hours where this has been agreed with the customer(s) involved).

### Fault Level Reinforcement

Work carried out on the existing network where the prime objective is to alleviate fault level issues associated with switchgear or other equipment.

### Fault Rate

A Fault Rate is the incidence per unit of unplanned incidents for a specific category of distribution assets.

Fault Rates form part of the DPCR5 Network Output Measures.

## Final Determinations

Set out the final DNO settlements for the price control period. In previous price control reviews, Final Determinations were called Final Proposals.

## Finance and Regulation

Performing the statutory, regulatory and internal management cost and performance reporting requirements, and customary financial and regulatory compliance activities for the DNO.

## Financeability

Financial models are used to determine whether the regulated energy network is capable of financing its necessary activities and earning a return on its regulated asset value (RAV) under the proposed price control. This financeability is assessed using a range of different financial ratios.

## Financial structure

The way in which a company finances its assets, for example through short-term borrowings, long-term debt and shareholder equity.

## Fuel poverty

A fuel poor household is defined as one that needs to spend 10% or more of their household income on all fuel use in order to maintain a satisfactory heating regime. DECC's latest fuel Fuel Poverty review (Hills Fuel Poverty Review) recommends that any household that requires fuel costs above the median level and, if they were to spend that, are left below the official poverty line, should be defined as fuel poor.

## G

### Gas and Electricity Markets Authority (GEMA)

(See the Authority/Ofgem)

### Gearing

A ratio measuring the extent to which a company is financed through borrowing. Ofgem calculates gearing as the percentage of net debt relative to the Regulatory Asset Value (RAV).

### General Reinforcement

Work carried out on the network in order to enable new load growth (both demand and generation) which is not attributable to specific customers.

### General reinforcement (EHV & 132kV N-1)

Work carried out on the network required to maintain or restore compliance with ER P2/6 or avert future non-compliance for first circuit outages.

### General reinforcement (EHV & 132kV N-2)

Work carried out on the network required to maintain or restore compliance with ER P2/6 or avert future non-compliance for second circuit outages (a fault outage following an arranged outage).

### General reinforcement (EHV & 132kV Other)

Work carried out on the network which falls outside of General Reinforcement (EHV and 132kV N-1) and General Reinforcement (EHV and 132kV N-2) such as:

- Reinforcement to correct potential voltage non-compliance
- Reinforcement to correct issues at a lower voltage where it is the most efficient and economic solution.

It excludes work associated with High Impact, Low Probability (HILP) expenditure.

### Generation connection

A new or modified connection that enables the electricity distribution system to receive a supply of electricity from the premises.

### Geometric Mean

A measure of the average value of a set of numbers, sometimes viewed as a better measure of the true average than the arithmetic mean it is calculated as the nth root (where n is the number of observations) of the product of all observations.

### Gigawatt Hour (GWh)

Equal to one million Kilowatt Hours.

### Greenhouse gas (GHG)

A collection of gases which absorb infrared radiation and trap its heat in the atmosphere.

### Guaranteed Standards of Performance

A set of service levels that must be met by each distribution company. These standards have been set to guarantee a level of performance that is reasonable to expect companies to deliver in all cases.

If the distribution company fails to meet the level of performance required, it must make a payment to the customer subject to certain conditions.

There are two sets of Guaranteed Standards of Performance, one for connections and one for reliability.

Payments under the guaranteed standards compensate for the inconvenience caused. They are not designed to compensate customers for subsequent financial loss.

## H

### Health Index (HI)

The Health Index (HI) is a framework for collating information on the health (or condition) of Distribution Assets and for tracking changes in their condition over time. The HI will be used to inform an assessment of the efficacy of the DNOs' asset management decisions over the price control period. Under the HI framework, each relevant asset is assigned a ranking by the DNO based on the DNO's assessment of its overall health or condition, and for the forecast period based on the DNO's views about future degradation, the options for Intervention and their impacts.

Health index arrangements were introduced as a part of DPCR5. Also see Network Output Measures.

### The Health and Safety Executive (HSE)

A public body responsible for regulating health and safety in Great Britain with the primary function to secure the health, safety and welfare of people at work and to protect others from risks to health and safety from work activity.

### Health and Safety and Operational Training

Health and Safety is the activity of promoting and maintaining health and safety of employees, contractors, customers and the public.

### High Impact Low Probability (HILP)

These are extreme events that could result in the prolonged loss of supply to localities that have a high gross [economic] value added (GVA). HILP activity relates to increasing the security of supply, to localities that have a high GVA, to levels that exceeds P2/6 recommended levels.

### High Value Projects (HVPs)

Schemes specified and agreed with individual DNOs to be undertaken during the DPCR5 period as laid out by Ofgem in the DPCR5 Final Proposals document.

### HV (High Voltage)

Voltages over 1kV up to, but not including, 22kV.

### HV end connections involving EHV work

A demand connection at HV level where the highest voltage of the assets involved in providing such connection, and any associated works, is extra high voltage.

### HV end connections involving only HV work

A demand connection at HV level where the only voltage of the assets involved in providing such connection, and any associated works, is high voltage.

### HV network

The DNO network that operates at all voltages above 1kV up to and including 20kV.

### HV or EHV end connections involving 132kV work

A demand connection provided at either HV or EHV, where the highest voltage of the assets involved in providing such connection, and any associated works, is 132kV.

### Human Resources and Non-Operational Training

The personnel management of all staff, and the provision of non-engineering training to office-based staff.

I

### IDNO (Independent Distribution Network Operator)

Any Electricity Distributor in whose Electricity Distribution Licence the requirements of Section B of the standard conditions of that licence have no effect (whether in whole or in part).

### Incentive rate (efficiency)

The percentage of underspends/overspends against expenditure allowed at the price control review that is kept by the company responsible. The remaining savings/losses are passed through to consumers.

### Independent Connection Providers (ICPs)

An independent connections provider not affiliated to a distribution network operator.

### Indexation

The adjustment of an economic variable so that the variable rises or falls in accordance with the rate of inflation.

## Incident

An incident is defined as any occurrence on the DNO's Distribution System or other connected distributed generation, transmission or Distribution System, which:

- results in an interruption of supply to customer(s) for three minutes or longer, or
- prevents a circuit or item of equipment from carrying normal load current or being able to withstand "through fault current" for three minutes or longer.

## Indirect Activities

Those activities which do not involve physical contact with system assets. For more information on what this includes, see the RIGs Glossary: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5\\_Glossary\\_of\\_Terms\\_clean\[1\].pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/DPCR5_Glossary_of_Terms_clean[1].pdf)

## Indirect Costs

The costs incurred undertaking Indirect Activities.

## Inflation index

This is a measure of the changes in given price levels over time. A common example is the Retail Prices Index (RPI), which measures the aggregate change in consumer prices over time.

## Inspections and Maintenance

Is the overall activity that encompasses Inspections, Shrouding of LV overhead line conductors and Repairs & Maintenance.

This excludes site surveys in relation to areas at risk of flooding.

### Interconnector

Equipment used to link electricity systems, in particular between two Member States.

### Interruption

An interruption is defined as the loss of supply of electricity to one or more customers due to an incident but excluding voltage quality and frequency abnormalities, such as dips, spikes or harmonics.

### Interruptions Incentive Scheme (IIS)

Scheme which provides financial incentives to DNOs with respect to the average quality of service they provide in terms of:

- the number of interruptions to supply (measured in CI)
- the duration of interruptions to supply (measured in CML)

### IT and Telecoms (IT&T)

The purchase, development, installation, and maintenance of non-operational computer and telecommunications systems and applications.

## **K**

### Key Performance Indicator (KPI)

A set of benchmarks to be met by DNOs; they are not backed up with any specific licence conditions or financial incentives.

### Kilowatt Hours (KWh)

A unit of energy equal to the work done by a power of 1000 watts operating for one hour.

## L

### Large User Group (LUG)

A key forum for engaging with business customer representatives. The LUG is open to large sized users of energy, for example metal manufacturers such as Corus.

### Legal and Safety

Investment or intervention where the prime driver is to meet safety requirements and to protect staff and the public. This does not include assets replaced because of condition assessment or to meet ESQCR regulations 17 and 18.

### Licence conditions (obligations)

An obligation placed on the network companies to meet certain standards of performance. The Authority (GEMA) has the power to take appropriate enforcement action in the case of a failure to meet these obligations.

### Load Index (LI)

The Load Index (LI) is a framework for collating information on the utilisation of individual substations or groups of interconnected substations and for tracking changes in their utilisation over time.

The LI will be used to inform an assessment of the efficacy of the DNOs' general reinforcement decisions over the price control period. Under the LI framework, each Demand Group is assigned a ranking based on the loading and firm capacity at the

site, and for the forecast period based on the DNO's views about future load growth, the options for Intervention and their impacts.

The Load Index was introduced as a part of DPCR5. Also see Network Output Measures

### Load Related Capex

The installation of new assets to accommodate changes in the level or pattern of electricity or gas supply and demand.

### Load Related Expenditure (LRE)

LRE refers to expenditure relating to the following activities:

- Connections
- Diversions and Wayleaves/Easements
- General Reinforcement
- Fault Level Reinforcement
- Relevant High Value Projects (HVPs).

### Logging up

A type of uncertainty mechanisms, logging up is a provision that a company will be compensated for all, or part, of its actual expenditure on a particular activity or area, through the revenue allowance set at the next price control review.

### Long Term Development Statement

A document that sets out the use and likely development of the distribution network and the distribution network operator's plans for modifying the distribution system for the following two years. The document should also cover the parts of the distribution system that are likely to reach capacity during the next five years, the distribution network operator's plans to reduce any shortcomings in operation/capacity and (where applicable) how actual developments have compared to the distribution

network operator's plans under the previous statements. All distribution network operators must produce and maintain a LTDS.

### Losses

Is defined in the electricity distribution licence as the difference between units entering and units exiting the DNO network through different connection points.

### Low carbon economy

An economy which has a minimal output of greenhouse gas emissions.

### Low Carbon Networks Fund (LCN Fund)

A mechanism introduced under the fifth distribution price control review to encourage the DNOs to use the forthcoming price control period to prepare for the role they will have to play as GB moves to a low carbon economy. The fund will see up to £500m made available for DNOs and partners to innovate and trial new technologies, commercial arrangements and ways of operating their networks.

### Lower Quartile (LQ) Cost Benchmarking

For the purposes of this document LQ cost benchmarking refers to the approach of setting the benchmark at the 75<sup>th</sup> percentile (ie the highest) of DNOs' costs. This approach has typically been proposed for areas of expenditure where there is a high degree of variability across different DNOs' expenditure.

*See also Upper Quartile Cost Benchmarking*

### LV (Low Voltage)

This refers to voltages up to, but not including, 1kV.

### LV end connections involving EHV work

A demand connection provided at LV where the highest voltage of the assets involved in providing such connection, and any associated works, is EHV.

### LV end connections involving HV work

A demand connection provided at LV where the highest voltage of the assets involved in providing such connection, and any associated works, is HV.

## **M**

### Market-to-Asset Ratio (MAR)

The ratio between a company's market value and its Regulatory Asset Value (RAV). This can be estimated from transactions (eg sale of a network) or, for companies listed in the stock market, from market capitalisation data. An MAR value greater than one might indicate that investors value a company above its RAV.

### Metered Connection

A connection that has a meter to measure consumption of electricity

### Modern Equivalent Asset (MEA)

This is the current replacement value of an asset.

## **N**

### National Grid Electricity Transmission (NGET)

The electricity transmission licensee in England & Wales.

## National Electricity Transmission System Security and Quality of Supply Standard (NETS SQSS)

As referred to in the electricity Transmission Licence Standard Conditions C17 and D3, this is the standard in accordance with which the electricity transmission licensees shall plan, develop and operate the transmission system.

## Net Present Value (NPV)

NPV is the discounted sum of future cash flows, whether positive or negative, minus any initial investment.

## Network charges

These are charges set for the use of network services.

## Network Design and Engineering

All processes and tasks involved in the:

- Strategic planning of the distribution network at all voltages; and
- Detailed engineering design of new connections, extensions and changes to the distribution network at all voltages.

## Network Innovation Allowance (NIA)

A set, use-it-or-lose-it allowance, that each DNO will receive in order to fund small-scale innovative projects as part of their price control settlement. The value of the NIA will be between 0.5 and 1 per cent of base revenues.

## Network Innovation Competition (NIC)

A single annual competition for electricity transmission and distribution network companies to apply for funding to trial large-scale, innovative projects with low carbon or other environmental benefits. Companies can apply to have a maximum of 90 per cent of the project costs funded through the NIC.

## Network Investment

Includes all costs associated with the following activities:

- Metered demand connections (Use of System funded)
- Core Network Investment
- Non-Core (ex-ante)
- Non-Core (reopener/logging up)
- Standalone funding (RAV)
- Standalone funding (not RAV)
- High Value Projects (HVPs).

## Network Operating Costs (NOCs)

Collectively includes the activities of:

- Trouble Call
- Atypicals – Severe Weather one-in-twenty Events
- Inspections and Maintenance
- Tree Cutting
- NOCs Other

## Network Output Measures

The Network Output Measures were introduced in DPCR5 and consisted of the Health Index, Load Index and Fault Rates. This framework ties the DNOs in to the delivery of specified network improvements by linking activities to allowed revenues. The arrangements are comparable to RIIO Secondary Deliverables.

### Network Policy

The development and review of environmental, technical and engineering policies, including all research and development apart from any defined as IFI.

It includes evaluating the impact of changes in relevant legislation; and development, regular review and updating of engineering policies.

### Network users

Companies along the gas and electricity supply chain (i.e. producers/generators, transmission and distribution networks, and energy suppliers).

### Non-contestable activities

Connection activities that cannot be carried out by a non-affiliated third party with relevant accreditation.

### Non-Load Related Capex

The replacement or refurbishment of assets which are either at the end of their useful life due to their age or condition, or need to be replaced on safety or environmental grounds.

### Non Load Related Expenditure (NLRE)

The installation of new assets and the planned installation of replacement assets for reasons other than load-related reasons.

### Non Quality of Service Occurrences

Any occurrence logged on the enquiry service operated by the licensee under standard condition 8 (Safety and Security of Supplies Enquiry Service) which is not an incident.

### Non-Operational Capex

Expenditure on new and replacement assets which are not system assets.

○

### Operating Expenditure (Opex)

The costs of the day to day operation of the network such as staff costs, repairs and maintenance expenditures, and overhead.

### Operational Information Technology and Telecoms (IT&T)

IT equipment which is used exclusively in the real time management of network assets, but which does not form part of those network assets.

### Operational training

Includes the activities of:

- Classroom training and
- On the job training
- Trainer and course material costs (classroom training)
- Training centre building & grounds and training admin
- Recruitment - operational training

For the following purposes

- Training Workforce renewal new recruit

- Operational upskilling.
- Operational refresher training

### Outcomes (objectives of new regulatory framework)

What the network companies are expected to deliver. The outcomes that we expect from the new framework are that network companies play a full role in the delivery of a sustainable energy sector and deliver value for money network services for existing and future consumers.

### Outputs

Output information is to be used to assess network company performance against the outcomes within a control period. This information may be both qualitative and quantitative in nature.

## **P**

### Pass through (of costs)

Costs for which companies can vary their annual revenue in line with the actual cost, either because they are outside the DNO's control or because they have been subject to separate price control measures.

### Pension protection fund (PPF)

The Pension Protection Fund was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

### Post Maintenance Interest Cover Ratio (PMICR)

A financial ratio used by rating agencies when determining credit ratings. It measures the amount of cash a company generates from the revenues it brings in, excluding costs associated with long-term investment (capex) relative to the interest paid on the company's debt.

### Price control (control)

The control developed by the regulator to set targets and allowed revenues for network companies. The characteristics and mechanisms of this price control are developed by the regulator in the price control review period depending on network company performance over the last control period and predicted expenditure in the next.

### Priority Service Register

A register of all customers in an electricity distribution area that are of pensionable age, disabled, chronically sick, require special communication needs, depend on electricity for medical reasons, or require certain information and advice about supply interruptions. The electricity distribution network operator must provide all customers on their PSR with prior advice and information about planned interruptions and appropriate information and advice about what precautions to take in the event of an unplanned supply interruption.

### Profile classes

Profile classes are used to differentiate between customer types. This differentiation is based on the when customers consume electricity across the day. A profile is made of up of estimated consumption in each half hour across a 24 hour period based on generic customer characteristics and the tariff which a customer is on. For instance, a domestic customer is more likely to have higher consumption on weekday mornings and evenings and lower during the day time. A non domestic

customer is likely to have higher consumption in the daytime but lower (or none at all) in the morning and evening.

The eight generic profile classes were chosen by industry as they represented large populations of similar customers. The eight profile classes are as follows:

- Profile Class 1 Domestic Unrestricted Customers
- Profile Class 2 Domestic Economy 7 Customers
- Profile Class 3 Non-Domestic Unrestricted Customers
- Profile Class 4 Non-Domestic Economy 7 Customers
- Profile Class 5 Non-Domestic Maximum Demand (MD) Customers with a Peak Load Factor (LF) of less than 20%
- Profile Class 6 Non-Domestic Maximum Demand Customers with a Peak Load Factor between 20% and 30%
- Profile Class 7 Non-Domestic Maximum Demand Customers with a Peak Load Factor between 30% and 40%
- Profile Class 8 Non-Domestic Maximum Demand Customers with a Peak Load Factor over 40%

A Peak Load Factor is the ratio, expressed as a percentage, of the number of kWh supplied during a given period compared to the number of kWh that would be supplied at times of maximum demand.

The profile classes are monitored and updated if consumption patterns amongst customers change. They are used by all industry parties to help estimate consumption at certain times.

## Project Management

Project management costs from authorisation through preparation, construction and energisation to completion.

## Property Management

The costs of providing, managing and maintaining all non-operational premises (with the exception of operational training centres).

## Q

### Quality of Service (QoS) costs

Costs where the prime purpose is to improve performance against the IIS targets or to improve the overall fault rate per km of the distribution network.

## R

### Real Price Effects (RPE)

Expected changes in input prices, eg wages, relative to the Retail Price Index (RPI).

### Regulatory Asset Value (RAV)

The value ascribed by Ofgem to the capital employed in the licensee's regulated distribution or (as the case may be) transmission business (the 'regulated asset base').

The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between

classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital stock.

### Regulatory burden

A term used to describe the cost – both monetary and opportunity – of regulation.

### Regulatory Instructions and Guidance (RIGs)

A document that is published as part of the price control settlement which sets out further detail on how the price control is to be implemented and how compliance with it will be monitored.

### Relevant Market Segments

Any of the relevant market segments that are described in or determined in accordance with Appendix 1 of Charge Restriction Condition 12 (CRC 12). In DPCR5 Final Proposals Ofgem considered that competition is viable in these market segments. DNOs currently charge a four per cent margin on contestable services provided in these market segments.

### Remote Location Generation

Remote location generation relates to the cost of fuel and contribution to maintenance to run and test diesel generation that provides permanent emergency backup in remote locations including islands.

## Re-openers

A process undertaken by Ofgem to re-set the revenue allowances (or the parameters that give rise to revenue allowances) under a price control before the scheduled next formal review date for the relevant price control.

## Retail Prices Index (RPI)

The RPI is an aggregate measure of changes in the cost of living in the UK. It differs from the CPI in that measures changes in housing costs and mortgage interest repayments, whereas the CPI does not, they are calculated using different formulae and have a number of other more subtle differences.

## Return on Regulatory Equity (RORE)

The financial return achieved by shareholders in a licensee during a price control period from its out-turn performance under the price control. The return is measured using income and cost definitions contained in the price control regime (as opposed to accounting conventions) and is expressed as a percentage of (share) equity in the business. Importantly, in the calculation the gearing (proportions of share equity and debt financing in the RAV) and cost of debt figures used are those given as the 'assumed' levels in the relevant price control final proposals. The aim of the RoRE measure is to provide an indication of the return achieved by the owners of a licensee which can be compared to the cost of equity originally allowed in the price control settlement and to the return achieved by other licensees on an equivalent basis.

## Revenue driver

A means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs. An example might be to allow a specified additional revenue allowance for each MW of new generation connecting to

the network. Revenue drivers are used by Ofgem to increase the accuracy of the revenue allowances.

### RIIO (Revenue = Incentives + Innovation + Outputs)

Ofgem's new regulatory framework, stemming from the conclusions of the RPI-X@20 project, to be implemented in forthcoming price controls. It builds on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network at value for money to existing and future consumers

#### RIIO-ED1

The price control review for the electricity distribution network operators, following DPCR5. This price control will run from 1 April 2015 to 31 March 2023.

#### RIIO-GD1

The price control review for the gas distribution network operators, following GDPCR. This price control runs from 1 April 2013 to 31 March 2021.

#### RIIO-T1

The price control review for the electricity and gas transmission network operators, following the TPCR4 rollover. This price control runs from 1 April 2013 to 31 March 2021.

### Rising and Lateral Mains

Individual DNO owned 3 phase cable or busbar, not laid in the ground, which runs within or attached to the outside of a multiple occupancy building for:

- More than 3m vertically or

- More than 3m horizontally
- And to which a number of individual services are connected, usually via a distribution board.

### Risk-free rate

The rate of return that an investor would expect to earn on a "riskless" asset. Typically, government-issued securities are considered the best available indicator of the risk-free rate due to the extremely low likelihood of the government defaulting on its obligations.

### Rolling average

An average of a specified number of data points which is updated continuously to reflect the most recent data.

### RPI-X

The form of price control currently applied to network monopolies. Each company is given a revenue allowance in the first year of each control period. The price control then specifies that in each subsequent year the allowance will reduce by 'X' per cent in real terms.

### RPI-X@20

Ofgem's comprehensive review of how we regulate energy network companies, announced in March 2008. Its conclusions published in October 2010 resulted in the implementation of a new regulatory framework, known as the RIIO model.

## S

## Secondary deliverables

Indicators of performance which may be used in support of the companies' required primary outputs

## Settlement data

Data arising through the Balancing and Settlement Code (BSC) settlement processes.

## Severe weather 1-in-20 events

Events which gives rise to more than 42 times the mean incidents at HV and above, give rise to more than the threshold for customer interruptions or customer minutes lost.

## Small and Medium User Group (SMUG)

A key forum for engaging with business customer representatives. The SMUG is open to small and medium sized users of energy, for example consumer groups such as the Federation of Small Businesses or the British Chambers of Commerce.

## Small tools & equipment (& other non-op Capex)

Expenditure on new and replacement Small Tools & Equipment assets which are not system assets.

## Smart grid

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.

## Span

Relates to overhead lines and is the term used to describe the portion of overhead line between two overhead line supports (i.e. poles and towers). The number of spans associated with a double circuit line

## Spans Cut

Relates to overhead line spans that are inspected in a reporting year in order to assess the need to undertake tree cutting to meet the requirements of ENATS 43-8 and where tree cutting is undertaken during the reporting year.

## Spans Inspected (but not cut)

Relates to overhead line spans that are inspected in a reporting year in order to assess the need to undertake tree cutting to meet the requirements of ENATS 43-8 and where no tree cutting is undertaken during the reporting year.

## Spans Managed

Is the sum of "Spans Cut" and "Spans Inspected (but not cut)"

## Stakeholder

Stakeholders are those parties that are affected by, or represent those affected by, decisions made by network companies and Ofgem. As well as consumers, this would for example include Government and environmental groups.

## Storage

Storage refers to any mechanism which can store energy which has been converted into electricity. This can be primary (super-conducting and capacitor technologies);

mechanical (pumped hydro, compressed air, flywheels); and electrochemical (batteries).

## Stores

The activity of managing and operating stores

Includes:

- Delivery costs of materials or stock to stores
- Labour and transport costs for the delivery of materials or stock from a centralised store to a satellite store (and vice versa)
- Quality testing of materials held in stores
- The value of losses on materials held in stores
- The costs of membership of the "ngt spares club".

Excludes:

- Costs of oil or other insulation medium (report under the activity for which it is used, e.g. Maintenance, faults)
- IT and property costs associated with Stores.

## Straight line depreciation

Straight line depreciation depreciates the asset value in a linear fashion throughout its useful life. It is calculated by dividing the Gross Book Value of an asset by its expected useful life.

## Sulphur Hexafluoride (SF<sub>6</sub>)

A potent greenhouse gas frequently used in electrical equipment.

## SF6 Leakage

Electrical plant utilising SF6 for insulation purposes containing the gas in a gas tight enclosure. Loss of integrity of the enclosure leads to escape or leakage of the gas.

## Supply chain

Refers to all the actors involved in the delivery of electricity and gas to the final consumers - from electricity generators and gas shippers, through to electricity and gas suppliers.

## Sustainable development

Refers to economic development which meets the needs of the present without compromising the ability of future generations to meet their own needs.

## Sustainable energy sector

A sustainable energy sector is one which promotes security of supply over time; delivers a low carbon economy and associated environmental targets; and delivers related social objectives (e.g. fuel poverty targets).

## System Mapping

The activity of mapping of the network and operational premises of the network to geographical locations.

## System Operator (SO)

NGG as the gas system operator has responsibility to construct, maintain and operate the NTS and associated equipment in an economic, efficient and co-ordinated manner. NGET as the electricity system operator has responsibility to construct, maintain and operate the NETS and associated equipment in an

economic, efficient and co-ordinated manner. In their roles as SOs, NGG and NGET are responsible for ensuring the day-to-day operation of the transmission systems.

## T

### Technical Life

The estimated length of time from the date of commission to a point in time when on average the assets fall below minimum acceptable and / or safety performance levels.

### Terawatt (TWh)

Equals one thousand Gigawatt hours.

### Third Package (Third Internal Energy Market Legislative Package)

The third package is a key step in implementation of internal EU energy market. It recognises the need for better co-ordination between European network operators and continuing co-ordination between regulators at that level. It continues many of the internal market principles identified above in relation to the earlier First and Second Packages.

### Traffic Management Act (TMA)

Introduced in 2004 to tackle congestion and disruption on the road network. The TMA Act places a duty on local traffic authorities to ensure the expeditious movement of traffic on their road network and those networks of surrounding authorities. It gives authorities additional tools to better manage parking policies, moving traffic enforcement and the coordination of street works

### Total expenditure (Totex)

Totex generally consists of all the expenditure relating to a licensee's regulated activities but with the exception of some specified expenditure items. The annual net additions to RAV are calculated as a percentage of the totex.

Total capital expenditure (capex) plus operational expenditure (opex). It can be seen as the aggregate net network investment, net network operating costs and indirect costs, less the cash proceeds of sale of assets and scrap.

### Transmission Owners (TO)

Companies which hold transmission owner licenses. Currently there are three electricity TOs; NGET, SPTL and SHETL. NGG NTS is the gas TO.

### Transmission system

The system of high voltage electric lines providing for the bulk transfer of electricity across GB.

### Transmission System Operator (TSO)

See System Operator

### Tree Cutting

The activity of physically felling or trimming vegetation from around network assets.

### Trouble Call

The activity relating to the resolution of Trouble Call occurrences.

## U

### Uncertainty mechanisms

Uncertainty mechanisms allow changes to the base revenue during the price control period to reflect significant cost changes that are expected to be outside the company's control. Examples include revenue triggers and volume drivers.

### Undergrounding

Is the process of replacing overhead power cables with buried electricity distribution cables.

### Unmetered Connection

A connection where the charges for electricity consumption are not measured via a meter. The Electricity (Unmetered) Supply Regulations 2001 describe the circumstances in which a supply of electricity may be unmetered, for example small electricity loads that have predictable consumption.

### Upper Quartile (UQ) Cost Benchmarking

For the purposes of this document UQ cost benchmarking refers to the approach of setting a benchmark at the 25<sup>th</sup> percentile (ie the lowest) of DNO costs. This approach has typically been proposed for areas of expenditure where there is a high degree of commonality across different DNOs' expenditure.

*See also Lower Quartile Cost Benchmarking*

## V

### Vanilla Weighted Average Cost of Capital (Vanilla WACC)

The weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity.

### Vehicles and transport costs

The activity of managing, operating and maintaining the commercial vehicle fleet and mobile plant utilised by the DNO or any other related party for the purposes of providing services to the DNO.

### Vertically integrated company

A company that is active at more than one level of an industry's supply chain (e.g. a company that generates electricity and also operates electricity distribution networks).

### VIX index

Chicago Board Options Exchange Volatility Index, a popular measure of implied volatility with high values implying pessimism and low values implying optimism.

## **W**

### Wayleaves

Access to property granted by a landowner including provision for constructing, retaining, using and maintaining an overhead line or underground cable

### Wayleaves and Easements/Servitudes Admin Costs

Obtaining, managing and administering Wayleave, substation rents, easements and servitudes.

### Wayleaves Payments

Annual payments made in advance to the owner and/or occupier to cover the financial impact of having equipment on their land

### Weighted Average Cost of Capital (WACC)

The weighted average of the cost of equity and the cost of debt, where the weighting is provided by the gearing ratio. This represents the cost to a company of raising the funds for its activities (specifically, its capex programme). As part of the price control process, Ofgem sets an allowance for the expected WACC that its regulated companies pay.

### Workforce Renewal

Workforce renewal involves the recruitment of training of new staff and upskilling of existing staff to replace leavers from the operational workforce (roles meeting definitions of "craftsperson", "engineers" and "non-engineering roles"). It includes learner costs associated with both classroom and new recruits and upskilling. It includes trainer and course material costs associated with classroom training. It also includes training centre and training admin costs associated with new recruits and upskilling. It includes the recruitment costs associated with operational trainers.

## Annex 2

### Chronology

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 the RPI-X@20 review.
6 February 2012	GEMA launches open letter consultation on the way forward for the new electricity distribution price control review – RIIO-ED1.
29 February 2012	Flexibility and Capacity Working Group
12 April 2012	Reliability and Safety Working Group
16 April 2012	Flexibility and Capacity Working Group
26 April 2012	Cost Assessment Working Group
27 April 2012	Connections Working Group
3 May 2012	Reliability and Safety Working Group
4 May 2012	Losses Working Group
9 May 2012	Flexibility and Capacity Working Group
10 May 2012	Cost Assessment Working Group
16 May 2012	Environment Working Group
17 May 2012	Reliability and Safety Working Group
24 May 2012	Connections Working Group
28 May 2012	Losses Working Group

29 May 2012	Cost Assessment Working Group
30 May 2012	Flexibility and Capacity Working Group
31 May 2012	Reliability and Safety Working Group
14 June 2012	Reliability and Safety Working Group
19 June 2012	Customer and Social Issues Working Group
20 June 2012	Flexibility and Capacity Working Group
21 June 2012	Environment Working Group
21 June 2012	Connections Working Group
22 June 2012	Losses Working Group
26 June 2012	Cost Assessment Working Group
28 June 2012	Reliability and Safety Working Group
10 July 2012	Cost Assessment Working Group
11 July 2012	Flexibility and Capacity Working Group
12 July 2012	Reliability and Safety Working Group
13 July 2012	Business Plan Guidance Workshop
18 July 2012	Losses Working Group
24 July 2012	Reliability and Safety Working Group
24 July 2012	Customer and Social Issues Working Group
31 July 2012	Cost Assessment Working Group
31 July 2012	Connections Working Group
1 August 2012	Flexibility and Capacity Working Group
8 August 2012	Reliability and Safety Working Group
29 August 2012	Connections Working Group

17 September 2012	Data Assurance Working Group
18 September 2012	Cost Assessment Working Group
28 September 2012	GEMA publishes its strategy consultation for RIIO-ED1.
9 October 2012	Cost Assessment Working Group
19 October 2012	Flexibility and Capacity Working Group
23 October 2012	Customer and Social Issues Working Group
24 October 2012	Connections Working Group
25 October 2012	Reliability and Safety Working Group
5 November 2012	Reliability and Safety Working Group
13 November 2012	Cost Assessment Working Group
19 November 2012	Flexibility and Capacity Working Group
26 November 2012	Data Assurance Working Group
4 December 2012	Cost Assessment Working Group
11 December 2012	Connections Working Group
13 December 2012	Cost Assessment Working Group
14 December 2012	Customer and Social Issues Working Group
19 December 2012	Flexibility and Capacity Working Group
19 December 2012	Reliability and Safety Working Group
20 December 2012	Losses Working Group
16 January 2013	Connections Working Group

16 January 2013	Customer and Social Issues Working Group
17 January 2013	Cost Assessment Working Group
19 January 2013	Flexibility and Capacity Working Group
24 January 2013	Reliability and Safety Working Group
21 February 2013	Customer and Social Issues Working Group
21 February 2013	Connections Working Group
22 February 2013	Flexibility and Capacity Working Group
4 March 2013	GEMA published its decision on its approach to RIIO-ED1 – the strategy decision.
26 March 2013	Cost Assessment Working Group
26 March 2013	Customer and Social Issues Working Group
26 March 2013	Connections Working Group
June 2013	The DNOs submit their fast-track business plans to GEMA.
5 June 2013	Customer and Social Issues Working Group
5 June 2013	Connections Working Group
1 July 2013	GEMA launches an open letter 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.
18 October 2013	Environment Working Group

8 November 2013	Customer and Social Issues Working Group
20 November 2013	Connections Working Group
22 November 2013	GEMA publishes its assessment of the 14 DNO business plans for RIIO-ED1 and considers that only WPD's plans are of sufficient quality to be fast-tracked.
22 November 2013	GEMA publishes the Draft Determinations for WPD's fast-track price control settlement.
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.
4 December 2013	Environment Working group
11 December 2013	GEMA issues its decision on the levels of reward/penalty that DNOs are to get under the RIIO-ED1 customer services and connections incentives.
19 December 2013	GEMA issues its decision on when it will set the revenue to be recovered by DNOs in 2015/16.
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.
22 January 2014	Connections Working Group
22 January 2014	Customer and Social Issues Working Group
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.
17 February 2014	GEMA issues its decision on the methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls.
27 February 2014	GEMA issues its decision to fast-track WPD.
27 February 2014	GEMA published the Final Determinations for the four licensees owned by 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.
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.
18 September 2014	Reliability and Safety Working Group
26 September 2014	GEMA launches informal consultation on changes to DNOs' SLCs for RIIO-ED1 that was 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.
4 December 2014	GEMA consults on the Incentive on Connections Engagement (ICE) guidance document.
16 December 2014	GEMA consults on the Stakeholder Engagement and Consumer Vulnerability (SECV) incentive (Closed 16 January awaiting decision)
17 December 2014	GEMA publishes corrections to elements of the RIIO-ED1 Final Determinations suite of documents for slow-track DNOs.
17 December 2014	GEMA commences statutory consultation on proposed modifications to the CRCs of the electricity distribution licences of the DNOs in the slow-track process.
7 January 2015	GEMA consults on the assessment of the benefits from the

	roll-out of proven innovations through the Innovation Roll-out Mechanism (Closed 4 March awaiting decision)
28 January 2015	GEMA consults on the draft RIIO-ED1 Environment Report guidance document (Closed 25 February awaiting decision)
28 January 2015	GEMA issues an informal consultation on the draft regulatory instructions and guidance for the electricity distribution licensees.
3 February 2015	GEMA consults on updates under CRC 4C (Price control update provisions) for the electricity distribution licences held by the four licensees owned by WPD.
3 February 2015	GEMA issues decision to modify the CRCs of the electricity distribution licences of the DNOs in the slow-track process.
25 February 2015	Incentive on Connections Engagement (ICE) guidance document decision.
4 March 2015	Directions under Parts A and D of CRC 4C (Price control update provisions for WPD) of WMID's, EMID's, SWALES's and SWEST's electricity distribution licences.

## Annex 3

### Errors in Frontier Report

The errors or incomplete descriptions in the Frontier report are, in order they appear, as follows:

1. In paragraph 2.17, Frontier states that "Table 2 below shows the total adjustments made to each DNO's submitted costs across the 13 year period included in the Authority's costs assessment." In fact, Table 2 only shows the adjustments for regional labour differentials across the eight years of RIIO-ED1. In addition, in paragraph 2.17 Frontier states that "NPg operates in the Rest of GB region (i.e. GB excluding London and the South East) where GEMA considers there are relatively low labour costs". In fact, the Authority did not merely "consider" the labour cost to be relatively low. Its conclusion in this regard was supported by evidence collected from the ONS Annual Survey of Hours and Earning (ASHE) and analysed by the Authority, which showed a clear labour premium in London and the South East.
2. In paragraph 2.27, Frontier states that any errors in pre-modelling adjustments would result in the outcomes of the model not accurately reflecting the DNOs' actual relative efficiency. While this is factually correct, Frontier fail to make clear that if the Authority did not make these adjustments its relative efficiency estimates would most likely be materially less accurate than if there were any errors in the adjustments.
3. In the first bullet point of paragraph 2.30 Frontier notes that the Authority's RIIO-ED1 approach differs from its RIIO-GD1 approach in its use of historical data in that it calculates the DNOs' RIIO-ED1 efficiency based on a ratio of the DNOs' forecast costs to Ofgem's modelled costs rather than including historical (DPCR5) performance as well. The Authority has two concerns with this statement:
  - (a) First, Frontier's assertion that "*no historical performance was incorporated into GEMA's assessment of the DNO's efficiency*" is incorrect. The DNOs' historical performance fed into Ofgem's models,

thereby helping set Ofgem's modelled costs. This is a particularly important aspect in the disaggregated modelling, where changes over DPCR5 were used to set Ofgem's view of DNOs' RIIO-ED1 requirements.

- (b) Secondly, the RIIO-ED1 modelling approach was an evolution from RIIO-GD1. In the latter, Ofgem assessed only using forecast models, but these were not found to be robust. Ofgem considered that data from the DNOs had been collected on a sufficiently robust basis to produce reliable results for RIIO-ED1.
4. In relation to the second bullet point of paragraph 2.30, the Authority notes, similarly to its response to paragraph 2.27, that using unadjusted costs to calculate efficiency scores would have been incorrect. This would have produced less accurate results than if there were any errors in the Authority's adjustments.
  5. In paragraph 2.31, Frontier states that "*GEMA calculated the combined efficiency score by weighting the efficiency scores from the three models.*" While this is in essence what happened, the actual calculation was to weigh together the difference between Ofgem's view and the DNOs' submission for each of the three models.
  6. The Authority has concerns with Frontier's language in paragraphs 2.37 to 2.41. In paragraph 2.37 Frontier refers to "*combined benchmark cost, post-reversal of adjustments.*" This is incorrect. This cost is not a "benchmark cost": rather it is the cost produced by the modelled cost with the pre-modelling adjustments reversed. At this stage no adjustment has been made for the upper quartile. Therefore, Frontier's statement that the upper quartile being below one "*had the impact of reducing the benchmark cost for all DNOs*" in paragraph 3.40 is misleading.
  7. In paragraph 2.51, where Frontier notes that SGBs were included in the calculation of the efficiency scores and assessed separately, Frontier fails to note that the additional adjustment was undertaken in such a way that

avoided double counting savings in both the comparative assessment and the SGBs assessment.

8. In paragraph 2.61, Frontier presents an example of how NPg may have been rewarded if its 'IQI ratio' (the difference between its submitted costs and Ofgem's view) had been 100; implying that NPg would have been heavily rewarded. This is a misleading example. As clearly set out in the Draft Determination, the IQI breakeven point was shifted (from 100 to 102.9) as no DNOs were found to have submitted costs in line with the Authority's view of efficient cost. Therefore, if NPg had submitted efficient costs (i.e. an IQI ratio of 100) it is highly unlikely that there would have been a need to shift the breakeven point and so NPg would not have received any upfront reward/penalty.