In the Competition and Markets Authority

In the matter of an Appeal under section 11C of the Electricity Act 1989

Northern Powergrid (Northeast) Limited

Northern Powergrid (Yorkshire) plc

Appellants

v.

The Gas and Electricity Markets Authority

Respondent

INTERESTED THIRD PARTY OBSERVATIONS OF

BRITISH GAS TRADING LIMITED

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1. INTRODUCTION

1.1 British Gas Trading Limited ('**BGT**') makes these observations as an interested third party in the appeal brought by the Appellants, collectively Northern Powergrid ('**NPG**'), against a decision by the Gas and Electricity Markets Authority ('**the Authority**'), published on 3 February 2015, to modify the Appellants' electricity distribution licenses ('**the Decision**'). These observations are made pursuant to paragraph 10.1 of the Competition and Market Authority's ('**CMA**') Energy Licence Modification Appeals Rules (document CC14).

1.2 The Decision forms part of a wider decision to modify the electricity distribution licenses of 10 Distribution Network Operators ('**DNOs**'), representing 5 of the 6 DNO groups in Great Britain. BGT has itself appealed that wider decision.

1.3 NPG relies on three grounds of appeal as set out in its Notice of Appeal ('**NoA**'), dated 2 March 2015, relating to Smart Grid Benefits ('**SGB**'), Real Price Effects ('**RPE**'), and Regional Labour Cost Adjustments ('**RLCA**'), respectively.

1.4 BGT considers that NPG's appeal should be dismissed. Mindful of its limited role as an interested third party and in order to avoid duplication with the Authority, BGT does not seek to address all of the issues arising in that appeal, but makes targeted

observations in relation to the following matters: in **section 2**, by way of context, BGT addresses the claims that NPG makes as to the financial magnitude of the errors alleged in NPG's NoA in contrast to any likely actual impact on NPG's ability to recover its efficient costs; in **sections 3 to 5**, BGT makes brief observations identifying defects in relation to each of NPG's grounds of appeal; and in **section 6**, BGT considers the relationship between NPG's grounds of appeal and those advanced in BGT's NoA.

2. FINANCIAL MAGNITUDE OF THE ERRORS ALLEGED BY NPG

2.1 NPG claims that the cumulative impact on the Authority's assessment of total costs of the three 'errors' it identifies amounts to **£104.3 million** in 2012/13 prices[1]. NPG further contends that it would also have been entitled to an additional reward of £19.6 million under the Information Quality Incentive ('**IQI**') scheme had the Authority correctly assessed efficient costs[2]. In this connection, BGT makes the following four observations:

a. First, the cost allowance which forms part of NPG's overall allowed revenue is determined on the basis of an interpolation of the Authority's assessment of total costs (a 75% weight) and NPG's own forecast (a 25% weight). The cumulative impact of the errors identified by NPG on its allowed revenue therefore would only amount to **£78.2 million** and not £104.3 million.

b. Secondly, under the RIIO-ED1 price control, NPG would still be able to recover a share of any costs incurred in excess of its cost allowance. That share is determined by the so-called 'efficiency incentive rate', which in NPG's case is 55%[3], meaning that NPG would be able to pass through to its customers 45% of any overspend. Thus, even if NPG were to overspend against its cost allowance by the £78 million identified above, it would only be unable to recover around **£43 million** of that amount.

c. Thirdly, as to the claimed further IQI reward, that assertion ignores the fact that the Authority relaxed the IQI matrix specifically to account for the SGB and RPE adjustments NPG now contends were made in error. BGT estimates that the effect of modifying the adjustment to the IQI matrix in the event that NPG's

[1] §1.8 of the NPG NoA.

[2] Frontier Economics report – Exhibit FE1 to the witness statement of Michael Paul Huggins, (Vol 5, Tab B, item 1), table 24.

[3] '**Final Determinations**' (The Authority, RIIO-ED1: Final determinations for the slow-track electricity distribution companies, 28 November 2014), Overview, p. 73.

appeal succeeds would more than offset any positive effect from an adjusted cost benchmark (as set out at §6.8 below).

d. Fourthly, interpolation as described above is a mechanism that the Authority employs precisely to '*recognise [it does] not have perfect information*'[4]. The benefit of interpolation alone on NPG's allowed revenue was **£71 million.**[5] For the same reason, it also generally seeks to benchmark efficient costs by reference to upper quartile rather than frontier performance. NPG's cost allowance therefore already contains a significant uplift compared with the Authority's actual estimate of efficient costs, in order to offset the impact of potential errors in the Authority's assessment. This approach is inherently favourable to DNOs, as modelling or measuring errors can reasonably be expected to go either against or in favour of DNOs.

2.2 Therefore, even assuming that NPG's case is justified in its entirety, the financial impact on NPG of the alleged errors it identifies is actually significantly smaller than the £104.3 million headline figure given, at around £43 million. Furthermore, this is in the context of a cost modelling approach which is inherently favourable to DNOs and is designed to provide a certain allowance for errors in the Authority's assessment.

3. GROUND 1: SMART GRID BENEFITS

3.1 The Authority's benchmark assessment of efficient costs is based in the first place on inputs provided by the DNOs themselves through their business plans. However, in the Final Determinations underlying the Decision, the Authority made further independent adjustments to its assessment of efficient costs in order to reflect SGBs and RPEs, which it considered that the DNOs had not appropriately estimated themselves in their business plans. Those adjustments led to a reduction in the efficient cost benchmark.[6]

3.2 NPG contends that the Authority's two-stage approach of undertaking a second independent assessment in relation to SGBs was '*unjustified, disproportionate and discriminatory*' (Ground 1A[7]), suffered from *'serious methodological and data flaws*'

[4] Final Determinations, §4.3.
[5] Final Determinations, Table 2.6 (difference between the Authority's view of NPG's costs and its allowance after interpolation)
[6] Final Determinations, §4.59.
[7] NPG NoA, §§1.29ff.

(Ground 1B[8]) and '*material errors in implementing [it] in practice*' (Ground 1C[9]). NPG also complains of procedural unfairness and a failure to consult (Ground 1D[10]).

3.3 BGT makes the following two observations in relation to Ground 1B of NPG's appeal.

3.4 First, NPG contends that the Authority's two-stage approach distorts incentives by '*rewarding savings made through "smart" solutions over conventional solutions*'[11]. However, that argument does not hold for the following reasons:

a. In setting the current price control, the Authority's approach cannot have distorted DNOs' incentives for the simple reason that the Authority's independent assessment of SGBs was developed *after* submission of business plans by the DNOs, specifically to address the concern that DNOs had failed to give sufficient weight to SGBs.

b. Over the course of the current price control, the Authority's approach cannot be said to create higher incentives to make 'smart' savings over 'conventional' savings. This is because the incentive for a DNO to make savings derives from its efficiency incentive rate, which determines the share of savings it is allowed to retain as revenue. The efficiency incentive rate for each DNO depends on its forecast to modelled cost ratio under the IQI, but importantly it is common to all expenditure. Reductions will be treated equivalently whether they reflect smart or conventional savings.

c. In relation to future price controls, the Authority's approach is unlikely to distort DNOs' incentives. There can be no expectation that the Authority will repeat its two-stage approach in relation to SGBs. The Authority's specific justification for that approach was that the industry had failed to give appropriate weight to a factor that represents a significant technological change in the context of the current price control. It is unlikely that the same will hold true in eight years' time. Furthermore, even if the Authority were to adopt a similar approach in future, it would likely only do so if it again found the industry to have under-forecast SGBs. This, however, would be inconsistent with the thrust of NPG's incentive argument, which is that the Authority's approach will lead to excessive focus by DNOs on smart savings rather than conventional savings. In such a hypothetical

[8] NPG NoA, §1.33.
[9] NPG NoA, §1.34.
[10] NPG NoA, §§1.35f.
[11] NPG NoA, §6.68.

scenario, it would also still be logical for the Authority to consider carefully whether DNOs had failed to reflect fully the impact of 'game-changing' technologies. This is because ignoring major shortcomings in business plans would, in BGT's view, always be inappropriate. In any event, this is not an appeal of future price controls.

3.5 Secondly, NPG contends that the Authority's benchmarking of SGB savings '*is not economically meaningful unless it is considered in the context of the DNOs' prevailing levels of efficiency*'[12]. In short, NPG contends that better performing DNOs should only be expected to be able to realise smaller incremental savings compared to lower performing DNOs, which can be expected to make more significant progress. However, that argument misunderstands the nature of SGB related savings. NPG assumes that DNOs' costs simply approach a predetermined '*optimal (or frontier) level*'[13] of efficient expenditure with diminishing returns as efficiency increases, and that SGBs are simply one of several means of achieving this frontier level of efficiency. However, it is more appropriate to consider the move to a smart grid as a technological 'game changer' that has an impact on the frontier level of expenditure itself, and which creates opportunities to achieve savings that were not previously accessible to any of the DNOs.

4. GROUND 2: REAL PRICE EFFECTS

4.1 NPG contends that the Authority has underestimated the RPEs that NPG (and other DNOs) will face in respect of labour costs. It argues that the Authority '*used inaccurate proxies for the labour costs facing the Appellants*'[14] and that '*the obviously relevant data ... was pay settlements awarded by DNOs*'[15]. NPG further comments that '*GEMA uses DNOs' own data for most of its comparative benchmarking and the Competition Commission ("**CC**") in the Northern Ireland Electricity Limited Price Determination ("**NIE**") used actual labour costs data for this purpose*'[16].

4.2 BGT makes three observations in response to this ground of NPG's appeal.

4.3 First, NPG has misunderstood the CC's approach in the NIE determination, and there are good reasons for not relying on DNOs' own pay data:

[12] NPG NoA, §6.64.
[13] NPG NoA, §6.65.
[14] NPG NoA, §7.16.
[15] NPG NoA, §2.14.
[16] Ibid.

a. In the NIE case, UK DNOs' wage data was used because it was *independent* of NIE[17]. That reasoning does not support the use of UK DNOs' data in respect of those same UK DNOs' price controls.

b. Although NPG claims that the DNO pay settlements were efficient, any reliance on DNO pay settlements suffers from a data independence or '*endogeneity*' problem. In particular, if regulated firms face less cost pressure than firms in the wider economy, then it would be wrong to embed this into future RPEs since this would merely perpetuate the lack of sufficient pressure on costs to keep pay rates in line with those in the wider economy.

4.4 Secondly, it is noteworthy that the Authority has moved more broadly towards the use of market-wide data in other contexts as well (e.g. in relation to the cost of debt).[18]

4.5 Thirdly, while NPG lists reasons why DNOs may face higher wage pressure than the rest of the economy, in support of its claim that the general labour market is an unsuitable benchmark for DNO labour costs, it fails to acknowledge potentially offsetting factors, including the following:

a. DNO staff may experience advantages relative to the general labour market such as increased job security due to greater stability in electricity demand. If anything, changes in the relative degree of job security as between DNOs and the rest of the market should be reflected in *lower*, not higher, wage pressure.

b. In addition, if, as NPG argues, the labour market for DNOs is effectively separate from that for other parts of the economy employing engineering staff, greater stability in electricity demand should also make DNOs immune from any rise in wage pressure due to the recovery of conditions in the wider labour market. This again points to *lower*, not higher, expected wage pressure for DNOs.

Taking those offsetting factors into account, it is far from clear that the wider labour market constitutes an unfavourable proxy for DNOs' labour costs, as NPG seeks to contend.

5. GROUND 3: REGIONAL LABOUR COST ADJUSTMENTS

5.1 NPG contends that the Authority '*materially overstated the difference between labour*

[17] Competition Commission, Northern Ireland Electricity Price Determination, Final Determination, 26 March 2014, paragraph 11.58.
[18] Final Determinations, §2.41.

costs in London and the South East relative to the rest of Great Britain'[19]. The Authority makes Regional Labour Cost Adjustments to DNOs' submitted costs in order to reflect differences in labour costs between London, the South East and other regions collectively. RCLAs impact on the relative efficiency assessment of DNOs since they are used to adjust DNOs' forecast costs prior to the benchmarking across DNOs. NPG contends that the Authority based its calculation of RCLAs on inappropriate data and concludes that RLCAs calculated on the basis of more granular or robust data would show much lower premiums for London and the South East relative to the rest of Great Britain.[20]

5.2 BGT makes the following observations in relation to this ground of NPG's appeal:

a. Any change in RCLAs would result in different costs being used for individual DNOs in the comparative benchmarking exercise, leading to changes in the measured (in-)efficiency of individual DNOs, and in turn to changes in their respective cost allowances.

b. Reducing the premiums for London and the South East would result in higher allowed costs for DNOs in other regions. However, at a sectoral level, there is no reason to suppose that a change in RCLAs would systematically lead to increased allowed costs.

c. Nevertheless, if NPG's argument succeeds and an increase in its allowed costs is permitted, customers would be worse off overall unless RCLAs and cost allowances are adjusted across all DNOs. The risk to customers is that the original higher RCLAs result in higher prices for London and the South East DNOs, but that the corresponding benefit of lower prices elsewhere will not be realised, in particular in the NPG licence areas.

5.3 BGT also notes that NPG's argument relating to RCLAs appears to be selective. For example, while NPG notes that the Authority could have applied a 6% RCLA for the Scottish DNOs but chose not to do so (which was in NPG's favour), it only challenges the Authority's assessment of the London and South East RCLAs (which it considers operate against it).[21]

5.4 In summary, BGT considers that any adjustment to RCLAs requires careful further

[19] NPG NoA, §8.4(A).
[20] NPG NoA, §2.23.
[21] See NPG NoA, §8.16.

analysis and will need to be applied across DNOs. BGT is doubtful whether the necessary analysis can efficiently be conducted within the scope of this appeal process which operates on a tight timetable. BGT therefore considers that if NPG were to succeed on this ground of appeal, the appropriate course of action would be to remit the ground to the Authority for further consideration.

6. CONNECTION BETWEEN BGT'S IQI GROUND AND NPG'S SGB AND RPE GROUNDS

6.1 As explained above, the Authority's benchmark assessment of efficient costs is based in the first place on inputs provided by the DNOs themselves through their business plans. However, in the case of SGBs and RPEs the Authority made further independent adjustments, as it considered DNOs had not themselves appropriately estimated related savings. Those adjustments led to a reduction in the efficient cost benchmark.

6.2 The IQI scheme seeks to encourage DNOs to prepare well-justified business plans during the process of developing the efficient cost benchmark. In the Strategy Decision[22], the Authority explained that the IQI was designed so that '*a DNO which submits an expenditure forecast for RIIO-ED1 that matches our assessment of that DNO's efficient expenditure can achieve a return equal to our estimate of its cost of capital, if it then spent the amount it had forecast over the control period*'. However, in the Final Determinations, the Authority decided to relax the breakeven point for the IQI so that '*a DNO group that forecasts 2.9 per cent above our efficient cost benchmark and achieve [sic] its forecast will earn its cost of capital ...*'. The Authority considered that change justified in light of its SGB and RPE related adjustments it had made to the efficient cost benchmark.

6.3 In its own NoA, BGT submits that this *ex post* change to the IQI was unwarranted and should be reversed. The reasons for restoring the original IQI matrix apply to all slow-track DNOs and not just to NPG, and furthermore do not rely on whether NPG's appeal succeeds. NPG's and BGT's grounds of appeal are therefore independent.

6.4 However, should NPG's appeal succeed in relation to the SGB and RPE grounds, it would be perverse not to also unwind the corresponding benefit that NPG gained from the Authority's IQI adjustment. This would achieve in part the same result as if BGT's IQI ground of appeal were to succeed.

6.5 The benefit of the change to the IQI break-even point was worth £49.6 million to

[22] The Authority, Strategy decision for the RIIO-ED1 electricity distribution price control, 4 March 2013.

NPG[23]. The adjustment to the Authority's assessment of NPG's efficient costs in relation to SGBs was £42 million, and the RPE adjustment was £141 million[24]. The SGB share of the total adjustments which took place outside of the standard benchmarking process is therefore 23%, and the RPE share 77%. Applying this share (as a simplifying assumption) to NPG's benefit derived from the Authority's change to the IQI breakeven point, leads to a benefit associated with the SGB adjustment in the region of £11.4 million (23% of £49.6 million), with the remaining c. £38.2 million being attributable to the RPE adjustment.

6.6 In relation to NPG's grounds of appeal, BGT therefore contends that the following adjustments should be made to NPG's IQI reward:

a. Should NPG succeed on its **Ground 1A, Ground 1B or Ground 1D** and the SGB adjustment to the efficient cost benchmark is reversed in its entirety, the corresponding change to the IQI should also be reversed and NPG's IQI reward should be reduced by c. £11.4 million.

b. Should NPG succeed on its **Ground 1C** (error in SGB calculations), NPG estimates that the impact of the SGB adjustment on NPG would be reduced by 65%[25]. As a result, a corresponding 65%, or c. £7.5 million, should be deducted from the share of NPG's IQI benefit that is attributable to SGBs (£11.4 million).

c. Should NPG succeed on its **Ground 2** (understatement of RPEs), NPG estimates that the impact of the RPE adjustment on NPG would be reduced by 29%[26]. As a

[23] This is given by the difference between the actual upfront reward provided to NPG of £2.7 million and the estimated upfront penalty that it would have faced under the original IQI matrix of £46.9 million. Please see AlixPartners' first report to the BGT appeal [BGT1/HH1/1], Table 7.2.

[24] NPg NoA §§ 6.39 and 7.12

[25] In the event that NPG's appeal grounds 1A and 1B fail, but that its appeal ground 1C (error in SGB calculations) succeeds, NPG estimates that the reduction in the SGB adjustment for NPG would be £27.4m (Frontier Report, Table 23, paragraph 5.11). This would reduce the net impact of the SGB adjustment falling from £42m to £14.5m, or by 65%. BGT therefore consider that 65% of the IQI adjustment benefit attributable to SGBs, or £7.5m (calculated as 65% of £11.4m), should be subtracted from NPG's upfront reward should NPG's Ground 1C succeed. (BGT noted that if BGT's Ground 3 succeeds, this benefit would in any event be removed from NPG).

[26] In the event that NPG's Ground 2 (understatement of RPEs for 2014/15 and 2015/16) succeeds, the size of Authority's RPE adjustment for NPG would fall by £41.1m. (Frontier Report, Table 22, page 90. Note that this relates to correcting for the 2014/15 RPE labour assumption only and does not include an estimate of the impact of correcting Authority's Labour RPE assumption for 2015/16.) The total RPE adjustment made by Authority to NPG was £140m. (Authority's Final Determination, Table 4.2) Therefore, NPG's Ground 2 would reduce the size of the RPE adjustment for NPG by 29%. The total benefit of the Authority's IQI adjustment to NPG is estimated at £49.6m. The proportion of this attributed to the RPE adjustment is estimated at £38.2m.(Calculated at £49.2 * £140m/(£140m+£41.9m), reflecting the share of RPE adjustments of the total for RPE and SGBs).) The share of the IQI adjustment benefit which should be removed, should Ground 2

result, a corresponding 29%, or c. £11.2 million, should be deducted from the share of NPG's IQI benefit that is attributable to RPEs (£38.2 million).

6.7 None of those adjustments will be required if BGT's IQI ground of appeal succeeds and the original IQI matrix is restored.

6.8 Should NPG's appeal succeed in its entirety, NPG's IQI reward should be reduced by a total of c. £22.6 million, more than offsetting the £19.6 million NPG contends it would have earned in additional IQI rewards had efficient costs been estimated correctly.[27]

7. CONCLUSION

7.1 BGT submits that:

7.1.1 NPG's appeal should be dismissed;

7.1.2 Alternatively, insofar as any part of NPG's appeal is upheld, consequential adjustments should be made to ensure consistency in the design and operation of the price controls.

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JOSH HOLMES

STEFAN KUPPEN

Monckton Chambers

22 April 2015

Statement of truth

I, Raj Roy, on behalf of British Gas Trading Limited, believe the facts and information stated in these observations to be true.

Signed:_

Dated: 22 April 2015

succeed and the RPE adjustment be reduced by 29%, is therefore £11.2m. (BGT noted that if BGT's Ground 3 succeeds, this benefit would in any event be removed from NPG).

[27] See §2.1 above.