

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

**BETWEEN:**

**BRITISH GAS TRADING LIMITED**

**Appellant**

**- and -**

**THE GAS AND ELECTRICITY MARKETS AUTHORITY**

**Respondent**

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**INDIVIDUAL SUMMARY SUBMISSION EASTERN POWER NETWORKS plc, SOUTH  
EASTERN POWER NETWORKS plc, and LONDON POWER NETWORKS plc**

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**INTRODUCTION**

1. This is the Individual Submission of the three licensed DNOs: Eastern Power Networks plc, South Eastern Power Networks plc and London Power Networks plc, which are in this submission together referred to as “UKPN”. This Individual Submission, which should be read in conjunction with the Joint Submissions filed by all DNOs, is in two parts.
2. First, UKPN makes three important contentions in relation to the legal principles which govern the CMA’s determination of BGT’s appeal:
  - (1) The appeal to the CMA is an appeal on the merits as opposed to one of judicial review.
  - (2) It is, however, intrinsic to a merits appeal of this kind that an appellate authority (here the CMA) will defer to the specialist expertise of the primary regulator (here the Authority).
  - (3) Moreover, and in any event, it is a necessary consequence of such an appeal process that the CMA is required to look at the appeal “in the round” and not determine the appeal solely on the basis of the grounds of appeal if such grounds have been “cherry-picked” and the outcome of the Authority’s Decision overall reflects a lawful exercise of its statutory functions.
3. Second, UKPN provides additional arguments to what is said in the Joint Submissions in relation to (i) cost of debt; (ii) asset life policy; and (iii) IQI. This is necessary because each DNO has a different perspective and the Joint Submissions do not reflect this.
4. Definitions and abbreviations used in the Joint Submissions are adopted herein.

**LEGAL SUBMISSIONS**

***(i) The scope of review issue***

5. There can be no doubt that the statutory regime under EA89 governing appeals against licence modifications is one of merits appeal as opposed to (i) a statutory appeal on a point of law or (ii) judicial review.
6. Some forms of statutory appeal are confined to an appeal where the appellant is ‘*dissatisfied in point of law*’. Plainly, the EA89 s. 11 statutory appeals with which the CMA is concerned on these appeals are not so restricted. The breadth of the grounds of appeal in EA89 s. 11E(4) are self-evidently not grounds that are constrained by the need to establish an error of law.

This is clear from the fact that an error of law is but one of the statutory grounds of appeal (see EA89 s. 11E(4)(e)).

7. As to judicial review, axiomatically, an appeal on merits is not the same as judicial review (save and insofar as statute confers on an appellate body only a power of judicial review). The distinction between an appeal on merits and judicial review has long been articulated in case-law: see e.g. *Hughes v. Architects' Registration Council of the UK* [1957] 2 QB 550<sup>1</sup> (an appeal, unlike judicial review, requires a court not simply “to see only if the [tribunal] had jurisdiction to make the order they did, and whether they had evidence on which they could act” but rather to “decide whether the decision of the tribunal was right and can be upheld”).
8. The above propositions are demonstrated by the following aspects of the EA89 regime:
  - (1) Parliament has not legislated in EA89 for a process of judicial review as it has, for example, in ss. 120(4) and 179(4) of the Enterprise Act 2002 (“...shall apply the same principles as would be applied by a court on an application for judicial review”).
  - (2) Nor has Parliament legislated for a process of appeal limited to a point of law.
  - (3) The grounds of appeal under EA89 s. 11E(4) go well beyond grounds on which an appeal on point of law or an application for judicial review may be made. Most obviously, a critique based upon the Authority’s alleged failure to “give the appropriate weight” to specified matters (EA89 s. 11E(4)(b)) is the language of merits appeal.
  - (4) By virtue of EA89 s. 11E(3), the CMA may have regard to new material that the Authority did not have the opportunity to look at. This is consistent only with an appeal on the merits, where the focus is on the correctness or otherwise of the decision rather than whether or not the decision-maker approached the process lawfully.

**(ii) The deference issue**

9. It is equally incontrovertible that an appeal on merits nonetheless requires the appellate tribunal to defer to the specialist expertise of the primary regulator.
10. A relatively recent exposition of this elementary principle is contained in *BT v Ofcom* [2014] EWCA Civ 133<sup>2</sup>, an appeal to the Court of Appeal from an appeal on merits to the Competition Appeal Tribunal (“CAT”). Three key principles emerge from the judgment of Aikens LJ at paras 87-88:
  - (1) The appellate court or tribunal (in *BT* the CAT; here the CMA) must accord weight to the decision of the primary regulator (i.e. the regulator on whom Parliament has placed the responsibility for making a statutory determination) and the reasons advanced for that decision by the primary regulator.
  - (2) It is not sufficient for the appellate tribunal to conclude that it might (or would) have reached a different decision had it been the designated decision-maker.
  - (3) The appellate tribunal should show “appropriate restraint” and should not interfere with the regulator’s exercise of judgment unless it is satisfied that it was wrong.
11. Further support for the above-mentioned principles is afforded by the judgment of the Court of Appeal in *BT v. Competition Commission* [2013] EWCA Civ 154 at para 22 *et seq*<sup>3</sup>. To similar effect, in *Colt Technology Services v Ofcom* [2013] CAT 29<sup>4</sup>, the CAT pointed out that “[i]f the regulator has addressed the right question by reference to relevant material, any value judgment on its part must carry great weight” and that “[w]here there are a

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<sup>1</sup> *Hughes v. Architects' Registration Council of the UK* [1957] 2 Q.B. 550, [UKPN1/1] page 9

<sup>2</sup> *British Telecoms plc v. Ofcom and Others* [2014] EWCA Civ 133 [UKPN1/2] paras 87-88

<sup>3</sup> *British Telecommunications v. Ofcom* [2013] EWCA Civ 154 [UKPN1/3] paras 22-24

<sup>4</sup> *Colt Technology Services v. Office of Communications* [2013] CAT 29 [UKPN1/4], para 52

*number of competing, legitimate views, there is a very clear line of authority in both the Court of Appeal and the Tribunal that the Tribunal will not interfere in a regulator's decision unless it is clearly wrong*" (para 53 et seq).

12. Finally, helpful clarification has also been provided in another CAT ruling on the relevance of an appeal ground referring (as in the EA89 appeal regime) to the weight placed by the regulator on particular factors. In *BT v Ofcom* [2014] CAT 14<sup>5</sup> the CAT pointed out that, as it was not "*a second tier regulator, the fact that [the CAT] might have preferred to give different weight to various factors in the exercise of a regulatory judgment would not in itself provide a sufficient basis to set aside the determination made by Ofcom*" (para 67). This is material to BGT's appeal because, like the CAT, the CMA is not a second-tier regulator.<sup>6</sup>
13. For these reasons the Judgments and evaluations of the Authority require deference to be paid to them by the CMA on the present appeals. Deference does not, of course, immunise a regulatory decision from being wrong, but it does mean that the CMA cannot conduct a *de novo* hearing. To do so would be to adopt a legally erroneous approach to these appeals.

### **(iii) The cherry-picking issue**

14. Elementarily, the BGT appeal is brought against a decision by the Authority to proceed with licence modifications. As the Authority expressly records, the modifications are concerned with, and made under, a system of price control (RIIO-ED1): "*In the RIIO-ED1 price control review we will set the outputs that the 14 electricity distribution network operators (DNOs) need to deliver for their consumers and the associated revenues they are allowed to collect. The review covers the eight year RIIO-ED1 price control period which lasts from 1 April 2015 to 31 March 2023*".<sup>7</sup> Thus, the modifications are not, and cannot be, hermetically sealed from the overall price control regime of which they form a part. The Authority's Decision on licence modifications is designed to lead to an overall price control outcome under the system that it has created. Indeed, the effects of the modifications (which the Authority is required to state – see EA89 ss. 11A(2)(b), 11A(7)(b)) – and which are contained in Schedule 3 of the Decision) will affect the revenues that the DNOs are allowed to collect over the relevant period.
15. Given both the nature of the statutory exercise (a merits appeal) and the fact that the CMA must, as an appellate body, have regard to the same extent as is required of the Authority to the matters which the Authority itself must have regard to in discharging its EA89 s. 3A function (the principal objective), it is clear that the CMA cannot permit an appellant such as BGT to 'cherry-pick' arguments that - taken atomistically – would distort the effect of the price control regime considered as a whole by reference to the Authority's statutory responsibilities.
16. Specifically, as to those statutory responsibilities, the Authority is required to undertake a number of statutory functions/responsibilities that in the present context lead to an overall price control decision the component elements of which are interdependent. Thus:
  - (1) The "*principal objective*" of the Authority in carrying out its statutory functions is to protect the interests of existing and future consumers in relation to electricity (EA89 s. 3A(1)).
  - (2) The Authority must carry out its statutory functions in the manner which it considers is best calculated to further the principal objective, wherever appropriate, by promoting

<sup>5</sup> *British Telecommunications Plc v. Ofcom* [2014] CAT 14, [UKPN1/5] para 67

<sup>6</sup> True it is that the CMA is, when considering appeal issues, bound by the same statutory obligations as the Authority, but this is in an appellate and not in a regulatory capacity.

<sup>7</sup> Authority: *Draft Determinations Consultation for the Slow-Track Electricity Distribution Companies* [BG2/30 A], page 2

effective competition in the electricity generation/transmission/distribution/supply markets (EA89 s. 3A(1B)).

- (3) Before deciding to carry out statutory functions in a particular manner with a view to promoting competition, the Authority must consider: (a) to what extent the interests of consumers would be protected by that manner of carrying out those functions; and (b) whether there is any other manner in which the Authority could carry out those functions which would better protect those interests (EA89 s. 3A(1C)).
  - (4) In performing the duties under subsections (1B) and (1C), the Authority must 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 regulatory obligations; and (c) the need to contribute to the achievement of sustainable development (EA89 s. 3A(2)).
  - (5) In performing the duties under subsections (1B), (1C) and (2), the Authority must have regard to the interests of certain categories of vulnerable individuals (as defined), and may have regard to the interests of consumers more generally (EA89 s. 3A(3)-(4)).
  - (6) Subject to subsections (1B) and (2), the Authority must carry out its functions in the manner which it considers is best calculated: (a) to promote efficiency and economy on the part of licensed suppliers; (b) to protect the public from dangers arising from supply or use of electricity; and (c) to secure a diverse and viable long-term energy supply, and in carrying out those functions the Authority must have regard to the effect on the environment of activities connected with electricity generation/transmission/distribution/supply (EA89 s. 3A(5)).
  - (7) In carrying out its functions in accordance with the preceding provisions, the Authority must have regard to: (a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and (b) any other principles appearing to it to represent the best regulatory practice (EA89 s. 3A(5A)).
17. Finally, as stated by the Court of Appeal in *BT v. Ofcom* in relation to the CAT (see para 10 above), the CMA is required, when making any findings of its own on a part of the price control modifications that have been challenged on appeal, also to ensure that it has worked out fully the impact that any different conclusions of fact would have on all the relevant conclusions reached by the Authority.

## **COST OF DEBT**

18. UKPN contends that (i) the Authority has acted consistently with previous statements and regulatory practice in trying to match interest costs to revenue; and (ii) as there is no evidence that DNOs have issued debt inefficiently, the Authority's approach is appropriate.

### ***(i) Allowing actual historic debt costs is standard regulatory practice***

19. It is acceptable and normal practice for a regulator to seek to match interest costs with revenues. Several CC reports contain words to the effect that the CC would, as the appeal body for regulated industries, “normally factor a measure of existing ‘embedded’ fixed-rate debt costs into its calculation of the cost of debt”.<sup>8</sup>
20. The CC observed in the recent Northern Ireland Electricity (“NIE”) inquiry that there are three elements to the cost of debt:

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<sup>8</sup> See e.g. CC (2010), *Bristol Water plc*, appendix N, para 45; [UKPN1/6-A] CC (2014), *Northern Ireland Electricity Limited: price determination*, para 13.55. [UKPN1/7-A]

- “(a) the cost of existing fixed-rate (embedded) debt;  
 (b) the cost of existing and new floating-rate debt (which depends on short-term interest rates during the price control period, as well as the relevant spread over government debt); and  
 (c) the cost of new fixed-rate debt (which depends on interest rates for this duration and type of debt at the time of issue, as well as the relevant spread over government debt)”.

Each of these three elements should be weighted according to its projected importance in the licence holder’s overall debt during the projection period.”<sup>9</sup>

21. It added that it is “*standard regulatory approach*” to calculate the cost of existing fixed-rate embedded debt by reference to the interest that a company pays on its actual debt.<sup>10</sup> The CC has followed the above-stated principles and taken companies’ actual interest costs through to its allowed cost of debt calculation in all of the regulatory inquiries it has undertaken.<sup>11</sup> The Authority therefore acted consistently with normal previous statements and regulatory practice in reaching its Decision.

**(ii) Strong incentives are in place to issue debt efficiently**

22. Part of BGT’s case focusses on the efficiency of historical debt issuance. UKPN’s historical debt is efficient. The 2014 NIE inquiry shows how difficult it is to explain the debt premium in any individual bond issue.<sup>12</sup> In the NIE inquiry, although there was a *prima facie* case that NIE’s interest costs had been inflated as a result of its Irish ownership, the CC concluded that it could not decide conclusively that the clearly observable premium was due to inefficiency, and consequently opted not to disallow any of NIE’s actual interest costs in its Final Determination. In the BGT appeal, there is nothing in the data that comes even close to the magnitude of the ‘ownership’ premium that NIE appeared to pay. It is therefore difficult to see how the CMA could determine that the Authority erred by not excluding one or more of the DNOs’ bonds from the index, not least given the absence of any specific evidence from BGT to support its vague ponderings about possible inefficiency.

23. As highlighted in the Joint Submissions, the Authority’s DPCR1 to DPCR5 approach to setting the allowed cost of debt (i.e. fixed, five-year allowances) has given DNOs every incentive to minimise their interest bills. It can therefore be presumed that costs are efficient, and it is for BGT to identify where this is not the case – which it has not done.

24. As part of its submission to the Authority, UKPN provided evidence that the bonds that it had issued which fell outside of the proposed ten to twenty year index period had been issued efficiently.<sup>13</sup>

**ASSET LIFE POLICY**

25. BGT alleges that the Authority erred in applying the transitional approach to regulatory depreciation.<sup>14</sup> The DNOs have responded to these allegations in their Joint Submissions. In addition, UKPN contends that (i) BGT has failed to consider the issues in the round, failed to substantiate its argument that there is a “*cross-subsidy*” and failed therefore to demonstrate

<sup>9</sup> CC (2014), *Northern Ireland Electricity Limited: price determination* (“NIE”), para 13.56 (emphasis added).[UKPN1/7-A]]

<sup>10</sup> *Ibid.*, para 13.58.

<sup>11</sup> *Ibid.*, para 13.69; CC (2010), *Bristol Water plc*, appendix N, paras 45-48; [UKPN1/6-A] CC (2008), *Stansted Airport Ltd: Q5 price control review*, appendix L, paras 39-44; [UKPN1/8] CC (2007), *BAA Ltd*, appendix F, paras 40 to 42. [UKPN1/9] In the two airport inquiries, the CC had concerns about the way that BAA geared up following its acquisition by foreign owners in 2006. The CC therefore opted to factor only pre-acquisition interest costs into its price cap calculations.

<sup>12</sup> *Northern Ireland Electricity Limited: price determination*, paras 13.64 -13.67 [UKPN1/7-B]

<sup>13</sup> UKPN “*RIIO – ED1 cost of debt, 8 October 2014, page 4*” [UKPN1/10]

<sup>14</sup> NOA, paras 4.73(a); 4.73(b); 4.128(d).

any alleged “*intergenerational inequity*”; and (ii) BGT has not considered the positive impact of the transitional depreciation profile on long term financeability.

26. As a preliminary point, UKPN highlights that the process of agreeing a transitional period for the move to longer asset lives was the subject of consultation for a number of years, including UKPN bilateral meetings with BGT.

***(i) Delay and inter-generational issues***

27. BGT contends that it is inappropriate for the Authority to apply the transitional arrangements for regulatory depreciation as the effect of doing so is that customers in RIIO-ED1 are paying, and will be obliged to pay, more than their fair share of assets which will also be used by future customers. It also contends that RIIO-ED1 customers are doubly disadvantaged because they are also overpaying (and will overpay in the future) for assets which have been depreciated over 20 years.
28. BGT’s argument is flawed. It is inappropriate to pick out only one or two of the determinants of current depreciation levels in the way that BGT has done. Depreciation allowances for 2015-23 are a function of the combination of the full set of the decisions taken historically by the Authority and its predecessor. In consequence, RIIO-ED1 customers will see:
- (1) Assets built prior to vesting in 1990: zero depreciation charges;
  - (2) Assets built prior to March 1995: zero depreciation charges, save for the small amount of catch-up depreciation referred to in paragraph B10 of Appendix B to the Joint Submission;
  - (3) Assets built between April 1995 and March 2005: 1/20th annual depreciation instalments initially, falling to zero when those assets drop out of the asset base after 20 years, plus, again, the small amount of catch-up depreciation referred to in paragraph [B15 of Appendix B to the Joint Submission;
  - (4) Assets built between April 2005 and March 2015: 1/20th annual depreciation instalments; and
  - (5) Assets built between April 2015 and March 2023: 1/23rd annual depreciation instalments shrinking to 1/45th instalments by the end of the RIIO-ED1 period.
29. BGT mentions the fourth and fifth of these matters in its NOA, but ignores the other drivers of cost to customers. It is particularly erroneous for BGT to omit to mention that RIIO-ED1 customers will benefit from not paying for pre-vesting assets and paying only a very small amount for assets built between 1990 and 1995.
30. The only reasonable way to assess whether the RIIO-ED1 depreciation rules are fair from an economic and an inter-generational perspective is to consider the totality of the picture. Had the Authority taken the approach that BGT advocates, UKPN’s analysis of the data shows that customers would be paying unreasonably small amounts in the RIIO-ED3 period. The primary effect of the transition to 45-year asset lives is therefore to dampen a very unnatural halving of depreciation charges to customers during the period to 2044 – i.e. contrary to BGT’s case, the policy in fact improves, rather than harms, intergenerational equity.
31. Moreover, BGT has failed to adduce any evidence to support its assertions that “*current consumers ... have overpaid for the use of assets*”, that “*current consumers [will] continue to pay more than is economically appropriate*” under the Decision and that there is therefore a “*cross-subsidy of future consumers*”.<sup>15</sup> In order to succeed with this line of argument, BGT would need to show that the total RIIO-ED1 depreciation charge exceeds annual capital

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<sup>15</sup> NOA, paras 4.75, 4.83.

consumption or a measure of ‘economic depreciation’. There is no reference to these points in the NOA.

***(ii) Case-by-case transitional arrangements***

32. Financeability is another important consideration. The two key metrics that are affected by the change in asset lives are Funds from Operation to Net Debt (“FFO/Net Debt”) and Retained Cashflow to Net Debt (“RCF/Net Debt”), with FFO/Net Debt being the more highly weighted of these by one of the key rating agencies. According to UKPN’s own analysis of the data, the benefit of the transitional approach is that both of these metrics are materially stronger in the period RIIO-ED1 to ED3 compared to the 45-year depreciation. In both RIIO-ED2 and ED3 these financial metrics come under significant pressure as the assets which have been depreciated over 20 years fall out of the RAV. This approach is better aligned with the RIIO principle of a long-term commitment to financeability.
33. The AlixPartners Report argues for a swap of debt for equity or for shareholders not to take dividends in order to ensure that DNOs do not find themselves facing financeability concerns. BGT maintains that the financeability of the company is primarily a concern of the shareholder.<sup>16</sup> As to this:
- (1) It is a statutory duty of the Authority to ensure that DNOs are able to finance their activities under the relevant legislation: EA89 s. 3A(2)(b).
  - (2) Further, the Authority has stated from the beginning that the RIIO process is about setting a revenue package for the price control. An investor injects capital into a company in order to grow the company and make a return. The revenue which DNOs generate from their regulatory depreciation is beyond their shareholders’ control, and therefore it is inequitable for the shareholder to be required to inject capital in order to help the Authority achieve one of its objectives.
  - (3) Investment in DNOs could be undermined by setting a precedent of the sort that BGT is suggesting.
34. In light of the above, the Authority’s decision to apply transitional depreciation arrangements is correct.

**INFORMATION QUALITY INCENTIVE**

35. UKPN contends that (i) notwithstanding the changes made by the Authority, IQI continues to incentivise DNOs to submit accurate business plans; and (ii) the Authority’s approach was appropriate in light of the justifiable discrepancies between the business plans as submitted by the DNOs and its own assessment.

***(i) Background***

36. The Authority has used IQI in price reviews since 2004. The purpose of IQI is to persuade a DNO to reveal its best estimate of future expenditure needs during the price review process.
37. The matrix used to calculate IQI could be calibrated in a number of different ways while still functioning as an incentive to ‘tell the truth’. By tweaking three ‘choice parameters’ – the efficiency incentive rates, the amounts of additional income/penalty, and the rule for calculating allowed expenditure – the Authority can present DNOs with any given level of pay-off for any particular result. The only constraint is that the matrix must in the end be ‘incentive compatible’, i.e. must always ensure that if a DNO expects to spend  $x$  it is best off declaring that value  $x$  to the Authority during the price review process.

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<sup>16</sup> [BGT1/HH1-1] AlixPartners Report, para 8.2.23.

38. BGT challenges the specific IQI matrix that the Authority has used in its RIIO-ED1 determination, arguing that it confers undue financial benefit on DNOs.

***(ii) Long-term incentive plan***

39. BGT's claim that the decision to alter the IQI design will weaken DNOs' incentives to make accurate expenditure forecasts in future is misconceived. The incentive to submit truthful expenditure projections comes from the 'incentive compatible' property of the IQI matrix. As explained above, a DNO is always better off financially under the current matrix if it reveals its most accurate estimate of expenditure to the Authority. Whether IQI is penal or tolerant towards subsequent differences between the Authority and the company affects whether there is a one-off, lump-sum transfer between customers and shareholders (or vice versa); but it cannot be said to enhance or diminish the incentive to tell the truth.

40. In any case, IQI is only one of a number of components within the RIIO model that influence DNOs' business plans. Other important parts of the framework include: customer engagement, which imposes considerable discipline on expenditure and output choices; the fast-tracking process, which gives a DNO a clear incentive to prepare the best and most challenging plan in the industry; and wider reputational incentives, especially the Authority's commitment that companies that 'play fair' will receive long-term rewards through lighter regulation.

***(iii) Justification for the Authority's approach***

41. BGT's view of the IQI issue is distorted. The IQI matrix BGT prefers would be unduly 'penal' towards DNOs. It is important to remember that DNOs prepared their business plans in the knowledge that they would be exposed to an IQI, and therefore had a clear financial incentive to declare their expenditure plans accurately and truthfully. The real issue in this part of the appeal is whether the Authority reacted appropriately to the emergence of non-trivial gaps between DNOs' business plan projections and the Authority's preferred estimates of efficient expenditure.

42. BGT's contention is, in effect, that the Authority should have penalised the DNOs financially. However, this goes far beyond the response that a reasonable regulator would make in a non-IQI price review.<sup>17</sup> Furthermore, the Authority would have had to take account of this penalty when finalising the overall settlement.

43. The Authority always signalled that it would adjust the IQI matrix "*to ensure that by Draft Determination the actual efficiency incentive rates that companies would face would not lie significantly outside our desired range*".<sup>18</sup> In its Draft Determination, the Authority stated that it had recalibrated the matrix from the one originally put forward (i.e. BGT's preferred design) because it had changed its approach in relation to RPEs and SGBs, with the effect that no DNO met the Authority's assessment of efficient costs.<sup>19</sup> In calibrating the matrix in this way, the Authority was signalling that it was willing to place some weight on DNO projections submitted in good faith against the backdrop of the incentive properties of IQI.

44. This approach was consistent with one of the advantages that the Authority has seen in IQI since its introduction in 2004, i.e. that it enables the Authority to place more reliance on DNOs' cost forecasts as opposed to its own views or those of consultants.<sup>20</sup> What the

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<sup>17</sup> See e.g. the CC NIE determination, where the CC set NIE's operating expenditure and capital expenditure ("capex") allowances in line with its assessment of efficient costs but took no additional punitive action on account of NIE's submission of higher cost forecasts.

<sup>18</sup> Authority: "*Strategy Consultation for the RIIO-ED1 Electricity Distribution Price Control Outputs, Incentives and Innovation*" [BG2/8 B para 9.22]

<sup>19</sup> Authority: "*Draft Determinations Consultation for the Slow-Track Electricity Distribution Companies - Overview*", para 4.55[BG2/30 A]

<sup>20</sup> *Electricity Distribution Price Control Review, Initial Proposals* [UKPN1/11] para 6.92

Authority has done with its ED1 IQI is to put this principle into practice. Rather than penalise DNOs for having different, higher forecasts of costs, it has accepted that some degree of discrepancy is understandable and acceptable.

***(iv) Explanation of the discrepancy***

45. Of the 13% gap between UKPN's business plan projections and the Authority's assessment of efficient costs, 7% is attributable to the Authority's comparative efficiency assessment; 4% to the Authority's lower forecasts of RPEs; and 2% to the Authority's higher estimates of SGBs.<sup>21</sup> A sizeable proportion of these gaps can be explained by two main factors.
46. First, additional information became available to the Authority after the submission of the DNOs' final business plans. For example, in the eight months that passed between the DNOs making their RPEs forecasts and the Authority calculating its Final Determination RPEs allowances, the Authority was able to take account of a general pushing back in forecasts of the point at which the UK economy would start generating real wage growth, as well as a sharp fall in oil and commodity prices between June and November 2014. Moreover, once all the DNOs' business plans had been submitted, it was possible for the Authority to identify further opportunities for SGBs. The IQI matrix actually used by the Authority is tolerant of differences caused by new information; the matrix preferred by BGT is not.
47. Second, there are inevitably instances during a price review where a company takes a different view from the Authority. In relation to comparative efficiency, the Authority made a number of decisions with regard to UKPN's cost allowances with which UKPN took issue during the process (e.g. cost reductions through modelling where UKPN had provided specific justifications for individual investments; reductions in costs allowed for operational training where the Authority did not recognise UKPN's historically higher staff turnover compared to the industry). There were also elements of the Authority's RPEs assessment that were subjective (e.g. the decision to benchmark RPEs during a period of expected economic growth to observed RPEs over the whole of the business cycle, including two periods of recession/stagnation; the Authority's refusal to make the adjustment to average earnings growth forecasts that the CC made in the NIE inquiry to account for changes in the mix of employment in the economy). In relation to SGBs, the Authority calculated a level of benefit well beyond the upper quartile overall benefits identified by the DNOs.
48. As noted at para 43 above, the Authority itself recognised that the toughness of its stance in relation to RPEs and SGBs justified a review of the design of IQI. Had the Authority not changed the IQI calibration, UKPN would have suffered a financial penalty for each of the above decisions. That would have been an unduly heavy-handed and punitive course of action for the Authority to take.

***(v) Relationship between IQI, SGBs, and RPEs***

49. As a final point, it is important for the CMA to understand that if there were to be adjustments to SGBs and RPEs resulting from the NPg appeal, there would inevitably be a knock-on consequence for IQI in the BGT appeal.
50. As outlined, IQI is a mechanism designed to incentivise DNOs to produce high-quality and well-justified business plans and to deliver them efficiently. The Authority must strike a balance between protecting consumers, by making sure DNOs deliver their business plans efficiently, and ensuring that an efficient DNO is able to finance its operations. As a result of that balancing exercise, the Authority determines the efficiency challenge that it wants to

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<sup>21</sup> RIIO-ED1 Final determinations for the slow-track electricity distribution companies Business Plan expenditure assessment [BG2/35 B] page 15, Table 2.6

impose on DNOs. As the Authority has stated, this challenge translates into adjustments to the estimated costs to account for the expected evolution of cost efficiency (e.g. RPEs or SGBs) and a reward/penalty, calculated using IQI, if the company deviates from the Authority's estimate of the efficient costs.<sup>22</sup>

51. The interaction between SGBs, RPEs, and IQI indicates how difficult it is to consider the issues in isolation. Whilst UKPN thinks that the Authority's approach to SGBs and RPEs is onerous to the DNOs, it considered that this was mitigated to a certain extent by a proportionate approach being taken by the Authority when setting the break-even point in the IQI. This highlights the difficulty of interfering with a regulator's discretion, even on supposedly discrete issues.

## **CONCLUSION**

52. In light of the points set out in the Joint Submission and above, it is clear that BGT's grounds of appeal in relation to cost of debt, asset life policy and IQI are entirely without merit. Taking into account the specialist expertise of the Authority, and looking at all the issues in the round, UKPN submits that there is no adequate basis on which to interfere with the Authority's Decision.

## **STATEMENT OF TRUTH**

Eastern Power Networks plc, London Power Networks plc and South Eastern Power Networks plc believe that the facts stated in this Individual Submission are true.

Signed: .....

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<sup>22</sup> RIIO-ED1: Draft Determinations for the Slow-Track DNOs Overview [BG2/30 A] page 34, para 4.52 – 4.54