British Gas Trading Limited
v The Gas and Electricity Markets Authority

Final determination

Notified: 29 September 2015
© Crown copyright 2015

You may reuse this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence.

To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

Website: www.gov.uk/cma
Members of the Competition and Markets Authority
who conducted this appeal

John Wotton  (Chair of the Group)

Graham Sharp

Jon Stern

Chief Executive of the Competition and Markets Authority

Alex Chisholm
6. Ground 3: change to Information Quality Incentives ............................................. 76
   Background........................................................................................................... 76
   The Information Quality Incentive: overview ...................................................... 76
   The upfront reward/penalty ................................................................................. 79
   GEMA’s Decision in relation to the IQI ................................................................. 80
   GEMA’s September 2012 Strategy Consultation .................................................. 80
   GEMA’s March 2013 Strategy Decision ................................................................. 80
   GEMA’s Draft Determinations for the slow-track DNOs ........................................ 82
   GEMA’s Final Determinations for the slow-track DNOs ........................................ 84
   GEMA’s 3 February 2015 letter to BGT ................................................................. 84
   Summary of BGT’s appeal ground 3 .................................................................... 85
   Summary of GEMA’s response to appeal ground 3 .............................................. 87
   Summary of BGT’s Reply to appeal ground 3 ....................................................... 91
   Summary of third party submissions on appeal ground 3 ...................................... 93
   Joint submission by the slow-track DNOs ............................................................. 93
   Electricity North West Limited – 20 April 2015 .................................................... 96
   Eastern Power Networks plc, South Eastern Power Networks plc and
   London Power Networks Plc .................................................................................. 96
   Other interested parties ....................................................................................... 97
   Our assessment of appeal ground 3 .................................................................... 98
   Justification for the decision to adjust the IQI per se .......................................... 98
   The scale of the IQI adjustment ........................................................................ 103
   Conclusion on appeal ground 3 .......................................................................... 116
   Remedy ............................................................................................................. 119
   Implementation .................................................................................................. 121

7. Ground 4: transitional arrangements for change in asset life policy .................. 122
   Background ........................................................................................................ 122
   Summary of BGT’s appeal ground 4 .................................................................... 124
   Summary of GEMA’s response to appeal ground 4 ............................................. 126
   Summary of the DNOs’ joint response to appeal ground 4 ................................. 129
   GEMA’s evidence at the hearing ....................................................................... 130
   Summary of BGT’s Reply to appeal ground 4 .................................................... 130
   Our assessment of appeal ground 4 .................................................................... 131
   Alleged procedural flaws .................................................................................. 133
   Conclusion on appeal ground 4 .......................................................................... 135

8. Ground 5: Change in cost of debt indexation ................................................... 136
   Background ........................................................................................................ 136
   Summary of BGT’s appeal ground 5 .................................................................... 137
   Summary of GEMA’s response to appeal ground 5 ............................................. 138
   Summary of third party responses to appeal ground 5 ........................................ 140
   Summary of BGT’s Reply to appeal ground 5 .................................................... 140
   Our assessment of appeal ground 5 .................................................................... 141
   Effect of the trombone compared to the ten-year trailing average ...................... 141
   Justification for the trombone .......................................................................... 145
Final determination

1. Introduction

1.1 On 3 February 2015, the energy regulator, the Gas and Electricity Markets Authority (GEMA), published its decision to modify the electricity distribution licences of ten Distribution Network Operators (DNOs). These licence modifications cover an eight-year period from 2015 to 2023 and include revenue allowances for each DNO. The Competition and Markets Authority¹ (CMA) has considered two separate appeals relating to this decision: one from an electricity supplier, British Gas Trading Limited (BGT), against the decision to modify the ten licences; and one from the Northern Powergrid group (NPg) against the licence modifications for its two DNOs, Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc.

1.2 This document sets out our final determination on BGT’s appeal. Under the applicable statutory framework for the appeals process, the CMA is required to reach its final determination by 30 September 2015.

1.3 In reaching our final determination, we have considered BGT’s Notice of Appeal and related documents; the response and related documents from GEMA; submissions and supporting evidence made as interested third parties by the ten DNOs whose licence modifications are the subject of the decision under appeal (the slow-track DNOs); and other interested third parties including Citizens Advice and EDF Energy plc (EDF Energy). We have also held hearings with BGT, GEMA and the slow-track DNOs and taken into account responses to our provisional determinations that were shared with the main parties and interested third parties.

1.4 In this document, we set out the background to the appeal before considering each ground of BGT’s appeal in detail. In Section 2, we summarise the role of electricity distribution in the electricity supply chain and the structure of the industry. We also describe the RIIO price control mechanism and the role of GEMA in setting a price control for the DNOs. This section of the document draws heavily on a submission jointly agreed between the appellant (BGT) and the respondent (GEMA).²

1.5 Section 3 sets out the legal framework for the appeal and our consideration of the standard of review. Both Sections 2 and 3 are substantively the same as the equivalent sections in our final determination on the appeal under the

---

¹ On 31 March 2015, in accordance with paragraph 4(2) of Schedule 5A to the Electricity Act 1989 (EA89), a group consisting of three members of the CMA’s panel was appointed to consider and determine this appeal.

² The content of this material was also agreed with NPg.
same statutory framework by NPg. For the avoidance of doubt, this includes addressing arguments made by parties in one or the other appeal in relation to the standard of review and the nature of the decision.

1.6 Sections 4 to 8 consider each of BGT’s five grounds of appeal in turn. In each case, we summarise the relevant main arguments and supporting evidence put forward by the parties, explain the reasoning for our determination on each ground and, where relevant, our remedy and a process for its implementation.

1.7 Section 9 sets out our determination on costs.

2. Background to the appeal

Distribution Network Operators and their role in the electricity supply chain

2.1 Electricity is transported from generators to consumers via networks: the high voltage transmission network, operated by Transmission Operators (TOs); and the lower voltage distribution networks, operated by DNOs. DNOs use the lower voltage networks to carry electricity to industrial, commercial and domestic users up to their meter points. Broadly, DNOs’ obligations are: to maintain security of supply; provide connections for generation and supply; and to operate in an efficient, economic and non-discriminatory manner.

2.2 Electricity suppliers, such as BGT, buy energy in the wholesale market, or directly from producers, and are obliged to enter into contractual arrangements with TOs and DNOs so that the electricity is delivered to consumers. Suppliers are the primary point of contact for most consumers for matters relating to the supply of electricity.

2.3 DNOs also have interactions with consumers. These interactions are often about ensuring that consumers receive a safe and reliable supply of electricity. For example, during power cuts it is the DNOs which supply information on the location and duration of the power cut; provide special assistance to consumers with priority needs; and liaise with other bodies (local councils, charities etc) to ensure vulnerable consumers are protected.

---

3 This section of the determination draws heavily on background material provided to the CMA and jointly agreed by main parties to this appeal and that of NPg.

4 The vast majority of customers in Great Britain are connected to the distribution network. There are a small number of large customers connected directly to the transmission grid.

5 Other consumers may have (or require) a more significant interaction with the DNO. For example, they may need a new or modified connection, have trees that are close to overhead power lines, or need covered overhead power lines that are near to their property.
The Distribution Network Operators and their ownership structures

2.4 DNOs are regional monopolies, owned and operated by private companies. There are 14 DNOs owned by six groups in Great Britain (see Figure 1 and Table 1).

Figure 1: DNO location and ownership

![Map showing DNO locations and ownership groups]

Source: GEMA.

Table 1: DNO acronyms

<table>
<thead>
<tr>
<th>DNO group</th>
<th>DNO</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENWL</td>
<td>Electricity North West Ltd</td>
</tr>
<tr>
<td>NPg</td>
<td>Northern Powergrid</td>
</tr>
<tr>
<td>WPD</td>
<td>Western Power Distribution</td>
</tr>
<tr>
<td>UKPN</td>
<td>UK Power Networks</td>
</tr>
<tr>
<td>SPEN</td>
<td>SPEN Energy Networks</td>
</tr>
<tr>
<td>SSEPD</td>
<td>Scottish and Southern Energy Power Distribution</td>
</tr>
<tr>
<td>ENWL</td>
<td>Electricity North West Limited</td>
</tr>
<tr>
<td>NPgN</td>
<td>Northern Powergrid: Northeast</td>
</tr>
<tr>
<td>NPgY</td>
<td>Northern Powergrid: Yorkshire</td>
</tr>
<tr>
<td>WMID</td>
<td>Western Power Distribution: West Midlands</td>
</tr>
<tr>
<td>EMID</td>
<td>Western Power Distribution: East Midlands</td>
</tr>
<tr>
<td>SWALES</td>
<td>Western Power Distribution: South Wales</td>
</tr>
<tr>
<td>SWEST</td>
<td>Western Power Distribution: South West</td>
</tr>
<tr>
<td>LPN</td>
<td>UK Power Networks: London Power Networks</td>
</tr>
<tr>
<td>SPN</td>
<td>UK Power Networks: South East Power Networks</td>
</tr>
<tr>
<td>EPN</td>
<td>UK Power Networks: Eastern Power Networks</td>
</tr>
<tr>
<td>SPD</td>
<td>SPEN Energy Networks: Distribution</td>
</tr>
<tr>
<td>SPMW</td>
<td>SPEN Energy Networks: Manweb</td>
</tr>
<tr>
<td>SSEH</td>
<td>Scottish and Southern Energy Power Distribution: Scottish Hydro Electric Power Distribution</td>
</tr>
<tr>
<td>SSES</td>
<td>Scottish and Southern Energy Power Distribution: Southern Electric Power Distribution</td>
</tr>
</tbody>
</table>
The regulation of Distribution Network Operators’ revenues

2.5 DNOs do not charge consumers directly for using the system; they charge generators and suppliers (use of system charges). It is up to suppliers how to reflect these costs in their charges to their customers, by including the distribution charges in those customers’ energy bills. Due to the differences in distribution networks across the country, charges in different areas can vary significantly. GEMA told us that the electricity distribution component of a typical annual domestic fuel bill in 2014/15 was £109.

2.6 Through price controls, which are given effect by modifications to DNOs’ distribution licences, GEMA regulates the revenues that DNOs can recover from generators and suppliers. It also seeks to incentivise the DNOs to innovate and find new ways to improve their efficiency and quality of service.

2.7 At fixed points in time GEMA conducts a price control review in which it sets the revenues for the DNOs over the next price control period. Historically, price control periods have lasted for five years – the most recent of these was the fifth electricity Distribution Price Control (DPCR5) which set allowed revenues for the period from 1 April 2010 to 31 March 2015.

RIIO-ED1

2.8 The price control under appeal is the first for the electricity distribution network set under GEMA’s new RIIO price control model (setting Revenue using Incentives to deliver Innovation and Outputs). The price control runs from 1 April 2015 to 31 March 2023, and was characterised by GEMA as RIIO-ED1. The new model was introduced in response to significant changes for the energy sector driven by the need to deliver a low carbon economy, with a target of 80% reduction in greenhouse gas emissions by 2050 and decarbonised electricity generation by 2030, while maintaining security of supply.

2.9 DNOs will need to be able to allow potentially large volumes of local generation (such as solar photovoltaic and wind) and low carbon demand (such as electric vehicles and heat pumps) to connect in a timely and efficient manner. Distribution networks are not currently designed to accommodate these loads which are expected to be a key driver of future investment needs.

2.10 Adding to the challenge is the considerable uncertainty around the take-up of these technologies, in terms of timing, volume and location as well as the

---

6 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.
impact on the network. To accommodate these new volumes, DNOs may need to move away from traditional investment to newer, more flexible solutions offered by so-called ‘smart grid’ technologies and contractual arrangements with demand and generation consumers (ie demand-side response) to find long-term efficient solutions. They will also need to consider the needs of their consumers, especially with respect to vulnerable customers and the fuel poor.

2.11 The RIIO model is an incentive-based model under which GEMA sets both the amount DNO companies can earn over the price control period and what the DNOs must deliver in return for those revenues. GEMA explained the revenue element of the price control as comprising:

- the base revenue a DNO may collect from its customers;
- the outputs it must deliver, and the rewards/penalties for over-/under-delivery; and
- certain mechanisms for funding defined elements of uncertainty (ie those GEMA decided it was inappropriate to forecast upfront).

2.12 This is shown in Figure 2 below.

**Figure 2: Components of allowed revenue**

![Diagram showing the components of allowed revenue](image)

Source: GEMA industry background briefing to the CMA, 15 April 2015.

2.13 Base revenue is the revenue that a DNO requires to cover efficient costs assessed by GEMA (including financing costs) of delivering outputs and long-term value for money, including allowances for maintenance of, and investment in, capital assets and taxation, plus an adjustment which gives some weight to the DNO’s own assessment of costs in its business plan.

2.14 GEMA describes base revenue as comprising four different categories:

- An allowance for DNO expenditures that is set at the time of the price control review. These expenditures are called totex (total expenditure).
- An allowance for certain elements of DNO expenditures that are provisionally set at the time of the price control review and then subsequently updated during the price control period. These expenditures
include operating costs the DNOs cannot control, eg directly remunerated services.

- An allowance intended to reflect the cost of capital for the network company.\(^7\)

- Tax (which is calculated each year, depending on the DNOs’ performance and circumstances).

2.15 Totex is a RIIO concept to ensure companies make balanced decisions between different types of solution. Totex is remunerated by a combination of ‘fast money’ and ‘slow money’. Fast money may be thought of as akin to operating costs or expenditure (opex) and is provided in-year. Slow money remunerates costs that are added to the regulatory asset value (RAV) which is depreciated. The expenditure funded by slow money may be thought of as akin to capital expenditure (capex).

2.16 In addition to the base revenue set within the licence, DNOs are allowed revenues from:

\[(a)\] uncertainty mechanisms, where GEMA has accepted that certain costs are outside companies’ control, and therefore it is not appropriate to set allowances ex ante;

\[(b)\] cost incentives, where DNOs retain a proportion of the difference between their actual out-turn expenditure and the allowances set by GEMA for the period, and share the remainder with consumers;

\[(c)\] output incentives, where DNOs may incur penalties or gain rewards from delivery against specific incentive schemes; and

\[(d)\] where appropriate, adjustments to revenues resulting from a review of actual performance in DPCR5, for example against incentive mechanisms in previous price control periods.

2.17 In developing the proposals for RIIO-ED1, there were a number of stages, from its launch in February 2012 to the start of the price control period in April 2015. There were two distinct phases: fast-track assessment and slow-track assessment.

2.18 The fast-track phase involved GEMA’s initial review of the business plans with a view to assessing which companies should face more or less intensive

\(^7\) The calculation of a firm’s cost of capital in which each category of capital (debt and equity) is proportionately weighted is known as the weighted average cost of capital (WACC).
scrutiny. Under RIIO, where a plan is judged by GEMA to be of sufficiently high quality and provides good value overall, it is considered for fast-tracking. This means that GEMA accepts the business plan as submitted and concludes the company’s price control review early. This is intended to incentivise the companies to submit their best business plan early in the process. Fast-tracking provides reputational benefits to the DNO and enables it to start preparing for the new price control early (for example, by negotiating contracts). It also aims to encourage companies to reveal information earlier in the process and to drive efficiencies and improve proposals for delivery from the companies remaining in the process.

2.19 The slow-track phase involves more detailed scrutiny of the remaining companies’ business plans. It is this slow-track process and GEMA’s consequent definition of costs which is the subject of this appeal.

2.20 As part of its review of slow-track business plans, GEMA performed efficiency benchmarking of the DNOs’ costs. Based on this benchmarking analysis, GEMA set targets for efficient costs for the slow-track DNOs by reference to the costs of the DNOs at the industry level. This benchmarking included adjustments to DNOs’ plans to improve comparability. The actual levels of totex assumed were based on GEMA’s efficiency assessment, together with the output of GEMA’s Information Quality Incentive (IQI). The IQI is intended to provide incentives for companies to provide high-quality business plans.

2.21 In addition, as part of this slow-track review, GEMA considered the implementation of other aspects of its RIIO strategy decision. This included the cost of capital, the approach to financeability, and other representations from stakeholders, including the DNOs within their slow-track business plans.

2.22 In RIIO-ED1, the WPD companies were fast-tracked. WPD’s licence modifications were finalised in May 2014. The timetable across both phases can be summarised as follows:

- **Strategy consultation** – September 2012 (‘the Strategy Consultation’).
- **Strategy decision** – March 2013 (‘the Strategy Decision’).
- **Initial business plan submissions and consultation** – July 2013.
- **Fast-track consultation and draft determinations for fast-tracked companies** – November 2013 (‘the Fast-Track Consultation and Draft Determinations’).
- **Fast-track decision and final determinations for fast-tracked companies** – February 2014 (‘the Fast-Track Final Determinations’).
• Consultation on the fast-track licence modifications – March 2014 (‘the Fast-Track Consultation’).
• Implementation of the fast-track licence modifications – May 2014 (‘the Fast-Track Decision’).
• Revised slow-track business plan submissions and consultation – March 2014.
• Slow-track draft determinations – July 2014 (‘the Draft Determinations’).
• Slow-track final determinations – November 2014 (‘the Final Determinations’).
• Consultation on the slow-track licence modifications – December 2014 (‘the Consultation’).
• Implementation of the slow-track licence modifications – February 2015 (‘the Decision’).

2.23 We refer to these stages, including submissions and responses to the various consultations, in this determination.

2.24 The Final Determinations for RIIO-ED1 set the allowed revenues for the slow-track DNOs for the period from 1 April 2015 to 31 March 2023. The Fast-Track Final Determinations covered the same period, but were completed earlier in 2014, have been accepted, and are not subject to any appeal. The total allowed base revenues included in the licences of the ten slow-track DNOs over the price control are shown in Table 2.

Table 2: Total allowed base revenues for slow-track DNOs

<table>
<thead>
<tr>
<th>2012/13 prices, £ million</th>
<th>ENWL</th>
<th>NPg</th>
<th>UKPN</th>
<th>SPEN</th>
<th>SSEPD</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base revenues</td>
<td>2,887</td>
<td>4,559</td>
<td>10,094</td>
<td>5,260</td>
<td>5,857</td>
<td>28,656</td>
</tr>
</tbody>
</table>

Source: GEMA’s Response to BGT’s Notice of Appeal, Table 1, p50.

3. The legal framework and the BGT appeal

The decision under appeal

3.1 GEMA’s periodic price controls are given effect by way of modifications to the DNOs’ licences. The licences that are the subject of this appeal are

---

8 There is provision in the RIIO model for a mid-period review of the price control in certain limited circumstances.
9 GEMA’s Response to BGT’s Notice of Appeal, Table 1.
‘distribution licences’ granted under section 6(1)(c) of the Electricity Act 1989 (EA89).

3.2 By virtue of section 11A of EA89, subject to the prescribed notice having been provided, GEMA may make modifications to:

(a) the conditions of a particular licence;

(b) the standard conditions of licences of any types mentioned in section 6(1) of EA89 (including distribution licences).

3.3 The price controls that are at issue in this appeal were introduced by way of modification to the DNOs' licences under section 11A of EA89. The decision to modify the licences appears in a GEMA document entitled *RIIO-ED1 modifications to amend the special conditions of the electricity distribution licence held by the above named licensees and reasons for the decision pursuant to section 11A and 49A of the Electricity Act 1989*, published on 3 February 2015 (the ‘Decision’).

3.4 The ten DNOs whose licences were modified by the Decision are: Electricity Northwest Limited (ENWL); Northern Powergrid (Northeast) Limited (NPgN) and Northern Powergrid (Yorkshire) plc (NPgY) (together NPg); London Power Networks plc (LPN), South Eastern Power Networks plc (SPN); Eastern Power Networks plc (EPN) (together UKPN); SP Distribution plc (SPD); SP Manweb plc (SPMW) (together SPEN); Scottish Hydro Electric Power Distribution plc (SSEH); and Southern Electric Power Distribution plc (SSES) (together SSEPD).

3.5 The licences of the other four DNOs, collectively owned by WPD, were modified in February 2014 by way of a separate GEMA decision at the ‘fast-track’ stage of its RIIO-ED1 price control. The modifications of these licences were outside the scope of the BGT appeal.

**GEMA’s objectives**

3.6 In carrying out its functions in relation to the supply of electricity, GEMA is subject to a ‘principal objective’, which is to protect the interest of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems.\(^\text{12}\)

---

\(^{10}\) Section 11A(2).

\(^{11}\) WPD East Midlands plc; WPD West Midlands plc; WPD South-West plc; and WPD South Wales plc.

\(^{12}\) EA89, section 3A(1).
In this context, EA89\(^{13}\) explains that the ‘interest of existing and future consumers’ means their interests taken as a whole, including:

(a) their interest in the reduction of electricity supply emissions of targeted greenhouse gases;

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

(c) their interest in the fulfilment by GEMA, of the objectives set out in Article 36(a) to (h) of the Electricity Directive.\(^{14}\)

Section 3A of EA89 goes on to set out a series of specific duties with which GEMA must comply in relation to its principal objective, as well as a series of considerations to which it must (or, in some cases, may) have regard in performing those duties.

First, GEMA is required to carry out its functions under EA89 in a manner which it 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.\(^{15}\)

Second, before deciding to carry out its functions in a particular manner with a view to promoting competition, GEMA must consider:

(a) to what extent the interest of consumers would be protected by the manner of carrying out those functions; and

(b) whether there is any other manner (whether or not it would promote competition) in which GEMA could carry out those functions which would better protect those interests.\(^{16}\)

Third, when performing the functions described above, GEMA 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 their activities; and

---

\(^{13}\) As amended by the Energy Act 2010.


\(^{15}\) EA89, section 3A(1B).

\(^{16}\) EA89, section 3A(1C).
(c) the need to contribute to the achievement of sustainable development.

3.12 Fourth, in performing its duties set out above, GEMA must have regard to the interests of a number of specified categories of individual (eg those who are disabled).17

3.13 Fifth, and subject to the requirements set out in paragraphs 3.9 and 3.11 above, GEMA must carry out its functions in relation to the supply of electricity in the manner which it considers is best calculated:

(a) to promote efficiency and economy on the part of persons authorised 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; and

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

and GEMA must, 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.18

3.14 Sixth, in carrying out its functions in relation to the supply of electricity, GEMA must have regard to (among others):

(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 principle appearing to it to represent the best regulatory practice.

The appeal

3.15 GEMA’s decisions to modify electricity licences (including distribution licences such as those held by the DNOs) are subject to a specific appellate regime. Under section 11C of EA89 certain persons are entitled to appeal GEMA’s

17 EA89, section 3A(3).
18 EA89, section 3A(5).
decision to the CMA. These include (i) persons who hold a licence under section 6(1) of EA89, where the decision at issue involves a modification to the terms of that licence (referred to in EA89 as a ‘relevant licence holder’) as well as (ii) any other person who holds a licence of any type under section 6(1) of EA89 whose interests are materially affected by the decision.

3.16 Potential appellants require permission from the CMA to bring an appeal. On 2 March 2015, BGT sought permission claiming standing as the holder of an electricity supply licence whose interests were materially affected by the decision. On 30 March 2015, the CMA granted permission for BGT to bring its appeal, subject to a condition.

3.17 The condition related to the sixth ground of appeal in BGT’s Notice of Appeal. This contained certain specific complaints about the elements of the Decision that were the subject of the first five grounds of the BGT appeal and a general complaint as to alleged procedural defects in GEMA’s decision-making process. The CMA granted permission subject to the condition that our consideration of BGT’s sixth ground of appeal would be limited to procedural matters arising in relation to the substantive complaints in the first five grounds of BGT’s appeal. In accordance with this condition, we considered the procedural matters raised by BGT in our assessment of each of the first five grounds of its appeal.

3.18 By virtue of section 11G(1) of EA89, the statutory deadline for the CMA’s final determination on the appeal is 30 September 2015.

**Test on appeal and standard of review**

3.19 Under section 11E(4) of EA89, having granted permission, the CMA may allow an appeal only where it is satisfied that the decision appealed was ‘wrong’ on one or more of the following specified grounds:

(a) that GEMA failed properly to have regard to the matters to which GEMA must have regard in carrying out its principal objective and its duties;

(b) that GEMA failed to give the appropriate weight to any of those matters;

(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 GEMA by virtue of section 11A(7)(b); and/or

---

19 By virtue of section 11C(3) of EA89, no appeal may be brought without the CMA’s permission.

20 See Permission to appeal decision.
(e) that the decision was wrong in law.

3.20 By virtue of section 11E(2) of EA89, in determining appeals under section 11C, the CMA must have regard, to the same extent as is required of GEMA, to the matters which GEMA must have regard:

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

(b) in the performance of its duties under section 3A; and

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

3.21 Under section 11(3) of EA89, in determining the appeal, the CMA may have regard to any matters which GEMA was not able to have regard to save that the CMA must not have regard to matters which GEMA would not have been entitled to have regard to in reaching its decision had it had the opportunity of doing so.

3.22 This is the first time that an appeal has been brought under section 11C of EA89 and there is therefore no directly applicable precedent which deals with the approach to be taken in determining this appeal, and in particular the standard of review which the CMA is required to apply in considering whether GEMA's decision was wrong on one of the prescribed statutory grounds. However, in making our decision, we have drawn on the approach taken in other regulatory appeal contexts and taken account of the submissions on the statutory framework that we received in the course of this appeal and the separate appeal from NPg.

3.23 The appellant and GEMA both submitted that the CMA’s role was not limited to reviewing the decision on traditional judicial review grounds. The DNOs also agreed with this approach. The appellant and the DNOs referred to the government’s response to the Department of Energy and Climate Change’s (DECC’s) consultation on the ‘Implementation of the EU Third Internal Energy Package’ which resulted in the introduction of the statutory appeal mechanism in EA89 and which states:

It is the Government’s intention that the proposed grounds for appeal for licence modification decisions also enable the appeal body to take into account 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.

3.24 We agree that we are not limited to reviewing the decision on conventional judicial review grounds and that we are not only able, but required by EA89, to
consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute.

3.25 The appellant, GEMA and the slow-track DNOs (with the exception of SSEPD) invited the CMA to adopt a similar approach to that taken by the Competition Commission (CC) in appeals under section 175 of the Energy Act 2004, and in particular the CC’s decision on such an appeal in the *E.ON UK plc v GEMA: energy code modification* (E.ON) appeal. Given that the grounds for allowing an appeal under the Energy Act 2004 are very similar to the grounds for allowing an appeal under section 11C of EA89, we agree that the *E.ON* decision is instructive as regards the proper approach to be taken in the present appeal.

3.26 Indeed, although we are not bound by the decision in *E.ON*, which concerns a different statutory appeal mechanism under a different legislative scheme, we consider that the decision accurately characterises the approach which the CMA should take in the present appeal.

3.27 In relation to the review of GEMA’s exercise of discretion, in paragraph 5.11 of the *E.ON* decision, the CC stated that

As a specialist appellate body charged with considering whether a decision of GEMA is wrong, the function of the CC is to provide accountability in relation to the substance of code modification decisions. However, leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator.

3.28 Further, the CC took the view that the statutory test

clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider to be inappropriate in the circumstances.

3.29 We consider that these observations are equally apposite for the standard of review which we must apply in the present context.
3.30 On issues of errors of fact, we note, and adopt, the CC’s reliance on the decision of the Court of Appeal in *Azzicurazioni Generali Spa v Arab Insurance Group*\(^{21}\) where the Court held that:

where the correctness of a finding of primary fact or of inference is in issue, it cannot be a matter of simple discretion how an appellate court approaches the matter. Once the appellant has shown a real prospect (justifying permission to appeal) that a finding or inference is wrong, the role of an appellate court is to determine whether or not this is so, giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the claimants challenge, while (b) reminding ourselves that, so far as the appeal raises issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge’s conclusion lay outside the bounds within which reasonable disagreement is possible. In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence.

3.31 We also agree that where the errors relate to evaluations of fact by GEMA rather than conclusions of primary fact then we should approach such evaluations in the same way that we approach the exercise of discretion.

3.32 Whilst there was substantial common ground between the appellant and GEMA as to the approach we should take in considering this appeal, we received a submission on behalf of one DNO group, SSEPD, which took issue with that approach as affording too great a margin of discretion to GEMA.

3.33 SSEPD pointed to the provisions of EA89 that required us to form our own view on certain matters such as whether the weight given to certain considerations was appropriate or whether proper regard had been given to certain matters.\(^{22}\)

\(^{21}\) [2003] 1 WLR 577.

\(^{22}\) SSEPD submission, paragraphs 11–15.
3.34 SSEPD also argued that the features of the EA89 appeals regime such as the wide scope for obtaining fresh evidence, the expertise of the CMA, its ability to appoint its own expert and its power to substitute its own decision for that of GEMA in the event that an appeal is allowed, among others, indicate that appeals under EA89 are by way of rehearing.23

3.35 Accordingly, SSEPD invited us24 to adopt the approach taken in appeals under the Communications Act 2003. It noted that the Supreme Court had described such appeals as appeals ‘on the merits’ which involve a ‘rehearing’: BT v Telefonica O2 UK (Telefonica).25

3.36 We do not consider that an appeal under EA89 involves a rehearing where it is open to us to decide matters afresh untrammelled by GEMA’s decision. Nor do we consider that SSEPD’s submissions accurately characterised the approach to be taken in appeals under the Communications Act 2003. We note Jacob LJ’s statement in T-Mobile (UK) Ltd and another v Office of Communications26 on the nature of appeals on the merits under the Communications Act 2003:

… it is inconceivable that article 4 [of the Framework Directive], in requiring an appeal which can duly take into account the merits, requires Member States to have in effect a fully equipped duplicate regulatory body waiting in the wings just for appeals. What is called for is an appeal body and no more, a body which can look into whether the regulator has got something material wrong. That may be very difficult if all that is impugned is an overall value judgment based upon competing commercial considerations in the context of a public policy decision.

3.37 Nor do we consider that we were required in the present context to have conducted a re-run of GEMA’s original decision-making process or to have held a de novo rehearing of all the evidence. The CMA must limit its consideration to the specific grounds of appeal set out in EA89, to the extent that such grounds are raised by the appellants. We think that a useful analogy can be drawn between the present appeal and the approach taken by the Competition Appeal Tribunal (CAT) in BT v Ofcom [2010] CAT 17 where the CAT stated, at paragraph 76, that:

By section 192(6) of the 2003 Act and rule 8(4)(b) of the 2003 Tribunal Rules, the notice of appeal must set out specifically

23 SSEPD submission, paragraph 17.
24 SSEPD submission, paragraph 16.
where it is contended OFCOM went wrong, identifying errors of fact, errors of law and/or the wrong exercise of discretion. The evidence adduced will, obviously, go to support these contentions. What is intended is the very reverse of a de novo hearing. OFCOM’s decision is reviewed through the prism of the specific errors that are alleged by the appellant. Where no errors are pleaded, the decision to that extent will not be the subject of specific review. What is intended is an appeal on specific points.

3.38 The appellant, GEMA and the slow-track DNOs have specifically referred us to the approach taken in relation to appeals brought under section 192 of the Communications Act 2003 which requires the CAT and the CC to consider appeals ‘on the merits’. Whilst we agree with GEMA that there is no direct analogy with the present appeals given the different statutory appeal provisions, we consider that the approach taken by the CAT and the CC in relation to appeals under the Communications Act 2003 is broadly analogous to the approach taken in E.ON and that it therefore also provides some helpful guidance as to level of scrutiny which an appellate body with particular expertise such as the CMA should adopt in reviewing GEMA’s decision in the present case.

3.39 In response to our provisional determination, SSEPD maintained that the present appeal should be by way of a rehearing rather than a merits review of the Decision and that the CMA was required to substitute its views for those of GEMA. In addition, SSEPD argued that we had failed to recognise and apply the authoritative guidance of the Supreme Court in Telefonica in our provisional assessment of the appropriate standard of review.

3.40 We have considered carefully and taken into account the judgment in Telefonica. Telefonica concerns appeals under the Communications Act 2003. It does not deal with appeals under EA89. In that judgment, the Supreme Court stated that appeals under the Communications Act 2003 were by way of rehearing. We do not consider that the Supreme Court intended by this statement to depart from the approach taken by the Courts in previous appeals under the Communications Act 2003. Indeed, it is clear from paragraph 24 of the Supreme Court’s judgment that the Supreme Court was drawing a distinction between appeals on merits and appeals that are limited to points of law or orthodox judicial review grounds. The approach we have
taken in the present case is not limited in this sense.\textsuperscript{27} In any event, what a rehearing entails will depend on the circumstances.

3.41 In \textit{Telefonica} the Supreme Court considered that the CAT was entitled (in the context of a rehearing on the merits) to make certain factual judgments. Again, that approach is entirely consistent with our approach in the present case, where we have not limited ourselves to errors of law or judicial review grounds, but have duly taken the merits of the case into account when considering whether any of the statutory grounds of appeal is made out.

3.42 We are accordingly not persuaded by SSEPD’s argument that we are required by the statutory scheme to adopt the approach it put forward. The provisions of EA89 require the CMA to consider whether GEMA’s decision was wrong by reference to the statutory grounds. We do not agree that the provisions require the CMA to substitute its decision for that of GEMA simply because it would have reached a different view without enquiring as to whether that decision was wrong. We consider that the approach we have taken has enabled the CMA to engage with the merits of the decision under appeal and to conclude whether it was right or wrong in accordance with the statutory requirements. Nor do we think that the \textit{Telefonica} decision requires us to adopt a different approach. Notably, the Supreme Court did not consider the extent to which an appellate body, in the context of what the Supreme Court describes as a ‘rehearing’ on the merits, should accord discretion to the regulator against whose decision an appeal is brought. It does not constitute a departure from the other authorities considered above which do deal with that issue.

3.43 Our view is therefore that the CMA should not substitute its views for GEMA’s solely on the basis that it would have taken a different approach (eg on issues of the weight to be attached to particular considerations), but the standard of review goes further than the traditional heads of judicial review. The key question is whether GEMA made a decision that was wrong on one of the prescribed statutory grounds. To that extent, the merits of GEMA’s decision must be taken into account and we have done so.

3.44 Our determination in this appeal reflects the application of a standard of review that is in line with the approach set out above. We consider that this approach is consistent with the approach taken by the CC in energy code appeals, and by the Courts in relation to appeals under the Communications

\textsuperscript{27} See, for example, \textit{Vodafone and others v Ofcom} [2008] CAT 22 at paragraphs 46 and 47: ‘As noted by the Tribunal on numerous occasions … the way the Tribunal exercises its jurisdiction is likely to be affected by the particular circumstances under consideration … the Tribunal may, depending on the circumstances, be slower to overturn certain decision where, as here there may be a number of different approaches which Ofcom could reasonably adopt (…).’

21
Act 2003; it reflects the government’s intention in implementing the relevant appeal provisions; and it accords with the submissions as to the standard of review put forward by the main parties in these appeals.

**Nature of the Decision under review**

3.45 We also received submissions from UKPN, which argued that the CMA must consider the effect of its findings of fact on all the relevant conclusions reached by GEMA.

3.46 Further, SSEPD submitted that GEMA’s decision would have been ‘an interrelated and integrated whole’ and that disturbing one element of that decision may have knock on effects on other parts of the decision.

3.47 SSEPD further submitted that allowing ‘cherry-picking’ would make the appeal process unfair, contending that the DNOs accepted the price control as a whole and that to consider one element in isolation would undermine the global bargain struck by the DNOs.\(^{28}\) SSEPD and UKPN pointed to the considerations that the CMA must take into account when making its determination. SSEPD supported its submission with evidence from Professor Littlechild.

3.48 **EA89**\(^{29}\) provides that an application for permission to appeal must be accompanied by all such information required by the *Competition Commission Energy Licence Modification Appeals Rules (CC14)* as adopted by the CMA (‘the Rules’). The Rules\(^ {30}\) state that a person who wishes to apply for permission to appeal must state in his notice of appeal the grounds of appeal on which he relies and must include a statement of facts and reasons supporting each ground of appeal on which he is relying. We consider that these provisions clearly envisage that we must determine the appeal ‘through the ‘prism’ of the specific errors’\(^ {31}\) alleged by the appellant.

3.49 Thus, we are required to consider whether the Decision was wrong on one of the prescribed statutory grounds, by reference to the grounds set out in the appellant’s Notice of Appeal.\(^ {32}\) It is only if we find that this is the case, that we may allow the appeal.

---

\(^{28}\) At the hearing with the slow-track DNOs, SSEPD noted that its position was not that an appeal could never succeed without reopening the whole price control.

\(^{29}\) At paragraph 1(4) of Schedule SA.

\(^{30}\) At paragraphs 5.1–5.3.

\(^{31}\) See *BT v Ofcom* [2010] CAT 17 cited in paragraph 3.37.

\(^{32}\) See paragraph 3.1 of *Energy Licence Modification Appeals: Competition Commission Guide (CC15)* (September 2012), which was adopted by the CMA on 13 February 2014.
3.50 We do not disagree that price control decisions may be taken and accepted on a global basis or reflect an ‘in the round’ assessment by GEMA and the DNOs. However, whilst we accept that, to some extent, the slow-track DNOs that did not appeal accepted the price control level as a global bargain, we do not see why this is relevant, in itself, to the position of an individual DNO or other appealing party who did choose to appeal. Moreover, whilst we accept that it may in some circumstances be necessary to take care that overturning one aspect of a complex regulatory decision does not have knock-on consequences for other, unappealed aspects of the Decision, we did not see evidence which persuaded us that there was a risk of such knock-on consequences in the two appeals we considered.

3.51 We note SSEPD’s submissions that we should not set the bar too high in terms of recognising when there is a relevant degree of interconnectedness between matters under appeal and other aspects of a decision. Further, SSEPD argued that there was no requirement to adduce evidence as to the integrated and holistic nature of the price control and expressed concerns that the CMA would not actively look for knock-on consequences. SSEPD submitted that evidence as to knock-on consequences had been provided.

3.52 We consider that the question as to whether there are sufficient links between the parts of the Decision which are challenged and parts which are not challenged must be decided on a case-by-case basis taking into account the circumstances of each case. Where there are such links, we would, in the first instance, have expected GEMA to have highlighted these and addressed them in its response. GEMA merely stated in its Response 33 that the decision is ‘made up of a number of discrete but inter-connected determinations that together give rise to the decision itself’. We accept, however, that if, in the evidence submitted to the CMA, such links become apparent, we may take this into account where appropriate.

3.53 SSEPD referred to the existence of links between the IQI, smart grid benefits (SGBs) and real price effects (RPEs). We do not consider that in the present case these links are sufficient to undermine our determination to allow the BGT appeal in respect of the IQI only without reopening other unappealed parts of the Decision. In its response to our provisional determination in the BGT appeal, UKPN argued that there was a need to consider the relationship between the IQI and SGBs. UKPN argued that when considering the remedy in the BGT appeal, the CMA should take into account the outcome of the NPg appeal and the other elements of the IQI. In the light of the complexity, UKPN invited us to remit the matter back to GEMA for redetermination. We have

---

33 *GEMA’s Response*, paragraph 69.
been invited by other slow-track DNOs both in this appeal and the NPg appeal to apply the outcome of the NPg appeal to all the slow-track DNOs. In this respect, however, we observe that the Decision on SGBs was not challenged in the BGT appeal. Nor do we consider that our conclusions in the NPg appeal have any knock-on consequences for other slow-track DNOs.

3.54 We consider that the approach that we have adopted in relation to the issues of ‘cherry-picking’ and ‘in the round’ strikes the right balance between recognising our role as an appeal body whilst at the same time recognising that price control decisions are complex.

3.55 SSEPD and UKPN also invited us to have regard to the matters set out at section 3A of EA89 and which we have described in paragraphs 3.6 to 3.14 above. As we set out above, we are required to take these considerations into account when determining this appeal and we have done so.

3.56 SSEPD referred us specifically to the risk that allowing the BGT appeal may have an impact on financeability. The statute requires us to have regard to the ability of the DNOs to finance their activities, and we have done so where relevant to this appeal. However, we do not consider that a mere assertion that allowing the appeal on any of the grounds raised could lead to a reduction in allowed revenues is sufficient to engage financeability concerns.

**Materiality**

3.57 GEMA argued in relation to some of the grounds alleged by BGT that even if it fell into error, any such errors were not material. The appellant argued that the alleged errors it had identified were all material.\(^\text{34}\)

3.58 We understand that it was common ground between the parties that we should only interfere with the decision if we considered that the error identified was material, and this is obviously correct.

3.59 We have drawn, to some extent, on the approach to materiality taken by the CC in its price control determinations under the Communications Act 2003.\(^\text{35}\) Accordingly, we have not found that GEMA was wrong unless we were satisfied that the error found had a material effect on the price control.

\(^{34}\) BGT’s Notice of Appeal, paragraph 1.14.

\(^{35}\) The Carphone Warehouse Group plc v Office of Communications (31 August 2001) and BT v Ofcom and BskyB and TalkTalk v Ofcom (27 March 2013).
3.60 We consider that an error will not be a material error where it has an insignificant or negligible impact on the overall level of price control set by GEMA.

3.61 Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle. This list is not intended to be exhaustive.36

The CMA’s powers when allowing an appeal

3.62 By virtue of section 11F, if the CMA allows, to any extent, an appeal in relation to a price control, it must do one or more of the following:

(a) quash the decision (to the extent that the appeal is allowed);

(b) remit the matter back to GEMA for reconsideration and determination in accordance with any direction given by the CMA;

(c) substitute the CMA’s decision for that of GEMA (to the extent that the appeal is allowed) and give any directions to GEMA or any other party to the appeal.

Conduct of the appeal

3.63 We conducted this appeal in accordance with the Rules and the associated Energy Licence Modification Appeals: Competition Commission Guide (CC15) (‘the Guidance’). In particular, we sought to be as transparent as possible about our procedures and had regard to the overriding objective (‘the Objective’) of the Rules which is to enable the CMA to dispose of appeals fairly and efficiently within the time period prescribed. We recognised that interested third parties should be afforded opportunities to submit views or respond to the grounds of appeal, as appropriate, and having regard to the nature of their interest.

3.64 In accordance with the Objective, we published on our website:

(a) BGT’s Notice of Appeal;

36 See, for example, paragraph 1.60 of the determination in BT v Ofcom and BskyB and TalkTalk v Ofcom.
(b) a note making available to any party, on request, non-confidential versions of submissions received about the permission stage and the supporting information submitted with BGT’s Notice of Appeal;

(c) a note inviting interested third parties to contact us should they wish to make submissions in response to the Notice of Appeal; and

(d) our decision to grant permission to appeal together with a press notice inviting interested third parties to make representations or observations about the grounds on which the appeal has been brought.

Following the granting of permission to appeal, the CMA held an appeals management conference (AMC) with the main parties and third parties that had expressed an interest in making submissions. The purpose of the AMC was to discuss how the appeal would be conducted at each stage.

3.65 Representatives of the main parties, the slow-track DNOs, Citizens Advice and First Utility Limited were present. After discussion with participants, we wrote to all parties during the course of the appeal to set out the procedures that would apply. We adapted these proposals in the light of representations from those represented at the AMC. Relevant parts of the process consistent with the Objective included:

(a) establishing a confidentiality ring to ensure the efficient sharing of confidential information between GEMA, the appellant and third parties;

(b) inviting responses to the Notice of Appeal from interested third parties;

(c) inviting BGT to submit a reply (the ‘Reply’) to GEMA’s response to its Notice of Appeal (the ‘Response’);

(d) holding hearings with: the appellant; the respondent and the slow-track DNOs;

(e) inviting observers from all parties within the confidentiality ring either to attend hearings or receive copies of transcripts and/or relevant papers;

(f) permitting written closing submissions from BGT and GEMA following the joint hearing with the slow-track DNOs; and

(g) consulting the main parties and interested third parties on our provisional determination.

37 On 15 April 2015, First Utility Limited confirmed that it no longer wished to be involved in or make submissions in respect of the appeal.
Submissions received

3.66 On 22 April, we received responses to BGT’s Notice of Appeal from GEMA, the slow-track DNOs jointly, Citizens Advice, EDF Energy, ENWL, SPEN and UKPN. We also received a joint submission from eight of the slow-track DNOs and a submission from SSEPD on the statutory framework.

3.67 On 7 May, we received the Reply from BGT to GEMA’s Response.

Hearings

3.68 On 15 April, we asked GEMA, BGT and NPg to deliver a jointly agreed industry background presentation to the Appeal Group and staff team.

3.69 On 22 April, we held a clarification hearing with GEMA in order to understand more about how and why it reached certain decisions in respect of the specific issues raised in the appeal. A non-confidential copy of the transcript was sent to the slow-track DNOs, Citizens Advice and EDF Energy.

3.70 On 5 June, we held a hearing with BGT about its appeal. Representatives of GEMA and the slow-track DNOs attended as observers.

3.71 On 8 June, we held a hearing with GEMA about BGT’s appeal. Representatives of BGT and the slow-track DNOs attended as observers.

3.72 On 19 June, we held a joint hearing with the slow-track DNOs about the BGT appeal. Representatives of GEMA and BGT attended as observers.

Closing submissions

3.73 We invited all hearing parties to make any closing statements at their respective hearings. In recognition of the sequencing of hearings and the fact that observers were not permitted to participate in the oral hearings, we additionally invited BGT and GEMA to make written closing submissions after the joint hearing with slow-track DNOs on 19 June.

Provisional determination

3.74 We sent our confidential provisional determination to the main parties and interested third parties on 29 July 2015 and invited comments by 12 August 2015. We have taken into account responses received in our final determination and referenced these as appropriate in our discussion of each ground.
Structure of our final determination on the grounds of appeal

3.75 The remainder of this document considers BGT’s specific grounds of appeal. For each ground, we set out the background to the appeal ground including, to the extent necessary, an explanation of any technical issues and a summary of how GEMA explained the relevant decision during the consultation on RIIO-ED1. We then summarise: the appellant’s case based on its Notice of Appeal; GEMA’s Response; BGT’s Reply; comments from interested third parties where relevant; and any points made by parties in their responses to the provisional determination. In reaching our final determination on each ground, we take into account all the written evidence and supporting documentation submitted (see Conduct of Appeal section) and the discussion at each of the oral hearings. Where relevant, we draw on this material in our assessment of each ground of the appeal.

4. Ground 1: alleged double recovery

Background

4.1 BGT’s first ground concerned GEMA’s decision to make a downward adjustment to the RAV of some of the slow-track DNOs from the beginning of RIIO-ED1 to reflect revenues that had been double-recovered in the previous price control (DPCR5). The RAV adjustment concerned revenues that certain DNOs had treated as excluded services revenue during DPCR5.

4.2 Excluded services (or ‘directly remunerated services’) were treated as outside the revenue control that GEMA applied to the DNOs. The revenue control covered what is referred to as Distribution Use of System (DUoS) revenues. Top-up, standby and enhanced security\(^{38}\) are services that can be treated as excluded services, and revenues from the provision of these services can be treated as excluded services revenues. They are referred to in the documentation, and by the parties, as ES4 revenues.

4.3 This section of our determination:

- summarises what GEMA said on this issue during the RIIO-ED1 consultation;

---

\(^{38}\) Paragraphs 19 and 20 of the DNOs’ joint response described these services as follows: Top-up and standby services are provided by DNOs to consumers to ‘top-up’ their on-site generation or on a ‘standby’ basis when their main connection (or their generation) is not available; enhanced system security services are provided by DNOs to consumers that require a higher level of security than provided for in relevant engineering recommendations.
sets out the criticisms of GEMA's approach made in BGT's Notice of Appeal;

summarises GEMA's response to those criticisms;

summarises comments made by other parties in response to BGT's Notice of Appeal concerning this ground; and

sets out our conclusion on this ground of appeal.

**GEMA's statements about double recovery during RIIO-ED1**

4.4 We found no reference to the double recovery issue in the RIIO-ED1 strategy documents, nor were we referred to one. The first reference appears to be in the Draft Determinations, in which, GEMA explained an apparent discrepancy between the ways different DNOs classified part of their revenue during DPCR5:

> Some DNOs have included charges for top-up and standby within their regulatory revenue control, while other DNOs have, as allowed by the licence, classified these revenues as excluded services. Since the costs associated with these services cannot generally be distinguished from the costs of the distribution network, they would have been taken into account in full in our determination of DPCR5 allowed revenues. Treating associated revenues as excluded services without adjustment would therefore imply a double recovery of costs.\(^39\)

4.5 GEMA set out its proposed approach to this implied double recovery, and why it considered its approach appropriate:

> The DNOs affected recognise the need for an adjustment. We propose to deduct 100 per cent of top-up and standby revenues that have been treated as excluded services from DNOs' Regulatory Asset Value (RAV) balances. We have made these deductions in our calculation of opening RAV balances for draft determinations.

> It is in consumers' long term interests to make these adjustments through the RAV, reducing the asset base on which cost of capital allowances are calculated.\(^40\)

---

\(^39\) *Draft Determinations*, paragraph 5.41.

\(^40\) *Draft Determinations*, paragraphs 5.42 & 5.43.
In relation to the treatment of top-up and standby revenues in RIIO-ED1 onwards, GEMA proposed an amendment of DNO licences. This would specify that 'top-up and standby charges are only directly remunerated if they relate to an agreement for the recharge of direct expenditure'. It went on: '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.'

Final Determinations

In its November 2014 Final Determinations for the slow-track DNOs, GEMA said that it had decided to implement the approach that it had proposed in the Draft Determinations:

We 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.

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.

Summary of BGT’s appeal ground 1

BGT described the key background as follows:

- BGT had identified that certain costs were being recovered twice by a number of DNOs during DPCR5.

Draft Determinations, paragraph 5.44.
Final Determinations, paragraphs 5.46 & 5.47.
BGT’s Notice of Appeal, paragraph 4.8.
• GEMA recognised that this had occurred, and considered it appropriate for the relevant revenues to be returned in full.\textsuperscript{44}

• GEMA addressed the issue by making a depreciating adjustment to the RAV of the relevant DNOs over a 20-year period.\textsuperscript{45}

• GEMA made no provision for the payment of interest in respect of the period between the overcharge and the adjustment.\textsuperscript{46}

4.9 BGT argued\textsuperscript{47} that GEMA erred:

(a) in deciding not to return the double-recovered revenues to consumers immediately; and

(b) in not making an adjustment for interest to the amount to be returned.

4.10 BGT argued\textsuperscript{48} that in making these decisions, GEMA:

(a) failed to have proper regard to the interests of consumers;

(b) failed to have proper regard to best regulatory practice;

(c) gave inappropriate and unsupported weight to subsidiary considerations of financeability; and

(d) failed to give adequate reasons in support of its decision, giving rise to an error of law.

4.11 BGT estimated the impact of GEMA’s approach to be that consumers would have to pay £32 million more than they should in RIIO-ED1. This was because of GEMA’s decision to return the double-recovered revenues over 20 years rather than within the eight-year period of RIIO-ED1. BGT’s estimate was based on the recovery of £101.3 million in total from the three slow-track DNOs affected: ENWL, NPg and UKPN.

Summary of GEMA’s response to appeal ground 1

4.12 In its Response, GEMA drew a distinction between:

\textsuperscript{44} \textit{BGT’s Notice of Appeal}, paragraph 4.10.
\textsuperscript{45} \textit{BGT’s Notice of Appeal}, paragraph 4.11.
\textsuperscript{46} \textit{BGT’s Notice of Appeal}, paragraph 4.11.
\textsuperscript{47} \textit{BGT’s Notice of Appeal}, paragraph 4.21.
\textsuperscript{48} \textit{BGT’s Notice of Appeal}, paragraph 4.21.
(a) the ‘intention’ in DPCR5, which GEMA said was that ES4 services were excluded from the main revenue allowance for regulated Use of System Charges, with DNOs allowed to charge for these services outside the main price control;\(^{49}\) and

(b) GEMA’s price control decision for DPCR5, which ‘… 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.’\(^{50}\)

4.13 GEMA said\(^{51}\) that it recognised this issue at the outset of the DPCR5 period and that it required DNOs to report on the basis that 85\% of these revenues should be deducted from their RAV balances. GEMA said that:

This would have meant that 85\% of the double-recovered amount would be returned to consumers.

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.\(^{52}\)

4.14 In responding to BGT’s arguments, GEMA commented:

(a) Both a return by way of an adjustment to the RAV and a more immediate payment are neutral in net present value terms, and existing and future consumers taken together suffer no harm: both approaches provide for all double-recovered costs to be returned to consumers.\(^{53}\)

(b) A more immediate repayment to consumers would have had an adverse impact on key credit metrics, and would have necessitated other adjustments in the financial package for at least one DNO to maintain its financial resilience at an appropriate standard.\(^{54}\)

(c) A more immediate repayment to consumers would have contributed to the savings to consumers that were otherwise already arising in RIIO-ED1 as

\(^{49}\) GEMA’s Response, paragraph 144.

\(^{50}\) GEMA’s Response, paragraph 145.

\(^{51}\) GEMA’s Response, paragraph 146.

\(^{52}\) GEMA’s Response, paragraphs 146 & 147.

\(^{53}\) GEMA’s Response, paragraph 149(a).

\(^{54}\) GEMA’s Response, paragraph 149(b).
a result of GEMA’s decision to move from a 20-year to a 45-year depreciation period for new assets.\(^\text{55}\)

\((d)\) Return by way of an adjustment to the RAV was an established approach that had been reflected in DNOs’ regulatory reporting in DPCR5.\(^\text{56}\)

\((e)\) Even if GEMA’s decision were flawed (which is denied), the amount (identified by BGT as £32 million) is:

\((i)\) immaterial in the context of the value and complexity of the price control as a whole (with the overall value of the combined slow-track DNO settlements being £28 billion over the RIIO-ED1 period);\(^\text{57}\) and

\((ii)\) disproportionate to the potential adverse perception of regulatory inconsistency that might be caused by change to the method established in DPCR5 for repaying consumers.\(^\text{58}\)

4.15 In relation to the criticism that its approach gave rise to inappropriate incentives, GEMA argued that:

\((a)\) the double-recovery of ES4 revenues was an isolated incident and that modifications to the DNO licences as part of RIIO-ED1 had structurally eliminated the potential for it to arise again;\(^\text{59}\)

\((b)\) as an adjustment to the RAV and an immediate reduction in allowed revenues are neutral in net present value terms, there would be no net gain to DNOs from GEMA’s approach;\(^\text{60}\)

\((c)\) while it accepted that it had not required interest to be paid by the DNOs on the double-recovered costs, the amount of any such interest would be trivial and insufficient to create an incentive of the kind alleged by BGT;\(^\text{61}\) and

\((d)\) the RAV is indexed by the Retail Prices Index (RPI), and during DPCR5 the RPI percentage change exceeded the interest rate that would have been applied for over-recovery payments during DPCR5 (roughly 2%). GEMA argued that the amount that consumers gained by way of an adjustment to the RAV therefore exceeded the interest payments that

\(^{55}\) GEMA’s Response, paragraph 149(c).

\(^{56}\) GEMA’s Response, paragraph 149(d).

\(^{57}\) GEMA’s Response, paragraph 149(d).

\(^{58}\) GEMA’s Response, paragraph 149(d).

\(^{59}\) GEMA’s Response, paragraph 155(a).

\(^{60}\) GEMA’s Response, paragraph 155(b).

\(^{61}\) GEMA’s Response, paragraph 155(c).
would be payable on the sum of the double-recovery if there was an immediate adjustment to allowed revenues.\(^{62}\)

4.16 GEMA rejected BGT’s criticism that it failed to give adequate reasons in support of its decision and pointed to:

(a) the explanation of its reasoning included in a letter it sent to BGT on 3 February 2015;

(b) the explanation of its approach in the Final Determinations; and

(c) the explanation of GEMA’s approach provided by one of its officials, Ian Rowson, at a meeting with Andrew Manning of BGT on 28 May 2014, following email correspondence between GEMA and BGT.

**Summary of third party submissions on appeal ground 1**

**DNOs’ joint response**

4.17 The DNOs argued\(^ {63}\) that BGT had misunderstood the position:

(a) There was no over-recovery of revenues, and therefore it would be inappropriate to make any cash payment to consumers.

(b) The issue concerned costs, and CRC15.9 of the DNOs’ licences in DPCR5 always permitted recovery of the relevant costs and the DNOs’ treatment of associated revenues.

(c) GEMA had not deferred the issue of how the revenues should be returned: the licence modifications in RIIO-ED1 merely implemented ‘close-out’ aspects of the DPCR5 decision.

4.18 The DNOs also argued\(^ {64}\) that:

(a) BGT misinterprets GEMA’s statutory duties when it states that GEMA failed to strike the appropriate balance between different generations of consumers: the fact that BGT takes a different view on that balance does not mean that GEMA was wrong.

(b) BGT is incorrect to assert that GEMA’s approach gives inappropriate and unsupported weight to considerations of financeability: GEMA’s decision was consistent with its statutory duties in taking into consideration the

\(^{62}\) GEMA’s Response, paragraph 155(d).

\(^{63}\) DNOs’ joint response, paragraph 12.

\(^{64}\) DNOs’ joint response, paragraph 13.
potential impact on DNOs’ finances when seeking to further the consumer interest.

(c) BGT does not appear to have understood the nature of the calculations when it states that no provision was made for the payment of interest: leaving aside the question of whether interest as such can be due, consumers will be better off as the relevant calculations are adjusted by RPI, which provides a higher uplift over the DPCR5 period than interest applied to over-recoveries.

4.19 The DNOs said\(^{65}\) that there was no incentive in place for the DNOs to over-recover at any point in the past because the licence permitted levying of the charges and a mechanism was in place to avoid costs being funded twice.

4.20 In relation to the adequacy of GEMA’s reasoning and engagement, the DNOs said\(^ {66}\) that GEMA’s policy intention was clear throughout DPCR5 and was the subject of extensive consultation. The DNOs said\(^ {67}\) that GEMA had provided sound reasons for its approach throughout that process and that, because the RIIO-ED1 licence modifications merely implemented the close-out aspects of DPCR5, the appropriate time for challenging GEMA’s approach in principle on this issue had long since passed.

Citizens Advice’s response

4.21 Citizens Advice agreed with BGT that the over-recovered amount should be returned to consumers without further delay.\(^ {68}\) It said\(^ {69}\) that consumers’ money had been collected in error and that this should be remedied in a way that is consistent with consumer redress practice in the broader energy market. Citizens Advice considered\(^ {70}\) that rather than applying a principle that had been developed to deal with the problem of spreading the costs of assets that degraded both physically and in value over time, GEMA should have been informed by its policy with respect to financial penalties and consumer redress, that was developed to deal – among other things – with the problem of over-recovery.

---

\(^ {65}\) DNOs’ joint response, paragraph 14.
\(^ {66}\) DNOs’ joint response, paragraph 15.
\(^ {67}\) DNOs’ joint response, paragraph 15.
\(^ {68}\) Citizens Advice’s response to the Energy Price Control Appeals: British Gas Trading and Northern Powergrid, paragraph 2.1 (‘Citizens Advice response’).
\(^ {69}\) Citizens Advice response, paragraph 2.1.
\(^ {70}\) Citizens Advice response, paragraph 2.1.
4.22 Citizens Advice considered\textsuperscript{71} that GEMA had not explained in its Final Determinations how returning the over-recovered amount during ED1 would contribute to regulatory uncertainty and drive up the cost of capital. It said\textsuperscript{72} that without a detailed justification it was difficult, if not impossible, for consumers to give what might be seen as their ‘informed consent’ to having the money returned over a longer period, and considered that we should look for evidence that the networks had explored this issue with their consumers as part of the stakeholder engagement process for ED1.

\textit{Summary of BGT’s Reply to appeal ground 1}

4.23 BGT pointed\textsuperscript{73} to GEMA as having acknowledged in its Response that, if directly charged for during DPCR5, ES4 revenues represented a double recovery of costs. BGT argued\textsuperscript{74} that the starting point, therefore, was that ES4 revenues during DPCR5 were monies that were paid by consumers which ought not to have been paid. BGT said\textsuperscript{75} that, given this, the correct approach was to restore the overpayment as promptly as possible.

4.24 In relation to DPCR5, BGT argued that:

(a) GEMA and the DNOs were incorrect if they were seeking to argue that the use of a RAV adjustment to unwind the double-recovery of revenues was somehow foreshadowed in the DPCR5 charge control, and GEMA was incorrect in suggesting that the only change was that it had decided that 100\% of excess revenues (rather than 85\%) should be returned in this manner.\textsuperscript{76}

(i) The RAV adjustment formed no part of the DPCR5 charge control.\textsuperscript{77}

(ii) GEMA proposed a RAV adjustment in the DPCR5 initial proposals but not as a primary means of preventing double recovery, nor as a means of returning double-recovered revenues to consumers. BGT argued that it was simply a way of allowing for forecasting error, and noted that GEMA had acknowledged this in its Response.\textsuperscript{78}

\begin{tabular}{l}
\textsuperscript{71} Citizens Advice response, paragraph 2.2. \\
\textsuperscript{72} Citizens Advice response, paragraph 2.2. \\
\textsuperscript{73} BGT’s Reply, paragraph 17. \\
\textsuperscript{74} BGT’s Reply, paragraph 17. \\
\textsuperscript{75} BGT’s Reply, paragraph 18. \\
\textsuperscript{76} BGT’s Reply, paragraphs 19 & 20. \\
\textsuperscript{77} BGT’s Reply, paragraph 21. \\
\textsuperscript{78} BGT’s Reply, paragraph 21. \\
\end{tabular}
(iii) The DPCR5 Financial Methodologies document made clear that at the outset of the DPCR5 period there was not intended to be any RAV adjustment for ES4 costs. BGT argued, therefore, that it was for DNOs to apply charges for ES4 only where these reflected costs which were incremental to the costs already included within the regulated price control.79

(b) The Cost and Revenue Reporting Regulatory Instructions and Guidance (RIGs) – which were issued by GEMA on several occasions during the DPCR5 charge control – did not assist the GEMA and DNO arguments:80

(i) Although later versions of the RIGs did include an instruction that reported RAV should in some cases be adjusted in respect of ES4 services, they were no more than a framework for the collection of cost and revenue information which DNOs were required to provide under their licence.81

(ii) The RIGs did not and could not amend the substance of price controls.82

(iii) The RIGs were not capable of legitimising (whether prospectively or retrospectively) the DNOs’ collection of ES4 revenues in breach of their licences.83 BGT argued84 that the DNOs which recorded ES4 revenues were in breach of their licences, because:

- The Charge Restriction Conditions (CRCs) 15.6 and 15.7 required that services were only to be treated as Excluded Services to the extent that the service was not remunerated under Use of System Charges.

- Since under DPCR5, ES4 costs were included in the calculation of allowed revenues, which drove the annual Use of System revenue cap, it followed that ES4 costs were already recovered by Use of System revenues.

- It followed that the DNOs were not permitted to reclassify any use of system charges for these services under CRC15.9 (which

79 BGT's Reply, paragraph 21.3.
80 BGT's Reply, paragraph 22.
81 BGT's Reply, paragraph 22.1.
82 BGT's Reply, paragraph 22.2.
83 BGT's Reply, paragraph 22.2.
84 BGT's Reply, paragraph 22.2.
permitted charging on a cost recovery basis for Excluded Services).

(iv) It was wholly inappropriate for GEMA to have argued that a prior decision which was reached without proper consultation (and which was not subject to an appeal in any event) should render its present decision immune from review on appeal. Furthermore, even if the RIGs had included a RAV adjustment which was comparable to that now proposed, that should not prevent the CMA from considering whether it is appropriate to include such a provision in the current charge control.\(^{85}\)

4.25 In relation to consumer interests and intergenerational equity, BGT argued that:

(a) Consumers 20 years in the future were much less likely to be the ones who have overpaid. Other things equal, the interests of those consumers who have paid more than they should clearly supported immediate repayment.\(^{86}\)

(b) The move to a 45-year depreciation policy was unrelated to the double-recovery at issue, and could not support depriving current consumers of the prompt repayment of monies that were wrongly charged under DPCR5.\(^{87}\)

4.26 In relation to financeability, BGT argued that:

(a) as a matter of principle, where DNOs wrongly overcharged consumers, financeability concerns could not justify deferring the prompt repayment of the overcharge;\(^{88}\)

(b) GEMA failed to point to any concrete financeability concerns;\(^{89}\) and

(c) even to the extent that valid financeability concerns were made out in respect of a specific DNO, the correct approach would have been to factor those in to the specific adjustment that was in any event being made in respect of the DNO in question, rather than by a general measure (the RAV adjustment).\(^{90}\)

\(^{85}\) BGT’s Reply, paragraph 22.3.
\(^{86}\) BGT’s Reply, paragraph 24.
\(^{87}\) BGT’s Reply, paragraph 25.
\(^{88}\) BGT’s Reply, paragraph 27.2.
\(^{89}\) BGT’s Reply, paragraph 27.3.
\(^{90}\) BGT’s Reply, paragraph 27.5.
4.27 In relation to materiality, BGT argued that:

(a) £32 million was in absolute terms plainly a material sum of money;\(^{91}\)

(b) this was £32 million which had been wrongly paid by consumers, and this raised a clear issue of principle.\(^{92}\)

BGT pointed to the contrast with GEMA requiring immediate repayment to consumers in a context where gas suppliers had been using out-of-date data relating to calorific value.\(^{93}\)

4.28 In relation to DNO incentives, BGT argued that:

(a) BGT was not claiming that DNOs would recover in the same way, but rather that it affected incentives for double recovery in relation to any costs, if they did not believe they would be required to return the money promptly to consumers. BGT argued that this point applied also to the impact of not requiring the payment of interest.\(^{94}\)

(b) The level of interest that should be applied to ensure that DNOs would not have an incentive to double recover would need to reflect both the real time value of money and the rate of inflation together.\(^{95}\)

4.29 In relation to inappropriate procedure, BGT argued that:

(a) the letter of 3 February 2015 did not adequately explain GEMA’s reasoning;\(^{96}\)

(b) it was inappropriate for GEMA to have sought to rely on how issues were discussed at a meeting in the context of a public consultation;\(^{97}\) and

(c) in any event, GEMA had not responded to the account of the meeting set out in the first witness statement of Andrew Manning.\(^{98}\)

Further correspondence with the main and third parties on appeal ground 1

4.30 Following the responses to BGT’s Notice of Appeal, we sought further clarification from the parties. This correspondence is summarised below.

---

\(^{91}\) BGT’s Reply, paragraph 28.1.
\(^{92}\) BGT’s Reply, paragraph 28.2.
\(^{93}\) BGT’s Reply, paragraph 28.3.
\(^{94}\) BGT’s Reply, paragraphs 29.1 & 29.2.
\(^{95}\) BGT’s Reply, paragraph 29.3.
\(^{96}\) BGT’s Reply, paragraph 31.
\(^{97}\) BGT’s Reply, paragraph 32.1.
\(^{98}\) BGT’s Reply, paragraph 32.2.
Letters from SPEN and SSEPD

4.31 We wrote to SPEN and SSEPD on 9 June 2015 requesting clarification in relation to their approaches to charging for top-up, standby and enhanced security services during DPCR5, and their approaches to reporting revenues associated with those services. SPEN told us that it did not provide any top-up or standby services during DPCR5 and that it recovered enhanced security costs (if any) via connection charges: given this, it did not receive any revenues from ES4 charges in DPCR5. SPEN said that its allowed expenditure/revenue under DPCR5 (recovered via DUoS), contained no allowance for ES4 costs, and accordingly there was no question of double recovery.

4.32 SSEPD said that it did not record any reportable ES4 revenues during DPCR5. Its approach was based on the DPCR5 final proposals in which, GEMA accepted that, in providing ES4, networks would necessarily incur incremental costs rather than be able to utilise existing core allowances to deliver the service. GEMA had directed the DNOs that the charges for ES4 should be on a cost recovery basis, recovering the incremental costs only. It appeared to be a common understanding between SSEPD, GEMA and BGT that ES4 services would be customer-led, with revenue and costs only generated as and when provision was requested by the end user. SSEPD reported no such revenues in respect of ES4 because it had received no relevant requests during the DPCR5 period.

4.33 SSEPD also said that, under the RIGS, charging and reporting ES4 would normally only be permitted where there were formal written contracts, and that it had not identified any formal contractual arrangements for top-up and standby services. When requested to provide relevant enhanced services, the incremental costs would be recovered from the consumer at connection and reported accordingly under relevant connections activity. SSEPD had no core revenue allowance set for the provision of incremental ES4 services.

Joint letter from the slow-track DNOs dated 12 June 2015

4.34 The slow-track DNOs provided further comments in a letter that addressed, among other things, a suggestion at the hearing with GEMA on 8 June 2015 that there was a consensus among the parties that there had been a double recovery. The DNOs did not agree with this suggestion and said that:

(a) it was GEMA’s clear intent that no allowance was made for ES4 costs in calculating allowed distribution revenue for DPCR5 so there would be no impact on charges;
(b) GEMA made clear in its DPCR5 Final Proposals that actual ES4 costs would not be added to the RAV. It achieved this in practice via a two-stage accounting adjustment to the RAV:

(i) GEMA collected data on distribution costs from DNOs on an annual basis and ES4 costs were included in this cost data as it was not possible to separate them out. These costs (including ES4 costs) were added to the notional RAV on an annual basis during DPCR5;

(ii) GEMA deducted actual ES4 costs charged from the notional RAV on an annual basis, by deducting an amount equivalent to actual ES4 charges, on the basis that those charges were required to be cost reflective;

(iii) GEMA made incontrovertible statements in the DPCR5 Final Proposals that no revenue allowances were made for ES4 services;

(c) no consumer was subject to any higher distribution charges as a result of GEMA’s treatment of ES4: there had been no over-charging and no overpayment; and

(d) BGT’s reliance upon the adjustment between Initial and Final Proposals as evidence that GEMA funded DNOs for ES4 activities within distribution revenues was misguided: this adjustment simply reflected a correction of an erroneous adjustment in GEMA’s Initial Proposals.

4.35 The DNOs said that it seemed from the GEMA hearing transcript that the GEMA representatives did not have contemporaneous knowledge of the events they sought to describe, whereas the DNOs could speak from their experience of being involved in the process.

Letter from GEMA dated 18 June 2015

4.36 GEMA commented further on the treatment of ES4 services in the DPCR5 price control in a letter to the CMA of 18 June 2015:

It was originally GEMA’s intention in its calculations of allowed revenues for Distribution Use of System Charges (‘DUoS’) for DPCR5 to exclude costs attributable to ES4 services. To this end, in its calculations behind its Initial Proposals for DPCR5 GEMA deducted forecast excluded services revenues, as a proxy for costs, from DUOS allowed revenues.

However, in its Final Proposals for DPCR5 GEMA reversed this deduction because it had come to its attention that in its Initial
Proposals it had also deducted the excluded services costs from the building blocks of DUoS allowed revenue calculations, and thus had double-deducted those excluded service costs. (This is the adjustment referred to in section 4 of Norton Rose Fulbright’s letter to the CMA on behalf of the DNOs dated 12 June 2015.)

In the case of ES4, however, this reversal did not fully deal with the issue because GEMA had in fact not attributed costs specifically relating to ES4 in calculating the excluded services costs which it had initially deducted – and, as a consequence, the costs attributable to ES4 services had not in fact been excluded from its price control decision.

This was not identified prior to the DPCR5 price control being finalised. Therefore to remedy the problem so as to maintain consistency with its established policy of excluding revenues attributable to ES4 services from DUoS allowed revenues, GEMA implemented an alternative mechanism which involved taking account of ES4 revenues by way of a deduction from the RAV, as described in paragraph 146 of its Response. The RAV adjustments for ES4 revenues were implemented through GEMA’s DPCR5 Regulatory Instructions and Guidance (‘RIGs’).

Our assessment of appeal ground 1

4.37 In considering BGT’s appeal ground 1, we are required to determine whether GEMA was wrong to have addressed the identified double recovery through a RAV adjustment that would return revenues to consumers over 20 years, and whether GEMA was wrong not to apply interest to the amount of the RAV adjustment.

4.38 The context within which we consider these questions is one where we had significant difficulties in establishing the relevant facts concerning the double recovery, and encountered substantive differences in view over what those facts are:

- BGT consistently argued that this matter was straightforward: consumers in DPCR5 had paid money that they ought not to have paid, and the correct approach was to restore the overpayment as promptly as possible, with interest.99

---

99 BGT’s Reply, paragraphs 17 & 18.
• Against this, the DNOs argued that there had been no overpayment during DPCR5, that the purpose of the RAV adjustment was instead to avoid double recovery in RIIO-ED1 and subsequently, and that the mechanics for this adjustment had been put in place through the RIGs at an early stage during DPCR5.

• GEMA agreed in part with both BGT and the DNOs: GEMA said it was clear that there had been a double recovery during DPCR5. However, GEMA also pointed to the development of approach in the RIGs as a reporting mechanism it had put in place that could enable this issue to be addressed through a RAV adjustment.

4.39 We note BGT’s comments in its closing submissions that because the DNOs did not appeal against GEMA’s decision finding that there had been a double recovery, that decision cannot be reopened now. Clearly the size and method of recovery was not challenged by the DNOs on appeal. Nevertheless, we do not consider that we should infer from this that the DNOs necessarily accepted GEMA’s version of events. It is clear from the evidence provided to us that the DNOs disputed the facts and that parts of this evidence suggest a plausible interpretation of what DNOs had been told to do.

4.40 In principle, we would have expected the best evidence on the facts to have come from GEMA. We would have expected GEMA to know what had, and had not, been included in the price control allowances it set, and to have been able to access appropriate supporting evidence.

4.41 However, we are not convinced that GEMA has been able to ‘bottom out’ what its past decisions on this matter were. While GEMA made it clear that it considered that most DNOs’ double-recovered costs related to ES4 services, it has not been able to verify that this was the case or to provide an evidence base which showed what happened when and why. As it acknowledged in its closing submissions: ‘Given the passage of time, the complicated history of this matter, and the statements made on the treatment of ES4 costs in DPCR5 Final Proposals, it is understandable that there has been some confusion about what took place.’

4.42 We consider the fact that different DNO groups had adopted different approaches to ES4 revenues (with no double recovery issues having been identified in relation to SPEN and SSEPD) to be consistent with GEMA’s view in this respect. Indeed, in the circumstances, it may be that there is more than one explanation of what happened if different understandings across DNOs affected the assumptions that were made during the DPCR5 process.
While there were significant ambiguities in GEMA’s descriptions of events, we consider it more likely than not that costs attributable to ES4 services were not excluded from GEMA’s calculation of the main revenue allowance for Use of System Charges for DPCR5. In arriving at this conclusion, we note that the DNOs’ evidence in some respects was consistent with this version of events. In particular, the DNOs’ reasoning as to the necessity of a RAV adjustment itself relied on there being difficulties associated with separately identifying ES4 costs in advance: this raised a material question over how the costs attributable to ES4 services could have been separately identified in a robust manner when the DPCR5 revenue allowance was being set.

Having taken the view that it was more likely than not that the costs attributable to ES4 services were not excluded from GEMA’s calculation of the main revenue allowance in DPCR5, it is necessary for us to consider the consequences of this in terms of double recovery.

BGT argued that the consequences of the inclusion of ES4 costs in the DPCR5 revenue allowance were straightforward: if directly charged for, ES4 revenues represented a double recovery of costs, and BGT pointed to GEMA having recognised this in its Response. It was common ground that ES4 revenues across the slow-track DNOs during DPCR5 were £101.3 million in 2012/13 prices (this being the total amount of the RAV adjustments that GEMA made). BGT said that £101.3 million was the scale of the double recovery, and represented the amount that consumers had been overcharged in DPCR5.

We consider that, as ES4 costs were not excluded from the DPCR5 revenue allowance, directly charging for ES4 services would have resulted in a double recovery of costs during DPCR5. However, in our view it does not necessarily follow from that that there had been a double recovery of £101.3 million during DPCR5. In particular, we considered that:

(a) If total ES4 costs during DPCR5 were £101.3 million, and this figure had been included within the totex figures used to set DPCR5 revenues, then this would not have resulted in the revenue allowances for DPCR5 being set £101.3 million higher than would otherwise have been the case. Rather, the allowed revenue would only have been higher as a result of provisions for:

(i) fast money: equal to 15% of the amount; and

---

100 BGT’s Reply, paragraph 17.
101 GEMA’s Response, paragraph 145.
(ii) slow money: with an allowance for depreciation and return on capital included in relation to the 85% of the amount that would have been treated as to be capitalised.

That is, while DPCR5 revenue allowances would have been higher as a result of not excluding ES4 costs, the amount would not have been equal to 100% of the assumed level of ES4 costs. The combined impact of this would depend on the assumed spend profile, but would likely have been around a third of that number.\textsuperscript{102}

(b) The precise level by which the DPCR5 revenue allowance had been increased as a result of ES4 costs not being excluded depends on the level of ES4 costs that were assumed at that time, not on the level of ES4 costs that were actually incurred during DPCR5.

4.47 In response to our provisional determination, ENWL argued that any attempt to estimate the potential level of any ES4 costs that GEMA may have included in DPCR5 revenue allowances could not produce a meaningful number, given – among other things – that DNO cost forecasts would have been subject to benchmarking when allowances were set. ENWL also said that its forecast ES4 costs totalled £27 million, and were 40% less than its actual ES4 costs over the period.

4.48 The evidence we received did not provide a sufficient basis for us to conclude on the likely level of any double recovery of ES4 costs that occurred during DPCR5, beyond the indicative observations presented in paragraph 4.46 above.

4.49 In its response to our provisional determination, BGT argued that we were mistaken in treating the amount of double charging which occurred in DPCR5 as dependent on the level of increase in DPCR5 Use of System Revenues which may have arisen from GEMA not excluding ES4 costs from the totex allowance during DPCR5. BGT said that the key point was that a greater amount of revenue had been recovered during DPCR5 than was permitted under the charge control. BGT argued that, regardless of whether the exact level of ES4 costs could be separately identified, all ES4 costs were included within the DPCR5 allowed revenues, and that use of system charges alone would still have enabled DNOs to cover their costs.

\textsuperscript{102} This is an estimate of the sum of fast money, depreciation and a return on capital assuming an even spend profile over the period.
4.50 We do not consider that BGT’s observation that use of system charges alone would still have enabled DNOs to cover their costs could, in the circumstances, be treated reliably as implying that all ES4 costs were included within DPCR5 allowed revenues. In line with paragraph 4.46 above, we consider that observation to be consistent with DPCR5 allowed revenues including a provision for fast money, and for depreciation and a return in relation to slow money, over the DPCR5 period.

4.51 We consider that, in addition to addressing the double recovery that had actually occurred in DPCR5, GEMA had to address the impact that actual ES4 costs incurred during DPCR5 could have had on the opening RIIO-ED1 RAV: this was the impact that the DNOs focused on in their submissions. That is, if, as the DNOs contended, totex figures during DPCR5 were being recorded without ES4 costs being identified separately, then this would have given rise to future double recovery issues as the RAV would have been unduly increased.

4.52 We examine GEMA’s decision in relation to ES4 revenues, and BGT’s criticisms of it, in the light of these two double recovery issues: double recovery of ES4 costs during DPCR5; and the potential for double recovery of ES4 costs in RIIO-ED1 and thereafter.

4.53 We consider that a downward RAV adjustment is clearly an appropriate tool for addressing the potential for future double recovery of ES4 costs. Future double recovery would only arise if the RAV was unduly increased, and a downward RAV adjustment can be understood as an accounting correction aimed at avoiding that unwanted effect. Correcting for this would only have required a RAV adjustment equal to 85\% of ES4 costs, as only 85\% of totex would have been capitalised. As this part of the adjustment would not relate to any overcharging that had actually occurred in DPCR5, there would be no basis for applying any uplift to reflect interest. Given this, to the extent that the RAV adjustment that GEMA applied addressed only the potential for future double-recovery issues, the use of 100\% of ES4 revenues as a proxy for relevant costs would have resulted in an overcompensation to the benefit of consumers. The scale of the overcompensation would have been equal to 15\% of ES4 costs incurred in DPCR5.

4.54 Given the circumstances, we do not consider that GEMA’s decision to address all of the double-recovery issues through a RAV adjustment and without an adjustment for interest was necessarily flawed. In particular:

(a) As was noted in paragraph 4.46 above, the scale of the double recovery during DPCR5 was uncertain, and would depend on what was included in DPCR5 cost forecasts. Taking this into account, we are not satisfied that
the scale of the adjustment that GEMA made – equal to 100% of ES4 revenues – was wrong. BGT did not show why this should be understood as a flawed basis for capturing, albeit approximately, the scale of any over-recovery that had occurred in DPCR5, including after accounting for any interest adjustments that could, in principle, be justified.

(b) We consider that GEMA’s actions in relation to this issue throughout the DPCR5 period, including through its development of the treatment of ES4 revenues in its RIGs, were broadly consistent with an expectation that double-recovery issues would be addressed through a RAV adjustment.

(c) The different views between the DNOs and GEMA of what happened in DPCR5 and what the RAV adjustment was intended to address are not insignificant. We note GEMA’s recognition of the extent of the difficulties that DNOs faced in identifying what the appropriate approach to ES4 costs should have been during DPCR5.

4.55 We also note that GEMA attempted to clarify what had happened in its letter of 18 June 2015. This suggested that even where GEMA had proposed an adjustment during the DPCR5 process, it had not been applied as explained at the time. In explaining a reversal of a cost allocation intended to ensure ES4 costs were not included in the price control decision, referred to by the DNOs in a letter from its representatives on 12 June, GEMA said:

In the case of ES4 this reversal did not fully deal with this issue because GEMA had in fact not attributed costs specifically relating to ES4 in calculating the excluded services costs which it had initially deducted – and as a consequence the costs attributable to ES4 services had not in fact been excluded from the price control decision.

4.56 In its response to our provisional determination, BGT argued that uncertainty as to exactly what costs were included in DPCR5 allowed revenue could not justify dismissing the appeal, as this just affected the precise sum that should be repaid (not the principles that should be applied to repayment), and the fact that GEMA referred to the matter as ‘complicated’ did not justify GEMA failing to investigate properly. BGT also argued that uncertainty as to how the overcharge arose was irrelevant to the issue of whether that overcharge should have been returned immediately or over a period of time, and that there was certainly no good basis for alleging that GEMA had made a clear and irrevocable decision in favour of a RAV adjustment.

4.57 BGT said that if we considered there to be material uncertainty about the extent of or reasons for the overcharge, the correct course would be to uphold
its ground of appeal on the basis that GEMA’s reasons in support of the RAV adjustment were not sustainable, and instead to remit the matter to GEMA to carry out any necessary factual investigation, with appropriate guidance as to how the overcharge was to be addressed in the light of that investigation.

4.58 BGT maintained its submission that £101.3 million should be returned to consumers immediately, but said that alternatively, the appropriate solution was to compensate consumers immediately for £34 million of overfunding which was, at a minimum, over-recovered during DPCR5. BGT argued that the balance (the undepreciated part of the £101.3 million equal to approximately £75 million) should then remain subject to a RAV adjustment.

4.59 Our consideration of these points does not alter the conclusion we had provisionally reached on this matter. While we note BGT’s concerns over the transparency with which the RIGs had been modified during DPCR5 to provide a mechanism for adjusting the recording of RAV additions during DPCR5, we consider it relevant that this mechanism provided a potential means of avoiding double recovery in the future. As we note in paragraph 4.53, we consider that a downward RAV adjustment is an appropriate tool for addressing the potential for future double recovery of ES4 costs (as it offsets the potential for future double recovery arising from the RAV being unduly increased). In line with our comments in paragraphs 4.46(a) and 4.53, we consider it appropriate to treat the majority of the RAV adjustment that GEMA provided for, as addressing the potential for future double recovery, and thus as unproblematic.

4.60 Given this, we consider whether adopting an approach that treats that remaining portion of ES4 revenues – which should be understood as having been double-recovered during DPCR5 – in the same manner (ie through a RAV adjustment) was wrong. Such an approach involved approximation in terms of the overall amount to be returned to consumers, and an implicit view that the use of a RAV reduction that would depreciate over 20 years would not unduly impact on one temporally defined group of consumers over another.

4.61 BGT, including in its response to our provisional determination, emphasised the in-principle view that overcharged revenues should be returned to those consumers that paid them, absent some cogent justification for adopting a different approach. In its response to our provisional determination, Citizens Advice said it was wary of any precedent being set in terms of reimbursement of overpayment through a RAV adjustment.

4.62 While we considered these points carefully, in the particular circumstances surrounding the treatment of ES4 revenues in this case, we are not persuaded that GEMA’s approach could be expected to have an undue
adverse effect on consumers and, in particular, that the interests of current consumers would be materially harmed by that approach. GEMA’s approach ensured that any double-recovered sums would be returned and the RAV adjustment was cost neutral for consumers as a whole. Alternative approaches, in the circumstances, risked GEMA applying a disproportionate remedy to any problems that remained following a RAV adjustment and we are not persuaded that the scale of any benefits from these alternatives are such that GEMA’s approach could be considered wrong.

4.63 Also, we do not consider that GEMA’s approach would be expected to have adverse effects on DNO incentives in relation to double-charging, and find that uncertainty over the extent of and reasons for any overcharge is relevant in this context. Taking all this evidence into account, we are not satisfied that the DNOs could necessarily have been expected to account for their ES4 costs in a consistent way. We do not agree therefore with BGT’s contention that this situation is broadly equivalent to that in which GEMA required immediate repayment to consumers in a context where gas suppliers had been using out of date data relating to calorific value.

4.64 Finally, we note BGT’s criticism about the level of reasoning provided in GEMA’s Draft and Final Determinations. We consider that the detail provided in GEMA’s explanation was not inconsistent with the materiality of the adjustment and we do not agree that the level of reasoning provided involved a procedural flaw which rendered the decision wrong in law or on any of the other prescribed statutory grounds.

Conclusion on appeal ground 1

4.65 The lack of clarity about how ES4 revenues should have been treated during DPCR5 and what was and was not included in DNOs’ allowed revenue in this period is clearly unsatisfactory. We expect GEMA to take steps to ensure that similar ambiguity does not reoccur in any elements of its future price control decisions.

4.66 Nevertheless, given the situation in which GEMA found itself when setting the price control for RIIO-ED1, its decision to adjust the RAV to ensure consumers were not disadvantaged by what happened does not seem to us to have involved any error on GEMA’s part. We therefore determine that GEMA’s decision to address the double recovery through a RAV adjustment, and to do so without adjusting for interest, was not wrong on any of the

---

103 BGT’s Notice of Appeal, paragraph 4.128a.
statutory grounds advanced by BGT. Accordingly, we dismiss BGT’s appeal on ground 1.

5. **Ground 2: incentive targets**

**Background**

5.1 BGT’s second ground of appeal is that GEMA set inappropriate incentive targets in relation to the interruptions incentive scheme (IIS) and the Broad Measure of Customer Satisfaction (BMCS). BGT argued that the design of the schemes was flawed in a way that was likely to lead to significant rewards for DNOs without these being justified by any substantive improvements in performance.\(^{104}\)

5.2 In relation to each scheme, this section of our determination:

- briefly describes the scheme and how it affects DNOs’ revenue during RIIO-ED1;
- summarises what GEMA said during the RIIO-ED1 consultation;
- sets out the criticisms of GEMA’s approach made in BGT’s Notice of Appeal;
- summarises GEMA’s response to those criticisms;
- summarises comments made by other parties in response to BGT’s Notice of Appeal concerning this ground; and
- sets out our conclusion on this appeal ground based on our assessment of each scheme.

**Interruptions incentive scheme**

*How the IIS works*\(^{105}\)

5.3 Under the IIS, GEMA set two targets for each DNO: first, the number of customer interruptions (CI); and secondly, the number of customer minutes lost (CML) due to these interruptions. Every year each DNO would receive a reward/penalty depending on whether it underperformed or outperformed these targets. GEMA stated that the marginal reward/penalty was based on

---

\(^{104}\) BGT’s Notice of Appeal, paragraph 4.25.

\(^{105}\) This description of the operation of the IIS draws on chapter 4 of the *reliability and safety annex* of GEMA’s strategy consultation.
evidence that it had gathered on the value that customers placed on the prevention of interruptions to electricity supply.

5.4 The CI target was intended to incentivise DNOs to reduce the number of interruptions to supply. GEMA set upfront targets for the number of CI per 100 customers for each DNO at the beginning of the price control. The key elements of the target-setting process were:

- The targets set by GEMA were based on each DNO’s own average historical performance up to 2012/13.

- GEMA then rolled these averages forward by applying an improvement factor to generate DNO targets for the first year of ED1 (2015/16) and each successive year of the price control period.

- GEMA applied an annual improvement factor of 0.5% a year for outperforming DNOs and 1.5% for underperforming DNOs.

- GEMA considered an outperforming DNO to be one that had an annual target below a benchmark level of performance.

- GEMA constructed a benchmark for each DNO based on a combination of their own average performance and benchmarking to industry performance. The benchmark value remained unchanged throughout ED1.

5.5 Similarly for CML, GEMA set an upfront target for CML for each DNO. The setting of targets for CML was intended to incentivise the DNO to reduce the duration of interruptions to supply rather than the number of interruptions. Therefore, the target-setting process took into account the interaction between the number of CIs and the average duration of interruptions (CML/CI). Values for each of these were used to generate a target for the annual CML per customer for each DNO. The setting of the CML target was a complicated process, the key elements of which were:

(a) A benchmark level of CML/CI performance was set for each DNO. The benchmarks were set from a combination of own average performance and benchmarking against the industry average or upper quartile performance.

(b) Unlike for the CI benchmark, some elements of the CML/CI benchmarks differed between companies depending on whether they performed better or worse than the industry benchmark. For some elements of the benchmarks, those companies performing relatively worse had benchmarks weighted toward their own performance; the benchmark for relatively
better-performing companies were more reflective of the industry benchmark.

(c) A ‘first pass’ CML target was set for each DNO by multiplying the CML/CI benchmarks by a value for the DNO’s CI. The CI values were based partly on the DNO’s own average performance. One element differed depending on whether the company’s recent performance was better or worse than its CI benchmark. For better-performing companies the CI value would be closely related to their CI benchmark value; for worse performers the CI value would be more closely related to their own recent average performance.

(d) The first pass targets for 2012/13 were rolled forward by applying improvement factors. The application of these improvement factors gave annual first pass targets until the end of the ED1 period.

(e) A 2013/14 ‘start point’ was generated as 75% of the first pass target and 25% of DNO recent average performance.

(f) The final target for each year of the price control was the minimum of the start point and the first pass target.

How the IIS was developed during the RIIO-ED1 consultation

5.6 In the handbook for implementing the RIIO methodology (‘the RIIO Handbook’), GEMA set out the principles it would consider when designing and implementing incentives, such as the IIS, intended to encourage network companies to deliver outputs.\(^\text{106}\) It developed its policy on the IIS in conjunction with the Reliability and Safety Working Group (RSWG) which consisted of the DNOs and, at various times, representatives from DECC, National Grid, the Environment Agency and Consumer Focus that also attended some of the meetings.

5.7 GEMA consulted on a number of elements of the IIS in its Strategy Consultation including the: incentive rates; revenue exposure; approach to target-setting and benchmarking; and the assessment of exceptional events. For the setting of targets relating to unplanned interruptions, which was the subject of this ground of appeal, GEMA considered a number of options but said that its preferred approach was upfront targets which provided ‘certainty

\(^{106}\) GEMA Handbook for implementing the RIIO model, paragraph 9.5.
when it comes to determining whether an investment to improve performance for customers is worth pursuing or not.”

5.8 In its Strategy Decision, GEMA described its decision on targets for IIS:

> We have decided to set unplanned targets for each DNO up front, in advance of RIIO-ED1, using the methodology indicated in the September strategy consultation document. We have decided to use data up to 2012-13 for setting unplanned targets for all DNOs. We have set out indicative targets for RIIO-ED1 in Appendix 2, using data up to 2011-12. To assist DNOs in anticipating where their targets may be set at for RIIO-ED1 a glidepath has been applied to the targets.

5.9 The proposed methodology set out in the Strategy Consultation was not changed significantly during the consultation on RIIO-ED1. At the Draft Determinations stage, GEMA noted that customers wanted a reliable supply and that the IIS ‘drives DNO performance’. In its Final Determinations, GEMA noted that ‘one respondent thought the targets will be too easily achieved.’ It also made specific reference to changes in targets for two DNOs related to specific projects intended to improve reliability.

5.10 After the publication of its Final Determinations, there was an exchange of correspondence between GEMA and BGT about the IIS. This correspondence covered a number of the points raised during this appeal and also included requests for additional information about the targets and how they were developed. Further disaggregated data was provided to BGT, and interested third parties, within the confidentiality ring for this appeal. GEMA had not provided this data ahead of the appeal as it considered it was unable to do so under the Utilities Act 2000.

**Summary of BGT’s criticisms of the IIS**

5.11 BGT’s core criticism of the IIS was that the targets were set in such a way that ‘they may be expected to confer substantial rewards on DNOs generally, without corresponding benefits for consumers in the form of substantive improvements in performance.’ It contended that, based on the most recently available data, ten out of 14 DNOs were achieving performance levels which exceeded GEMA’s average target for RIIO-ED1.

---

107 Strategy Consultation, paragraph 4.29, p22.
110 BGT’s Notice of Appeal, paragraph 4.30.
5.12 Specifically, BGT argued that GEMA erred because:

- its targets for CI and CML were based on outdated information and failed to take account of recent improvements in performance. Specifically, they failed to take account of actual performance data for 2013/14;\(^{111}\)

- the improvement factors that it applied during the RIIO-ED1 price controls were well below historical average rates of improvement; and substantially below the rates achieved by upper quartile DNOs;\(^ {112}\) and

- its initial targets for CML were asymmetric: DNOs that had performed above target were able to benefit from past performance because their CML targets were based on an industry benchmark rate; underperformers were not penalised for poor performance to date as their targets were set with reference to their own performance.\(^ {113}\)

5.13 BGT also considered that the manner in which the IIS was described in the GEMA public consultation documents was opaque.\(^ {114}\)

5.14 In its Notice of Appeal, BGT suggested that, in order to remedy the errors it said it had identified, the following action should be taken:

\(a\) CI: initial targets for each DNO for 2015/16 should be set based on an average of the four years to 2013/14 with a further improvement rate for two years. For underperforming DNOs (defined as those that were set higher improvement factors in at least the initial year by GEMA), the improvement rate should be set using the long term average of 3.2% a year. For outperforming DNOs, the improvement rate should be set at 0.5% a year. These same annual improvement rates should be applied for the duration of RIIO-ED1.

\(b\) CML: initial targets for each DNO for 2015/16 should be set based on an average of the four years to 2013/14 with a further improvement rate for two years. For underperforming DNOs (defined as above), the improvement rate should be set using the long term average of 4.7% a year. For outperforming DNOs, the improvement rate should be set using 1.5% a year. These same annual improvement rates should be applied for the duration of RIIO-ED1.

\(^{111}\) BGT’s Notice of Appeal, paragraph 4.34.
\(^{112}\) BGT’s Notice of Appeal, paragraph 4.34.
\(^{113}\) BGT’s Notice of Appeal, paragraph 4.34.
\(^{114}\) BGT’s Notice of Appeal, paragraph 4.29.
Summary of GEMA’s response on the IIS

5.15 In response to the criticism that it should have used data up to and including 2013/14, GEMA argued that it was not available at the time and was still not at the time of its Response to the Notice of Appeal.\textsuperscript{115} It further contended that it was important to give clarity at the time of the Strategy Consultation, to DNOs and stakeholders, about what was required.\textsuperscript{116} GEMA also argued that to signal in its Strategy Decision that it would use data on 2013/14 DNO performance in its CI and CML target-setting would have provided an incentive to DNOs to stop making improvements so that their targets for ED1 would be lower than otherwise.\textsuperscript{117}

5.16 GEMA said that it did not consider the downward trend over recent years to be a useful indicator of future performance.\textsuperscript{118} This was because of the inherent volatility in the data and the fact that it was unlikely that the kind of step changes in performance observed following the takeovers of WMID, EMID and the UKPN companies could be replicated in the future.

5.17 In response to the criticism that improvement factors were not consistent with historical performance, GEMA said that it had applied a conservative rate of improvement to the CI target. This was on the basis that improvements to CIs required greater investment than improvements to CMLs and therefore more substantial improvements to the network were needed to reduce the number of interruptions.\textsuperscript{119} GEMA also noted that historical DNO performance was achieved in the context of the IIS and that it would have been unreasonable to expect that DNOs would achieve that level of improvement as a baseline in the future.\textsuperscript{120}

5.18 GEMA said that the CML targets were a combination of symmetric and asymmetric components selected to take into account important differences between voltage levels and network characteristics. Overall, GEMA said that the targets incentivised DNOs:

- to keep improving their CI performance and to catch up relative to better performers through the use of different improvement factors; and

\textsuperscript{115} GEMA’s Response, paragraph 178.
\textsuperscript{116} GEMA’s Response, paragraph 176.
\textsuperscript{117} GEMA’s Response, paragraph 177.
\textsuperscript{118} GEMA’s Response, paragraph 178 b
\textsuperscript{119} GEMA’s Response, paragraph 182.
\textsuperscript{120} GEMA’s Response, paragraph 181.
to achieve industry best practice with regards to restoration speed through the use of CML/CI benchmarking.

5.19 GEMA also criticised BGT’s analysis. It contended that BGT’s forecasts for 2014/15 data were soundly made and that notwithstanding this, BGT’s overall assessment that there would be systematic unearned rewards during RIIO-ED1 was incorrect. In contrast, GEMA argued that, if the slow-tracked DNOs were to maintain the 2014/15 level of performance suggested by BGT, there would be an overall penalty of £19 million.121

**Summary of third party responses on the IIS**

5.20 A joint submission from the slow-track DNOs broadly supported the views of GEMA in response to BGT’s criticisms of the IIS. The submission addressed the role of the schemes in the overall price control:122

First, IIS and BMCS provide mechanisms by which DNOs’ revenues can be adjusted to account for effective investment (or lack of investment) in quality-of-service and customer service. In the initial calculation of the DNOs’ base revenue allowances, no account is taken of expenditure above the deemed efficient cost. IIS and BMCS play a critical role in funding, and thus incentivising, long-term investment in service. Such incentives provide a balance to what would otherwise be a cost-focused price control settlement.

5.21 Also, the DNOs specifically addressed BGT’s criticisms on the outdated information, improvement factors and asymmetry and rewards and penalties. In conclusion, they argued that ‘the benefit to consumers brought about by the IIS scheme is evidenced by the fact that when compared with the equivalent final year targets for DPCR5, the new IIS targets for the Slow-Track DNOs in the RIIO-ED1 period represent a benefit of circa £730m to consumers.’123

5.22 Citizens Advice commented on the difficulty of obtaining information about the development of the scheme during the ED1 process. It referred to:

a broader problem we encountered during the development of ED1, where crucial information about the performance of the networks and their earnings during DPCR-5 was not made available to stakeholders until GEMA issued its Final

---

121 GEMA’s Response, paragraph 173(c).
122 DNOs’ joint response, paragraph 72.
123 DNOs’ joint response, paragraph 134.
Determination, by which time it was too late to consider it as part of our assessment of the appropriateness of performance targets.

**Summary of BGT’s Reply on the IIS**

5.23 BGT said that GEMA’s response had ‘failed to address the main conclusion of the 1st AlixPartners Report, namely that the IIS is likely to lead to systematic outperformance and over-rewarding of the DNOs.’ BGT maintained its position that GEMA was using outdated data, its improvement factors were too lenient and that the initial targets for CML were asymmetric.

5.24 Following its review of GEMA’s response, and its analysis of the disaggregated data, BGT revised its proposed remedy. For CI, the proposal was largely unchanged but was revised using the disaggregated data. For CML, BGT suggested the following changes to GEMA’s method:

(a) using data from a four-year period until 2013/14 to set CML/CI benchmarks for all network levels including EHV and 132kV; and

(b) removing the asymmetric aspects of the CML target-setting.

5.25 BGT did not propose to update the improvement factors for the CML targets because: ‘following receipt of the disaggregated data from the Authority and Anna Rossington’s witness statement, we consider the improvement factors of 1% for LV, EHV and 132 kW and 3% for HV voltages appear appropriate.’

**Our final assessment of the IIS**

5.26 In assessing BGT’s criticisms of the IIS, we first consider the objectives of the scheme in the light of the conflicting submissions we received on this issue. We then assess BGT’s specific points on: using 2012/13 data rather than 2013/14 data; improvement factors; and the asymmetry of the CML targets. We then consider the overall criticism that the scheme systematically over-rewards the DNOs. In doing so, we draw, as appropriate, on the supporting analysis provided by the parties and the discussion at the hearings.

---

124 *Citizens Advice response* paragraphs 2.4 & 2.5.
125 *BGT’s Reply*, paragraph 42.
126 *ie* the DNO CI target is based on an assessment of data at different network voltage level. Unlike GEMA, which used tie series of ten years for the EHV and 132kV network level, BGT proposed that a four-year average (until 2013/14) is used for all network levels.
127 *In its Reply, BGT included the example of setting the HV CI number for use in the CML calculation. It proposed that for all DNOs the CI target rather than the CI benchmark is this starting point. BGT was clear that it did not consider this to be the only asymmetric aspect of CML but used this example as an illustration of the overall point.*
Objectives of the IIS

5.27 In our view, the evidence and submissions we received from BGT, GEMA and the DNOs, revealed different perspectives on the objectives of the IIS. This is important for assessing questions about how the scheme works and the extent to which targets are generous or not. In particular, we sought to understand the extent to which the scheme is intended to fund, as well as incentivise, improvements to network reliability by rewarding DNOs for improvements in the CI and CML performance on their networks.

5.28 In its Notice of Appeal, BGT set out its view on the scope of the scheme: ‘rewards should be available to operators delivering high performance, while inefficient operators should face penalties to encourage them to catch up to the rest of the industry.’

5.29 From our review of the RIIO documentation, and GEMA’s response, it appears that GEMA’s own view of the scheme went beyond that suggested by BGT. For example, in its Strategy Consultation, GEMA said that it did ‘not intend to provide any ex ante allowances for Quality of Service investment [a category into which expenditure to improve CI and CML performance would fall] in RIIO-ED1’.128 During the appeal, GEMA similarly told us that price control allowances specifically did not allow for the funding of measures designed to improve the number of customers affected by faults on the DNO network, nor those designed to limit the length of interruptions. This suggests that it was an objective of the IIS to fund improvements in DNO performance beyond a baseline level, where those improvements are valued by customers.

5.30 This view is supported by a number of aspects of the implementation of the scheme. For example, unlike at DCPR4, there was no specific funding related primarily to improvements in network reliability. In addition, there was evidence of adjustments to some DNO IIS targets, for example for SSEH and LPN, where investments were considered to lead to an improvement in network reliability. This view was also supported by the DNOs which, as set out in paragraph 5.20, highlighted the role of the scheme in incentivising quality of service and long-term investment in service in what would otherwise be a cost-focused price control settlement.

5.31 We accept BGT’s contention that it cannot be considered that there was no provision in the ED1 price control settlement for funding that would have implications for network reliability. This is because some expenditure not primarily aimed at improvements reliability would, nevertheless, have this

128 Strategy Consultation, paragraph 46.28, p50.
effect. However, based on the evidence, our view is that the IIS was intended to be the primary funding mechanism for reliability improvements and that this would have been understood by the DNOs at the time of formulating their business plans.

Justification for using 2012/13 data

5.32 BGT disputed GEMA’s arguments that DNOs needed visibility of targets when preparing their business plans. It argued that the investment decisions of DNOs were dependent on knowledge of the marginal incentive rate rather than the absolute target level. It contended that GEMA’s strategy decision contained provisional, rather than finalised, targets suggesting that the arguments about the lack of availability of valid 2013/14 data were overstated. In its Reply, BGT compared the level of certainty that GEMA argued was necessary for DNOs with a company operating in a competitive market which would not know what it was expected to achieve over the following eight years.

5.33 We recognise that GEMA’s approach gave the DNOs a degree of certainty as to required outputs over an eight-year period that is not comparable with a company operating in a market that is open to competition. Furthermore, as BGT argued, it would be possible for DNOs to have some engagement with stakeholders on the basis of indicative targets that could be later calibrated to reflect 2013/14 data. As such, it does not appear to us that DNOs required finalised, or nearly finalised data, to prepare their business plans nor was it therefore absolutely necessary for GEMA to base DNOs’ targets on 2012/13 data.

5.34 Nevertheless, there were in our view advantages in doing so. GEMA’s approach was consistent with the RIIO principles and specifically the stated intention to set targets to use financial incentives when there was clarity on the primary outputs to be delivered and there was confidence in the data used to measure performance.129

5.35 Data for 2012/13 was the most up-to-date available at the time and was used in the Strategy Decision in order to provide visibility of the targets. While the data may not have been finalised at the time of the publication of the Strategy Decision, there would have been sufficient knowledge about the likely values to have provided a significant degree of certainty. GEMA’s Strategy Decision

set out its intention to base targets on 2012/13 data\textsuperscript{130} and it was on this basis that DNOs prepared their business plans.

5.36 While comparisons with competitive markets are useful, any regulatory settlement needs to take into account the different way regulated companies’ prices are set and business plans developed. The regulatory framework needs to achieve a balance between a number of objectives. It is clear that one important objective of the RIIO framework was to provide a high degree of upfront clarity for DNOs to encourage them to engage with stakeholders in the development of their plans and to help elicit high-quality plans as part of the fast-track process. In our view, GEMA’s approach was consistent with this.

5.37 However, the benefits of providing visibility of targets early in the process needs to be balanced with the benefits of using more up-to-date information in the target-setting. We therefore consider whether, as BGT contended, by not using 2013/14 data, GEMA failed to take account of recent improvements in performance and therefore set targets that were too generous.

5.38 BGT contended that by not using 2013/14 data, the targets would allow DNOs to receive rewards over ED1 without providing corresponding improvements in performance. An example it gave of where this could happen was in the case of two companies which made an apparent step change in performance in 2011/12. This improved performance would only be reflected in two of the four years of data used in setting the IIS targets for these DNOs.

5.39 GEMA argued that the proposition put forward by BGT was dependent on an assumption of a downward trend over time. It did not consider the recent downward trend to be a good indicator of future performance. This was because of the inherent volatility of the CI and CML performance data and the increasing difficulty of delivering successive incremental performance improvements.

5.40 BGT’s alternative methodology relied on a different time series of data (2010–2014 rather than 2009–2013). In our view, a clear and significant year-on-year improvement in DNO CI and CML performance between 2012/13 and 2013/14, beyond the improvement factors already built in by GEMA, would need to be evident to call into question GEMA’s approach.

5.41 All parties submitted analysis of trends in the CI and CML data with differing, but in our view largely unsubstantiated, interpretations of what the analysis means. Our view is that, on the basis of the data submitted, there is some

\textsuperscript{130} Strategy Decision: Reliability and safety annex, paragraph 4.17.
evidence of an overall downward industry trend in both CML and CI but that this trend is very volatile and it is difficult to draw firm conclusions from it. Table 3 shows that, in general, year-on-year industry performance for CI and CML had tended to improve but the scale of the improvement is extremely variable. Figures 3 and 4 below, produced from data submitted as part of this appeal, show volatility in the year-on-year changes across DNOs.

Table 3: Year-on-year change in industry CI and CML

<table>
<thead>
<tr>
<th>Year</th>
<th>CI year-on-year change</th>
<th>CML year-on-year change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003/04</td>
<td>–1</td>
<td>–8</td>
</tr>
<tr>
<td>2004/05</td>
<td>–6</td>
<td>–8</td>
</tr>
<tr>
<td>2005/06</td>
<td>–5</td>
<td>–9</td>
</tr>
<tr>
<td>2006/07</td>
<td>11</td>
<td>19</td>
</tr>
<tr>
<td>2007/08</td>
<td>–7</td>
<td>–6</td>
</tr>
<tr>
<td>2008/09</td>
<td>–7</td>
<td>–6</td>
</tr>
<tr>
<td>2009/10</td>
<td>–2</td>
<td>–4</td>
</tr>
<tr>
<td>2010/11</td>
<td>–1</td>
<td>–3</td>
</tr>
<tr>
<td>2011/12</td>
<td>–12</td>
<td>–23</td>
</tr>
<tr>
<td>2012/13</td>
<td>–2</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Slow-track DNOs’ joint response.

Figure 3: Year-on-year changes in DNO CI performance

Source: Slow-track DNOs’ joint response.

We have verified the calculations in this submission.
5.42 The data suggests that in recent years there has been modest improvement in industry CI and CML performance with the exception of 2012/13 where a large improvement was made in both CI and CML performance. It would appear that this was heavily influenced by a large change in performance made by two DNO groups. We are not persuaded these improvements are indicative of a long-term trend at that rate.

5.43 In our view, there is little in the trends that suggests that, at the time of the Strategy Decision, GEMA should have had a strong expectation that there would have been a significant improvement in performance by some DNOs or on average across the industry beyond the level of the improvement factors that GEMA applied to the targets. We therefore consider that GEMA did not, as BGT contended, ignore a likelihood of significant benefits to customers that might have accrued from using 2013/14 data.

5.44 We note, however, that GEMA’s judgements about how apparent trends in the data should inform future targets might have been better informed by detailed multivariate statistical analysis of the more than ten years of data across the 14 DNOs. Although we do not consider the fact that GEMA did not carry out such an analysis rendered its approach wrong, GEMA may wish to consider the merits of such analysis to inform future price controls.

5.45 Overall, we consider that there are benefits from providing visibility of IIS targets to DNOs when preparing their business plans. These benefits are not offset by any weaknesses from basing those targets on using 2012/13 rather
than 2013/14 data especially given that the 2013/14 data that would have been relied on at that stage would have been provisional rather than final and that there were multiple years of data for the IIS.

Justification for improvement factors

5.46 On the choice of improvement factors, there was broad agreement between GEMA and BGT that these were based on an analysis of historical trends and that GEMA, particularly in the case of CI improvement factors, had selected from the conservative part of the observed range of DNO average improvement. BGT argued for a slightly different approach to improvement factors, specifically, that the improvement factor should have been equivalent to its estimate of the industry average improvement since 2002/03 (3.3%) for DNOs which were performing below the benchmark standard. This compared with the 1.5% improvement factor for such companies selected by GEMA.

5.47 Our view is that both are plausible approaches and it is not possible to conclude on the basis of the evidence submitted that one is demonstrably better than other. We agree that there is some merit in the argument put forward by GEMA that it is legitimate to choose factors from the conservative end of the observed range. This is because the intention of the IIS is to set a baseline over the ED1 period for performance without IIS and that improvements beyond that baseline would then be funded by rewards under the IIS. We consider this approach to be consistent with the objectives of the IIS as we understand them and as described in paragraphs 5.27 to 5.31.

Justification for CML asymmetries

5.48 There was a consensus between the parties that aspects of the CML targets were asymmetrical but a difference of view on the justification for this asymmetry. BGT contended that the asymmetries meant that well-performing companies tended to get rewarded for their good performance while poorer performing companies did not get punished for performing below the industry standard. GEMA argued that whilst there were both symmetric and asymmetric aspects of the CML targets, the choice of each aspect took into account ‘important differences between voltage levels and network characteristics’. It also argued that it was reasonable to reward well-performing companies as those at the frontier generated benefits for the whole industry by providing a benchmark against which other companies’ performance could be assessed.

5.49 In our view, the comparability of DNO networks and the robustness of the data for different voltage levels were important factors that should have been taken into account when setting targets. It appears that GEMA exercised its
judgement on these issues and attempted to calibrate the targets in line with this judgement. For example, where it considered that the data was robust and comparable across DNO networks, as with the high voltage aspects of the benchmark, GEMA adopted a more challenging upper quartile benchmarking approach to target-setting. In contrast, GEMA took a different approach to setting, for example, the low voltage CML/CI benchmarks where it considered that network differences made comparison across DNOs difficult. For this aspect of the CML/CI benchmarks, GEMA chose a less challenging industry average standard with a 25% weight towards a DNO’s own performance where it was performing below the industry average.

5.50 GEMA therefore and in our view appropriately, adapted its approach to setting different aspects of the CML targets depending on the robustness and comparability of data across DNOs. We also consider that its view that well-performing companies should be rewarded for the benefits they brought by providing industry benchmarks is consistent with the regulatory principle that good performance is not unduly disincentivised. Overall, in our view, GEMA made a number of legitimate choices, based on its judgement, in setting the CML targets. BGT highlighted other potentially plausible choices but did not demonstrate that GEMA’s approach was wrong on the basis of asymmetry.

Potential for unjustified systematic rewards over the ED1 period

5.51 BGT submitted that the IIS targets as currently set would lead to systematic rewards for certain DNO and across the industry without corresponding improvements in performance. In particular, BGT contended that nine out of 14 (including five out of ten slow-track) DNOs would receive rewards over the ED1 period even if they only maintained the forecast 2014/15 level of performance. BGT claimed that its analysis showed that there would be rewards paid out to all DNOs, including the fast-track DNOs, in excess of £250 million over ED1 if they maintained 2014/15 performance based on the forecast data used.

5.52 GEMA did not agree that the forecasted 2014/15 data that BGT relied on was a sound basis for predicting performance over the ED1 period. It further argued that, even on the basis of this forecast data, if this level of performance were to be maintained across the slow-track DNOs, the IIS target would result in a small overall penalty of £19 million.

5.53 Our review of the analysis presented by BGT, GEMA and the DNOs suggests it is broadly accurate and consistent across the parties. The analysis GEMA presented is consistent with that of BGT in that it also shows that five out of the ten slow-track companies will receive rewards. The explanation for the different estimates of the overall reward/penalty is that BGT’s estimate
includes the fast-track DNOs and GEMA’s does not and GEMA included other parts of the price control mechanism in its calculation.

5.54 The disagreement between the parties is largely in the interpretation of what the analysis of the data means. In our view, there is no clear evidence from the analysis presented that there would be systematic rewards for the slow-track companies if recent forecast levels of performance were maintained across ED1. GEMA’s forecast of a small overall penalty is consistent with our own analysis. This also shows that the overall penalty would not be distributed evenly across DNOs as some would receive rewards in the low tens of millions whilst others would receive penalties.

5.55 In the light of our interpretation of the objective of the IIS, to fund improvements away from a baseline level of performance, an outcome where the level of rewards/penalties across the slow-track DNOs is close to zero, if current levels of performance were maintained, does not appear to be inappropriate. In a scheme, such as the IIS, where targets for performance are set across companies with a significant degree of variation in network types and past performance, we would expect the outcomes to vary across those companies.

5.56 We note that BGT’s analysis showed that some of the fast-track companies would earn very significant rewards over ED1 if they were to maintain current performance. However, we agree with GEMA that the rewards that might accrue to the fast-track companies over ED1 are not relevant to this appeal. We do not consider that there is evidence that the calibration of the scheme is inappropriate for the slow-track companies or that it suggests systematic rewards for the maintenance of current performance by them.

5.57 As we set out in paragraphs 5.26 to 5.56, GEMA’s decision to base its targets on data to 2012/13 was consistent with its RIIO approach and provided a degree of certainty to DNOs that supported the development of business plans. The volatility in the data, and lack of evidence for a continued consistent downward trend in performance, suggest that it was appropriate for GEMA to maintain its reliance on the 2009 to 2013 time series.

5.58 In developing an incentive scheme of this type, a regulator needs to make a number of finely-balanced choices when setting targets. In our view, GEMA’s choices in relation to improvement factors and asymmetrical targets were appropriately supported by reasons and evidence. They were also consistent with an objective for the scheme that it should fund improvements in DNO

132 And where DNOs are funded through the expenditure allowances within the price control to roughly maintain current levels of performance.
performance beyond a baseline level where those improvements are valued by customers. Our assessment does not support a view that the IIS targets set by GEMA will systematically reward slow-track DNOs for maintaining current levels of performance.

5.59 While BGT, in part, put forward potentially plausible alternative choices for the design of the IIS, its criticisms of the scheme have not, in our view, demonstrated that GEMA’s was wrong on any of the statutory grounds.

5.60 Our review of the material presented in this appeal supports, to some extent, BGT’s view that the description in GEMA’s price control documents of the target-setting process, and the implications of different approaches, was somewhat opaque. While we do not consider that this vitiates the Decision so far as it related to the IIS, we do draw attention to this to help inform the approach to be taken in future price controls.

5.61 While we recognise that price controls are complex decisions requiring consultation on multiple issues with many parties, we consider that the level of discussion in these documents and the absence of detailed published data created difficulties for any non-DNO seeking to engage fully with the IIS target-setting process. For example, while we note that the disaggregated data that informed the target-setting process was restricted and the DNOs had not given permission for its disclosure, its relevance during this appeal suggests that GEMA and the DNOs should consider how to make it available to parties who request it in respect of future consultations. We consider that future price controls should seek to learn lessons from the target-setting process in RIIO-ED1 and the issues of transparency which arose during this appeal. In our view, GEMA should engage stakeholders who criticised the process when developing future target-setting approaches given that these affect consumers directly. Citizens Advice’s comments on the process (see paragraph 5.22) summarised the issues well and, in our view, could usefully influence GEMA’s future approach to IIS target-setting. That said, we do not think that these transparency issues were sufficient to undermine GEMA’s substantive approach to IIS.

5.62 In its response to our provisional determination, BGT said that our view that GEMA had made legitimate choices permitted it too broad a degree of regulatory discretion. It further submitted that the shortcomings we had identified in the consultation process called for either a full ‘on the merits’ review or remittal to GEMA so that an effective consultation could be carried out. Citizens Advice was also concerned that by not finding that any shortcomings with the consultation process invalidated GEMA’s decision, this could ‘set a precedent that failure to properly consult with non-DNOs on key elements of settlements do not threaten the validity of the GEMA decisions’.
5.63 In our view, proper consultation with all stakeholders is an important part of the process for making regulatory decisions. We have balanced our view, based on the extensive evidence submitted during the appeal, on the substance of the Decision while taking into account criticisms of the decision-making process. Our view is that GEMA made legitimate choices and that there is no evidence of systematic rewards to slow-track DNOs without corresponding improvements in performance. We are also satisfied that, in this case, the shortcomings in the consultation process or potential improvements to the approach (for example, as described in paragraph 5.44), to which we have drawn attention with a view to promoting best practice, nonetheless do not render the Decision wrong on any of the statutory grounds advanced by BGT.

**Broad Measure of Customer Satisfaction**

*How the BMCS works*\(^{133}\)

5.64 GEMA introduced the BMCS as part of the last price control, DPCR5, but it was only fully operational from 2012/13. It comprised three elements: a customer satisfaction survey; a complaints metric; and a stakeholder engagement incentive.

*Customer satisfaction survey*

5.65 The customer satisfaction survey sought to gauge the views of three categories of customers, randomly sampled, who *(a)* made a general enquiry, *(b)* experienced an interruption or *(c)* requested a new connection. DNOs’ average satisfaction score for each category of customer determined the level of the financial reward or penalty. For each category there was a capped reward/penalty expressed as a percentage of the annual base revenue (Connection +/- 0.5%, interruptions +/- 0.3% and general enquiries +/- 0.2%).

5.66 The targets for the customer satisfaction survey were set as an absolute value based on an external index. The targets were based on the upper quartile level of performance of companies in the Institute of Customer Service UK Customer Service index (UKCSI). For each category, the target was set at a

---

\(^{133}\) The description of the operation of the BMCS draws on Chapter 6 of GEMA’s Strategy Decision: supplementary annex outputs, incentives and innovation; and GEMA’s Consultation on RIIO-ED1 customer service and connection incentives.
score of 8.2 out of 10\textsuperscript{134} for the whole of the ED1 period. The targets were fixed for the RIIO-ED1 period.

5.67 Other elements of the customer satisfaction survey metrics are that the maximum reward/penalty score was based on 1.75 standard deviations from the average (mean) of the UKCSI.\textsuperscript{135} Also, the incentive rate was set by dividing the maximum/minimum reward/penalty by the difference between the target and the maximum/minimum penalty score.

5.68 In addition to changing the method of setting targets and the overall revenue exposure from that in DPCR5, GEMA changed some other elements of the customer satisfaction survey metrics:

- an unsuccessful call adjustment was to be made to the DNO interruption scores;\textsuperscript{136} and
- the scope of the customer survey would be increased so as to include customers who had made general enquiries by any means and also customers who had been proactively contacted by the DNOs regarding interruptions by any means.\textsuperscript{137}

The complaints metric

5.69 The complaints metric measures DNO performance on four measures that are weighted to calculate a composite score. These measures (and their relative weighting or contribution to the composite score in RIIO-ED1) are:\textsuperscript{138}

- the percentage of total complaints outstanding after one day (10%); 
- the percentage of total complaints outstanding after 31 days (30%); 
- the percentage of total complaints that are repeat complaints (50%); and
- the percentage of Energy Ombudsman decisions that find in favour of the complainant as a percentage of total complaints (10%).

\textsuperscript{134} The survey requires customers to rank companies out of ten across a range of measures.

\textsuperscript{135} This is the overall average not for separate customer categories. The target is the same for all categories.

\textsuperscript{136} Strategy Decision: Outputs, incentives and innovation annex, paragraph 6.47.

\textsuperscript{137} ibid, paragraph 6.44.

\textsuperscript{138} ibid, paragraph 6.13.
A DNO’s performance against the above measures resulted in the calculation of an overall score using a formula.\textsuperscript{139} The target was 8.33 based on the average level of DNO performance in 2012/13 and remained the same for the whole of the ED1 Period. GEMA said that this recognised that ‘current average levels of performance are acceptable but ensures that the worst performers have a strong incentive to improve’, a view that was in part based on the relatively good performance of DNOs compared with that of gas distribution companies.\textsuperscript{140}

The complaints part of the BMCS did not offer rewards for companies which beat the target but it did penalise companies which failed to meet it. The maximum level of penalty was set at the level of the worst-performing company in 2012/13 and the incentive rate was the maximum penalty divided by the difference between this and the target level.

\textit{The stakeholder engagement incentive}

GEMA’s Strategy Decision stated that this was intended to encourage DNOs to engage effectively with a wide range of stakeholders and use the outputs from this process to inform how they planned and ran their business.\textsuperscript{141} It aimed to reward exceptional stakeholder engagement and there was no penalty system associated with this part of the scheme. The maximum possible reward was 0.5% of base revenue.

DNOs were required to submit a stakeholder engagement report to GEMA on an annual basis. GEMA then assessed the submissions against a set of minimum requirements. Those DNOs that satisfied the minimum requirements were forwarded for assessment by an independent panel which assessed the submissions against a set of predetermined criteria and awarded an overall score for each DNO. The financial reward was based on the score (out of 10) awarded by the independent panel. GEMA did not specify how the overall panel score was converted into a financial reward in the DNOs’ licence conditions. Rather, GEMA provided guidance on how to convert the stakeholder engagement incentive score into a financial reward and set out in its strategy plans that it would update the guidance to take into account the lessons learned and best practice demonstrated by the DNOs.\textsuperscript{142}

\textsuperscript{139} (percentage of complaints outstanding after 1 day x 10) + (percentage of complaints outstanding after 31 days x 30) + (percentage of repeat complaints x 50) + (percentage Energy Ombudsman decisions that go against the DNO x 10).

\textsuperscript{140} Consultation on RIIO-ED1 customer service and connection incentives (4 September 2013), pp8–9.

\textsuperscript{141} Strategy Decision: Outputs, incentives and innovation annex, paragraph 6.16.

\textsuperscript{142} ibid, paragraphs 6.43–6.50.
How BMCS was developed during the RIIO-ED1 consultation

5.74 In its Strategy Consultation, GEMA stated its intention was broadly to retain BMCS in the form implemented at DPCR5 but to change a number of elements of the scheme. These changes included the strengthening of the financial incentives now that it had more confidence in the BMCS as an output measure; the introduction of fixed targets for the customer satisfaction survey and customer complaint metric; and increasing the scope of the customer satisfaction survey along the lines set out in paragraph 5.68 above.\(^\text{143}\)

5.75 In its Strategy Decision, GEMA summarised the different elements of the BMCS and the level of financial exposure that would be associated with DNO performance. This table is reproduced below. GEMA also stated that its decision was to adapt the BMCS along the lines set out above.\(^\text{144}\)

<table>
<thead>
<tr>
<th>Table 4: Broad Measure of Customer Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMCS incentive</td>
</tr>
<tr>
<td>Customer satisfaction survey</td>
</tr>
<tr>
<td>– Connections</td>
</tr>
<tr>
<td>– Interruptions</td>
</tr>
<tr>
<td>– General enquiries</td>
</tr>
<tr>
<td>Complaints metric</td>
</tr>
<tr>
<td>Stakeholder engagement incentive</td>
</tr>
<tr>
<td>Maximum penalty/reward exposure</td>
</tr>
</tbody>
</table>

Source: Strategy Decision: Outputs, incentives and innovation annex, Table 6.1.

5.76 In September 2013, GEMA consulted separately on the setting of targets and incentive rates for the customer satisfaction survey and complaints metrics.\(^\text{145}\) Most of the position set out in that document was ultimately incorporated into GEMA’s Final Determinations.

Summary of BGT’s criticisms of BMCS

5.77 BGT argued that the BMCS was flawed in several respects and that as a consequence, it would have expected these flaws to lead to systematic unearned reward across the industry without corresponding improvements in performance. BGT contended that:

(a) the targets set by GEMA under the BMCS have been relaxed by comparison with the targets applicable under the last price control; and/or

---

\(^{143}\) Strategy Consultation, paragraphs 6.3–6.50.

\(^{144}\) Strategy Decision, paragraphs 6.43–6.54.

\(^{145}\) Consultation on RIIO-ED1 customer service and connection incentives.
set at a level that was too low, when assessed against DNOs' recent performance; specifically:

(i) In the case of the customer satisfaction survey, the targets for the interruptions were set below the average level of performance of DNOs in 2013/14;

(ii) In the case of the complaints metrics targets, the target was set at a less demanding level than for DPCR5; and

(iii) In the case of stakeholder engagement, no change was made to the method used to measure and reward DNO performance and failure to tighten the existing incentive arrangements had the effect that substantial rewards were likely to be conferred on all DNOs, including the worst performing;

(b) GEMA had not incorporated any improvement factors in the absolute targets set under the BMCS; and

(c) the incentive rates for the customer satisfaction survey rewards and penalties were not symmetric.

5.78 By way of remedy, BGT requested that the stakeholder incentive scheme target should be recalibrated as follows:

(a) Customer satisfaction survey: the target starting point for each of the customer satisfaction survey elements should be set at the average of DNOs' average performance in each category across 2012/13 and 2013/14. To encourage improvements in performance, the target score should be increased each year on a straight-line basis from the starting point to the average of DNOs' upper quartile performance in each category across 2012/13 and 2013/14.

(b) Complaints metric: the target starting point for the complaints metric should be set at DNOs' average performance across 2012/13 and 2013/14 with straight line improvements to the upper quartile as per the customer satisfaction survey.

(c) Stakeholder engagement incentive: the scheme should offer a linear reward incentive between the minimum reasonable performance of 6 and the maximum possible score of 10.

---

146 BGT's Notice of Appeal, paragraphs 4.45–4.47.
5.79 GEMA made a number of general points regarding BGT’s assertion that the targets that it had set for the BMCS would lead to systematic unearned rewards. The main points were:\textsuperscript{147}

(a) historical performance data was not a good indicator of future performance. This was because of the evolving nature of customer satisfaction, and the fact that the scope of the BMCS changed in RIIO-ED1;

(b) GEMA looked at data outside the electricity distribution industry in designing the BMCS to ensure that DNOs’ customer service was good when compared with a national standard;

(c) BMCS data for 2013/14 was not available at the time when GEMA set the targets, in December 2013; and

(d) the aim of the BMCS was not in any case solely to incentivise improvements, but also to encourage DNOs to maintain good levels of customer service.

5.80 In response to the allegation that the targets were set at a level that was too low when assessed against the DNOs’ recent performance, GEMA argued that since customers’ expectations would evolve over time, the DNOs would need to make continuing improvements to maintain current performance and that the 2013/14 data was not available. GEMA noted that the scope of the scheme had changed and that the new unsuccessful call element of the scheme had not been properly considered in the BGT analysis. GEMA also noted that any complaints about the stakeholder engagement aspect of the BMCS were misconceived as the details which would set out how companies will be rewarded had not been finalised.

5.81 On the absence of improvement factors, GEMA noted that:

(a) in the case of the customer satisfaction survey, the requirement for improvement was effectively built in to the absolute targets, insofar as customer expectations changed over time;

(b) for the same reasons, the stakeholder engagement incentive would have a requirement for improvement effectively built in once the absolute

\textsuperscript{147} GEMA’s Response, paragraph 193.
targets were finalised, insofar as the panel’s expectations would change over time; and

(c) in the case of the complaints metric, GEMA’s policy was not necessarily to improve performance across all DNOs, but to encourage the worst-performing DNOs to improve and maintain the best-performing DNOs at their current level of performance.

5.82 GEMA argued that the approach was not to ensure that reward and penalty incentive rates were symmetrical. Rather, it 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.

**Summary of third party responses on BMCS**

5.83 The joint DNO submission was consistent with GEMA’s Response. The DNOs emphasised the lack of historic data for the BMCS:

There was limited historical information available to the Authority, as the BMCS customer satisfaction survey was not introduced until 1 April 2012. The Authority consulted and decided to use wider UK service industry customer satisfaction performance data when reviewing appropriate targets. The Authority’s assessment in relation to BMCS needs to be considered by the CMA in the light of this distinction between BMCS and IIS.\(^\text{148}\)

5.84 The DNOs also submitted a chart of recent trends in the UKCSI index in support of their view that customer satisfaction is declining and that this was indicative of increasing customer expectations. We reproduce the chart below.

\(^{148}\text{DNOs' joint response, paragraph 87.}\)
Our assessment of BMCS

5.85 We consider the context of the relatively recent introduction of the BMCS to be important. This means there is very limited information on the historical performance of DNOs and there is therefore a limited basis for making a judgement about likely future DNO performance. This is especially the case given that a number of elements of the BMCS were changed for ED1.

5.86 In setting the customer satisfaction targets, GEMA used what we consider to be a credible external benchmark to set the target level of performance. There is a lack of evidence, on the basis of two years of recent performance data, that DNOs will systematically outperform the targets over ED1.

5.87 In considering BGTs proposal to incorporate improvement factors, we recognise that the evidence provided on increasing customer expectations is not particularly compelling. However, it is not clear to us that there is any strong basis for assuming either that baseline performance in terms of customer satisfaction should be improving over time, or that the failure to include improvement factors will lead to systematic rewards.

5.88 We assessed the arguments for the asymmetrical marginal penalties and rewards in this aspect of the scheme. We agree that the consequence of this asymmetry is that marginal improvements above the target level will be

---

149 Either that it shows that the UKCSI index is likely to declines over the period of ED1 or that this would necessarily be an indication of increasing customer expectation with regard to customer service.
rewarded at a greater rate than an equally marginal deterioration below this level. However, we do not consider that it was necessary for GEMA to maintain symmetry in the maximum penalties and rewards. BGT did not demonstrate that, as a consequence of this, DNOs would earn systematic unearned rewards. We note that neither party submitted evidence on what appropriate marginal rates of penalties and rewards would be.

5.89 In the case of the customer complaints metric, while we acknowledge that the target represents a relaxation compared with DPCR5, it is a relevant consideration that this is a penalty-only metric. We consider it an entirely reasonable approach to set a target for a penalty-only metric at the level of the industry average.

5.90 As for the stakeholder engagement element of the BMCS, we do not consider that GEMA’s approach was wrong given that the setting of the level of rewards outside the base level of price control funding has not been set. We note also that rewards are to be determined at the discretion of a panel that has not yet been appointed and in accordance with guidance that has not yet been finalised.

5.91 Finally, we note BGT’s criticism about the level of transparency in the consultation on the BMCS. We are not persuaded that the level of information GEMA provided was inadequate. The fact that BGT raised specific points with GEMA to clarify its understanding of the scheme does not, in itself, suggest that the process was flawed. As GEMA demonstrated in its Response, there were opportunities for BGT to engage with GEMA about the design of the BMCS and raise questions of clarification during the RIIO consultation and these were not taken.

Conclusion on appeal ground 2

5.92 Based on our assessment of BGT’s criticisms of the IIS and BMCS set out in paragraphs 5.26 to 5.61 and paragraphs 5.77 and 5.78 above, our view is that GEMA’s design of the schemes is not flawed such that the schemes are likely to lead to significant rewards for DNOs, without these being justified by any substantive improvements in performance. We therefore determine that GEMA was not wrong on any of the prescribed statutory grounds. Accordingly, we dismiss BGT’s appeal on ground 2.

---

150 Ofwat, for example, in its broadly similar service incentive mechanism scheme applies a lower level of maximum reward (0.5% base revenue) than they do maximum penalty (1% of base revenue). See Ofwat Service Incentive Mechanism (SIM) for 2015 onwards – conclusions (pp3–4).
151 BGT’s Notice of Appeal, paragraph 4.128b.
152 GEMA’s Response, paragraph 299.
6. Ground 3: change to Information Quality Incentives

Background

6.1 BGT’s third ground was that GEMA erred in deciding to adjust the IQI scheme after the DNOs had submitted their business plans. BGT argued that GEMA’s decision to make this adjustment was:

(a) irrational and/or based on irrelevant considerations, and therefore wrong in law;

(b) contrary to GEMA’s principal objective to protect the interests of consumers;

(c) contrary to GEMA’s duty to act in a consistent and proportionate manner, conferring unnecessary and excessive ex post benefits on DNOs, at the expense of consumers; and

(d) unsustainable for achieving the effect aimed at by GEMA, namely to improve incentives to prepare well-justified business plans in the present and future price controls.

The Information Quality Incentive: overview

6.2 As GEMA put it in the RIIO Handbook:

8.45. The Information Quality Incentive (IQI) is used to set the strength of the upfront efficiency incentives each company faces according to differences between its forecast and GEMA’s assessment of its (efficient) expenditure requirements. The aim of the tool is to encourage companies to submit more accurate expenditure forecasts to GEMA.

8.46. Under the RIIO model, we will use the IQI in all four energy network sectors to provide financial incentives to encourage companies to submit more accurate expenditure forecasts than they would in the absence of the IQI. In particular, the IQI will provide:

---

153 BGT’s Notice of Appeal, paragraph 1.9(c).
154 BGT’s Notice of Appeal, paragraph 4.63.
155 Handbook for implementing the RIIO model, October 2010.
an additional financial motivation for companies to spend the
time and resources necessary to produce high-quality and
well-justified business plans; and

a financial deterrent against the submission of inflated
expenditure forecasts.

6.3 Due to the asymmetry of information that exists between GEMA and the
DNOs, the latter may have faced incentives to submit expenditure forecasts to
GEMA that exceeded their private views of what they would actually spend. In
particular, by submitting inflated forecasts (relative to the DNOs’ ‘private’ view
of what was necessary), a DNO may have been able to secure a higher
expenditure allowance from GEMA, and then benefit from the difference
between this (inflated) expenditure allowance and the lower level of
expenditure that it privately expected, and was able, to achieve.

6.4 In order to address this issue, the IQI sought to incentivise the DNOs to
provide expenditure forecasts that matched their expectations of what they
would actually spend, by ensuring that the most financially attractive option for
DNOs was to submit business plan expenditure forecasts that were equal to
their best estimate of their actual future expenditure requirements.

6.5 Broadly, there were two stages at which these incentives were relevant. At the
first stage, DNOs were incentivised to submit their best business plans by the
prospect of being fast-tracked. Fast-tracking conferred significant financial
rewards and increased certainty in advance of the price control period. Fast-
tracked companies received 2.5% of totex as an upfront reward, a guarantee
that they would not be worse off relative to the final settlement for the slow-
track companies and a finalised licence modification around eight months
before the slow-track DNOs. The second stage was the submission of the
revised business plans by the slow-tracked DNOs. At this stage, the IQI was
intended to incentivise the DNOs to submit their best estimate of forecast
costs by the prospect of financial rewards conferred as a result of an
individual DNO’s forecast relative to GEMA’s view of efficient costs. The
mechanism by which these incentives operate is set out below.

6.6 The objectives of the IQI were not under dispute: BGT’s description of these
objectives in its Notice of Appeal\textsuperscript{156} was consistent with GEMA’s own
explanations as set out in the RIIO Handbook (which is directly referenced by

\textsuperscript{156} BGT’s Notice of Appeal, paragraph 4.51.
6.7 The IQI operated by using, for each company, the relationship between the company’s forecast of expenditure requirements over the control period, and GEMA’s assessment of efficient expenditure for that company. The IQI operated by using this relationship in three separate ways:

(a) First, the relationship determined the efficiency incentive rate which was applied to that DNO. This rate determined the amount of any underspend (relative to its final expenditure allowance) that a DNO was permitted to retain, and the amount of any overspend (again, relative to its allowed expenditure) that it must bear itself. The lower a DNO’s submitted forecast expenditure relative to GEMA’s assessment of efficient expenditure, the higher the efficiency incentive rate that the DNO would receive over the course of RIIO-ED1. The efficiency incentive rates that GEMA included in the IQI matrix used for its Draft and Final determinations for the slow-track DNOs ranged between 45 and 65%. Fast-track DNOs were given an efficiency incentive rate of 70%.

(b) Second, the relationship was relevant to the process of interpolation by which GEMA set the allowed expenditure for each DNO as the weighted average of GEMA’s own assessment of efficient expenditure (given a 75% weighting) and the forecast expenditure submitted by that DNO (given a 25% weighting). The interpolation mechanism did not affect the revenue allowance of the fast-track DNOs as GEMA accepted their business plans as forecasts of efficient expenditure.

(c) Third, and finally, the relationship determines the upfront reward or penalty that was applicable to a given DNO (sometimes referred to by GEMA in its RIIO-ED1 publications as ‘additional income’). The quantum of that reward/penalty for a given slow-track DNO was, again, determined by the extent to which that DNO’s expenditure forecast matched GEMA’s own assessment of efficient expenditure. Fast-track DNOs received an upfront reward of 2.5%.

6.8 BGT did not challenge GEMA’s approach to the efficiency incentive rate or to interpolation. Its criticisms under appeal ground 3 related specifically to the upfront reward/penalty element, and in particular, GEMA’s decision to alter this aspect of the IQI during the consultation on RIIO-ED1 ahead of the

---

157 The scope of expenditure included in the IQI is discussed below.
158 Strategy Consultation: Outputs, incentives and innovation annex, paragraph 9.10.
licence modifications, by adjusting the so-called ‘break-even’ point (see below).

The upfront reward/penalty

6.9 Before turning to the specific approach that GEMA took to the IQI in its RIIO-ED1 decision, and in particular the recalibration of the ‘break-even’ point which was under challenge in BGT’s appeal, we consider it helpful to provide a brief illustration of the importance of the upfront reward/penalty to the IQI mechanism.

6.10 In essence, the purpose of the upfront reward/penalty was to provide the DNOs with a financial incentive to provide expenditure forecasts that were in line with their own ‘private’ estimates of what they actually needed to spend over the RIIO-ED1 period. This was referred to as ‘incentive compatibility’.

6.11 This can be illustrated by considering a DNO that expected its actual expenditure to be the same as GEMA’s assessment of efficient expenditure (‘expects 100’). Table 5 below shows the pay-offs that a DNO which expects 100 would get from submitting different levels of expenditure forecast, assuming that (over the price control period) it achieved its own private view of expected expenditure (ie if it actually spent 100% of its efficient expenditure allowance), both with and without the application of the upfront reward/penalty. The table demonstrates that the highest net gain in the absence of the upfront reward/penalty (ie arising from the application of interpolation and the efficiency incentive rate) results from the submission of an inflated expenditure forecast, equivalent to 130% of GEMA’s assessment of efficient expenditure in the range of options considered in Table 5. In contrast, after the effect of the upfront reward/penalty is taken into account, the highest net gain comes from submitting a forecast that has the same ratio to GEMA’s assessment as the DNO’s private view (ie 100).

Table 5: Illustration of IQI pay-offs when DNO expects to spend 100% of GEMA’s assessment of efficient expenditure (using IQI matrix applied at Final Determinations)

<table>
<thead>
<tr>
<th>Ratio of DNO’s submitted forecast of expenditure to GEMA’s assessment of efficient expenditure</th>
<th>Net gain/loss absent upfront reward/penalty</th>
<th>Upfront reward/penalty (Additional income)</th>
<th>Net gain (with upfront reward/penalty)</th>
</tr>
</thead>
<tbody>
<tr>
<td>90</td>
<td>–1.6</td>
<td>3.1</td>
<td>1.5</td>
</tr>
<tr>
<td>95</td>
<td>–0.8</td>
<td>2.4</td>
<td>1.6</td>
</tr>
<tr>
<td>100</td>
<td>0.0</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>105</td>
<td>0.7</td>
<td>0.9</td>
<td>1.6</td>
</tr>
<tr>
<td>110</td>
<td>1.4</td>
<td>0.1</td>
<td>1.5</td>
</tr>
<tr>
<td>115</td>
<td>2.0</td>
<td>–0.8</td>
<td>1.1</td>
</tr>
<tr>
<td>120</td>
<td>2.5</td>
<td>–1.8</td>
<td>0.7</td>
</tr>
<tr>
<td>125</td>
<td>3.0</td>
<td>–2.8</td>
<td>0.1</td>
</tr>
<tr>
<td>130</td>
<td>3.4</td>
<td>–3.9</td>
<td>–0.6</td>
</tr>
</tbody>
</table>

Source: GEMA, Final Determinations, Business Plan Expenditure Assessment, Table 2.8 and CMA analysis.
6.12 The level of the upfront reward/penalty is set so that this ‘incentive compatibility’ (ie the fact that it is always most advantageous for a DNO to submit a forecast which matches its own private expectations of what it will actually spend over the RIIO-ED1 period) holds for all levels of expected expenditure.

**GEMA’s Decision in relation to the IQI**

**GEMA’s September 2012 Strategy Consultation**

6.13 In its September 2012 Strategy Consultation, GEMA confirmed, in terms which match those used in the RIIO Handbook, its intention to use the IQI in RIIO-ED1 to encourage DNOs to provide business plans that reflected best available information about their future efficient expenditure requirements.

6.14 The Strategy Consultation also included a specific proposal with respect to how the IQI would be calibrated, namely that a company that submitted a forecast which exactly matched GEMA’s own assessment of efficient expenditure would: ‘be able to achieve a return equal to its cost of capital, if it were then to spend, over the price control period, the amount it had forecast (leaving aside the impact of other incentive schemes on the company’s returns).’

6.15 GEMA noted that this approach differed from that adopted in its other price control reviews where ‘a company with 100 per cent would earn additional returns on top of baseline cost of equity’.

6.16 GEMA also explicitly noted that it was proposing that RPEs should be covered by the IQI, on the basis that this would help ensure that DNOs submitted robust RPE forecasts, and sought views on this.

**GEMA’s March 2013 Strategy Decision**

6.17 In its March 2013 Strategy Decision, GEMA confirmed that the IQI would be used for RIIO-ED1, and summarised and commented on responses to its

---

159 Strategy consultation.
161 ibid, paragraphs 9.17 & 9.18.
162 ibid.
163 RPEs represent estimations of the changes in prices that DNOs will experience, over the price control period, relative to general inflation (as measured by the RPI).
165 Strategy Decision.
166 Strategy Decision: Overview, paragraphs 6.16–6.23; Outputs, incentives and innovation annex: Section 9.
Strategy Consultation, and set out its Strategy Decision in respect of the IQI in the light of that consultation.

6.18 The overview to the Strategy Decision included the following description of GEMA’s proposed approach to the ‘break-even’ point:

We will set the break-even point in the IQI so that a DNO that forecasts [total expenditure] 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. Respondents to our September strategy consultation were concerned about this tightening of the break-even point. However we do not consider that it is appropriate to relax the IQI matrix. To do so would increase the reward/reduce the penalties for all companies, including those who provide less challenging forecasts, without changing the incentives.167

6.19 GEMA explained its reasoning in a supplementary annex:

We believe that how we determine the upper quartile has to be taken into consideration as well. In past price reviews DNOs have criticised us for applying upper quartile benchmarking at a very disaggregated level, resulting in a ‘cherry picked’ answer, which no one DNO can achieve across the board. Our cost assessment approach for RIIO-ED1 takes a more holistic approach to determining efficiency and as such our view of the appropriate rewards/penalties available in the IQI matrix reflects this.168

6.20 In an annex to the Strategy Decision entitled ‘Outputs, Innovation and Incentives’, GEMA:

(a) stated that the IQI matrix would be set based on the final submissions from all 14 DNOs, and would be set out as part of GEMA’s Draft Determinations for the non-fast-track DNOs;169

(b) noted that respondents to its consultation had given different views on the approach to the IQI. It had been suggested that the calibration of the IQI should either be consistent with RIIO-T1 and GD1 (ie providing expenditure estimates which match GEMA’s estimates would result in a

167 Strategy Decision: Overview, paragraph 6.22.
168 Strategy Decision: Outputs, incentives and innovation annex, paragraph 9.37.
169 ibid, paragraphs 9.13 & 9.18.
financial reward), or that IQI should be aligned with ‘mean’ rather than upper quartile benchmarking;\textsuperscript{170} and

\textbf{(c)} confirmed that the IQI would be calibrated so that a DNO which submitted an expenditure forecast for RIIO-ED1 that matched GEMA’s assessment of that DNO’s ‘efficient expenditure’ would be able to achieve a return equal to GEMA’s estimate of its cost of capital, if it were then to spend, over the price control period, the amount it had forecast (leaving aside the impact of other incentive schemes on the company’s returns). GEMA reiterated that its assessment of DNOs’ ‘efficient’ expenditure would be based on ‘upper quartile benchmarking of totex’ (and not, for example, mean benchmarking as proposed by certain respondents).\textsuperscript{171}

6.21 In relation to RPEs, GEMA noted\textsuperscript{172} the suggestion in response to the Strategy Consultation that RPEs should be excluded from the IQI assessment and that they would be more appropriately dealt with via an uncertainty mechanism instead. However, GEMA considered\textsuperscript{173} that including RPEs within the IQI would provide strong incentives for companies to put forward efficient RPE forecasts, and reduce any incentives to load costs on to RPEs while proposing low unit costs for activities that fed into the IQI.

\textit{GEMA’s Draft Determinations for the slow-track DNOs}\textsuperscript{174}

6.22 In its Draft Determinations, GEMA adopted an approach to setting the break-even point for the IQI that differed from that set out in its Strategy Decision. GEMA explained this proposed change as follows:

\begin{quote}
We have reviewed the design of the IQI in the light of the cost adjustments we are making after setting the UQ efficiency benchmark (RPEs and smart grid savings). These adjustments mean that no DNOs are achieving our view of efficient costs and that no DNO would receive a reward according to our original design.

We think the IQI is key to encouraging better information at slow-track. We think that it is right to reward companies that have provided good information that has helped our comparative benchmarking. In the light of this we have adjusted the break-
\end{quote}

\begin{flushleft}
\textsuperscript{170} Strategy Decision: Outputs, incentives and innovation annex, paragraph 9.28.
\textsuperscript{171} ibid, paragraph 9.14.
\textsuperscript{172} ibid, paragraph 9.29.
\textsuperscript{173} ibid, paragraph 9.38.
\textsuperscript{174} Draft Determinations.
\end{flushleft}
even point in the IQI matrix so that the best-performing DNO
groups receive a reward. The break-even point is now an IQI
score of 102.9 rather than 100. This means 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 but no
additional reward or penalty.  

6.23 GEMA noted\textsuperscript{176} that – because there may be increased uncertainty in a
forecast of RPEs – it would consult, ahead of final determinations, on its ex
ante methodology for taking account of RPEs, and that if its RPE approach
was changed as a result of this consultation, it would look at whether the IQI
calibration should be revised to take account of this.

6.24 The IQI matrix that GEMA used for its Draft Determinations for the slow-track
DNOs is reproduced below as Table 6. The outcome of GEMA’s IQI
assessment in its Draft Determinations in terms of DNO rewards and
penalties (on a per-group basis) is shown in Table 7 below.

Table 6: IQI Matrix used for Draft Determinations

<table>
<thead>
<tr>
<th>DNO:Ofgem ratio</th>
<th>90</th>
<th>95</th>
<th>100</th>
<th>105</th>
<th>110</th>
<th>115</th>
<th>120</th>
<th>125</th>
<th>130</th>
</tr>
</thead>
<tbody>
<tr>
<td>Efficiency incentive</td>
<td>65%</td>
<td>63%</td>
<td>60%</td>
<td>58%</td>
<td>55%</td>
<td>53%</td>
<td>50%</td>
<td>48%</td>
<td>45%</td>
</tr>
<tr>
<td>Additional income (£/100m)</td>
<td>3.1</td>
<td>2.4</td>
<td>1.7</td>
<td>0.9</td>
<td>0.1</td>
<td>-0.8</td>
<td>-1.8</td>
<td>-2.8</td>
<td>-3.9</td>
</tr>
<tr>
<td>Rewards &amp; Penalties</td>
<td>Allowance expenditure</td>
<td>Actual expenditure</td>
<td>97.50</td>
<td>98.75</td>
<td>100.00</td>
<td>101.25</td>
<td>102.50</td>
<td>103.75</td>
<td>105.00</td>
</tr>
<tr>
<td>90</td>
<td>7.95</td>
<td>7.9</td>
<td>7.7</td>
<td>7.4</td>
<td>7.0</td>
<td>6.4</td>
<td>5.7</td>
<td>4.3</td>
<td>4.0</td>
</tr>
<tr>
<td>95</td>
<td>4.7</td>
<td>4.76</td>
<td>4.7</td>
<td>4.5</td>
<td>4.2</td>
<td>3.8</td>
<td>3.2</td>
<td>2.5</td>
<td>1.7</td>
</tr>
<tr>
<td>100</td>
<td>1.5</td>
<td>1.6</td>
<td>1.7</td>
<td>1.6</td>
<td>1.5</td>
<td>1.1</td>
<td>0.7</td>
<td>0.1</td>
<td>-0.6</td>
</tr>
<tr>
<td>105</td>
<td>-1.8</td>
<td>-1.5</td>
<td>-1.3</td>
<td>-1.2</td>
<td>-1.3</td>
<td>-1.5</td>
<td>-1.8</td>
<td>-2.2</td>
<td>-2.8</td>
</tr>
<tr>
<td>110</td>
<td>-5.1</td>
<td>-4.6</td>
<td>-4.3</td>
<td>-4.1</td>
<td>-4.1</td>
<td>-4.1</td>
<td>-4.3</td>
<td>-4.6</td>
<td>-5.1</td>
</tr>
<tr>
<td>115</td>
<td>-8.3</td>
<td>-7.7</td>
<td>-7.3</td>
<td>-7.0</td>
<td>-6.8</td>
<td>-6.7</td>
<td>-6.8</td>
<td>-7.0</td>
<td>-7.3</td>
</tr>
<tr>
<td>120</td>
<td>-11.6</td>
<td>-10.9</td>
<td>-10.3</td>
<td>-9.9</td>
<td>-9.6</td>
<td>-9.4</td>
<td>-9.3</td>
<td>-9.4</td>
<td>-9.6</td>
</tr>
<tr>
<td>125</td>
<td>-14.8</td>
<td>-14.0</td>
<td>-13.3</td>
<td>-12.7</td>
<td>-12.3</td>
<td>-12.0</td>
<td>-11.8</td>
<td>-11.7</td>
<td>-11.8</td>
</tr>
<tr>
<td>135</td>
<td>-21.3</td>
<td>-20.2</td>
<td>-19.3</td>
<td>-18.5</td>
<td>-17.8</td>
<td>-17.2</td>
<td>-16.8</td>
<td>-16.5</td>
<td>-16.3</td>
</tr>
<tr>
<td>140</td>
<td>-24.6</td>
<td>-23.4</td>
<td>-22.3</td>
<td>-21.4</td>
<td>-20.6</td>
<td>-19.9</td>
<td>-19.3</td>
<td>-18.9</td>
<td>-18.6</td>
</tr>
<tr>
<td>145</td>
<td>-27.8</td>
<td>-26.5</td>
<td>-25.3</td>
<td>-24.2</td>
<td>-23.3</td>
<td>-22.5</td>
<td>-21.8</td>
<td>-21.2</td>
<td>-20.8</td>
</tr>
<tr>
<td>150</td>
<td>-31.1</td>
<td>-29.6</td>
<td>-28.3</td>
<td>-27.1</td>
<td>-26.1</td>
<td>-25.1</td>
<td>-24.3</td>
<td>-23.6</td>
<td>-23.1</td>
</tr>
</tbody>
</table>

Source: Draft Determinations, Business Plan Expenditure Assessment, Table 2.7.

Table 7: Draft Determinations: IQI results for the DNO groups (2012/13 prices)

<table>
<thead>
<tr>
<th>DNO group</th>
<th>DNO submitted (£m)</th>
<th>Ofgem IQI benchmark (£m)</th>
<th>IQI ratio</th>
<th>Allowed expenditure (£m)</th>
<th>Efficiency incentive rate</th>
<th>Ex ante reward/penalty (£m)</th>
<th>% total ex ante reward/penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENWL</td>
<td>1,877</td>
<td>1,766</td>
<td>106</td>
<td>1,794</td>
<td>57</td>
<td>0.7%</td>
<td>13</td>
</tr>
<tr>
<td>NPg</td>
<td>3,172</td>
<td>2,846</td>
<td>111</td>
<td>2,928</td>
<td>53</td>
<td>-0.2%</td>
<td>-5</td>
</tr>
<tr>
<td>UKPN</td>
<td>6,584</td>
<td>5,799</td>
<td>114</td>
<td>5,995</td>
<td>53</td>
<td>-0.6%</td>
<td>-32</td>
</tr>
<tr>
<td>SP</td>
<td>3,491</td>
<td>3,111</td>
<td>112</td>
<td>3,206</td>
<td>54</td>
<td>-0.3%</td>
<td>-10</td>
</tr>
<tr>
<td>SSE</td>
<td>3,635</td>
<td>3,319</td>
<td>110</td>
<td>3,398</td>
<td>55</td>
<td>0.2%</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Draft Determinations, Business Plan Expenditure Assessment, Table 2.8.

\textsuperscript{175} Draft Determinations, Overview, paragraphs 4.55 & 4.56.

\textsuperscript{176} Draft Determinations, Overview, paragraph 4.57.
6.25 In its November 2014 final determinations for the slow-track DNOs, GEMA confirmed that it would maintain the IQI approach that it had presented in the draft determinations.\textsuperscript{177}

6.26 GEMA noted\textsuperscript{178} that it had received mixed responses to its draft determination proposals for the IQI, but continued to consider it appropriate to reward companies that had provided information that helped its comparative benchmarking. The outcome of applying the IQI at Final Determinations can be seen from Table 8 below.

Table 8: IQI results for the DNO groups (2012/13 prices)

<table>
<thead>
<tr>
<th>DNO group</th>
<th>Final determination (FD)</th>
<th>IQI ratio</th>
<th>Upfront financial reward/penalty if DNO spends in line with the FD allowance %</th>
<th>£m</th>
<th>Total reward/penalty if DNO spends in line with its forecast %</th>
<th>£m</th>
<th>Total reward/penalty if DNO spends in line with Ofgem’s modelled view %</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENWL</td>
<td>103.8</td>
<td>1.1</td>
<td>20.2</td>
<td>–0.5</td>
<td>–9.5</td>
<td>1.7</td>
<td>30.4</td>
<td></td>
</tr>
<tr>
<td>NPg</td>
<td>109.9</td>
<td>0.1</td>
<td>2.7</td>
<td>–4.0</td>
<td>–115.2</td>
<td>1.5</td>
<td>43.1</td>
<td></td>
</tr>
<tr>
<td>UKPN</td>
<td>113.4</td>
<td>–0.5</td>
<td>–31.5</td>
<td>–5.9</td>
<td>–344.6</td>
<td>1.2</td>
<td>75.3</td>
<td></td>
</tr>
<tr>
<td>SPEN</td>
<td>113.0</td>
<td>–0.5</td>
<td>–14.2</td>
<td>–5.7</td>
<td>–175.1</td>
<td>1.3</td>
<td>40.7</td>
<td></td>
</tr>
<tr>
<td>SSEPD</td>
<td>107.1</td>
<td>0.6</td>
<td>19.7</td>
<td>–2.4</td>
<td>–81.8</td>
<td>1.6</td>
<td>54.4</td>
<td></td>
</tr>
</tbody>
</table>

Source: GEMA, Final Determinations, Business Plan Expenditure Assessment, Table 2.9.

6.27 GEMA’s consultation on RPEs (referred to above at paragraph 6.23) did not result in a change to its ex ante allowance approach\textsuperscript{179} (and thus the approach to RPEs for final determinations was the same as that which had been applied for the draft determinations).

GEMA’s 3 February 2015 letter to BGT

6.28 In a letter to BGT of 3 February 2015, GEMA provided further explanation of its approach to the IQI. GEMA noted the following:

- Its description in the Strategy Decision of the calibration of the IQI implied that there would be four DNOs outperforming their benchmark and therefore earning a reward under the IQI because they had submitted more robust forecasts (the Strategy Decision having specifically referred to rewards being calculated by reference to GEMA’s upper quartile benchmarking exercise).

\textsuperscript{177} Final Determinations, paragraph 4.86.
\textsuperscript{178} Final Determinations, paragraph 4.96.
\textsuperscript{179} Final Determinations, paragraph 2.1.
• However, as part of its ‘Final Determinations efficiency analysis’, GEMA had applied two sets of adjustments after the upper quartile calculation: 
  (a) for RPEs and (b) for incremental smart grid efficiencies.

• One of the consequences of this was that no DNOs or DNO groups outperformed GEMA’s final cost benchmarks, and thus no DNOs would have received rewards under the IQI for providing better forecasts if no change had been made to the break-even point.

• This would have been inconsistent with GEMA’s Strategy Decision. In effect, GEMA explained, the change to the IQI break-even point ‘restored the original intent of rewarding companies that have provided better information not only in this price control but also in future price controls’.

6.29 While GEMA referred to the ‘potential downside’ of the recalibration (in the form of smaller overall penalties and hence higher costs to consumers of approximately £290 million), GEMA noted that this was more than offset by the benefits of the change, including the savings delivered through effective comparative benchmarking in this and future price controls. GEMA observed that the slow-track comparative cost benchmarking had delivered cost savings of over £700 million.

**Summary of BGT’s appeal ground 3**

6.30 BGT argued\[180\] that in deciding to adjust the IQI scheme in the way that it did after the DNOs had submitted their business plans, GEMA fell into error, and adopted a decision which was harmful to the interests of consumers without any countervailing benefit.\[181\]

6.31 BGT’s principal contention in its Notice of Appeal was that the change to the IQI could not advance the purpose of encouraging DNOs to produce good business plans for RIIO-ED1, as DNOs had already submitted their business plans ahead of the change (on the basis of what had been announced in the Strategy Decision about the IQI). Any incentive effect from the IQI in relation to RIIO-ED1 had therefore already been achieved.\[182\]

6.32 BGT’s Notice of Appeal also made specific reference to the reasons put forward in GEMA’s letter to BGT of 3 February 2015 (the contents of which – in relation to the IQI – are summarised above), arguing the following:

---

\[180\] BGT’s Notice of Appeal, paragraph 1.9(c).
\[181\] BGT’s Notice of Appeal, paragraph 4.55.
\[182\] BGT’s Notice of Appeal, paragraph 4.56.
(a) It was irrational for GEMA to seek to justify the change to the IQI by reference to the ‘cost savings of nearly £700 million’ which resulted from the slow-track comparative cost benchmarking exercise, since those cost savings were the result of business plans that had already been submitted by the time the change to the IQI was made.183

(b) The effect of ex post adjustments to the IQI was to weaken the incentives of DNOs in subsequent price controls to submit high-quality and well-justified plans, contrary to GEMA’s suggestion that the adjustment to the IQI was needed to encourage the submission of better information in future price controls. The perception that GEMA could repeat its ex post adjustment to the IQI in future will lead to an expectation of reduced penalties for inefficient cost bids in future.184 In any case, if GEMA did consider that the IQI needed adjusting for the future, then that could be done by announcing a revised mechanism prior to the submission of business plans for RIIO-ED2. It did not require an adjustment to the IQI in RIIO-ED1.185

(c) The fact that GEMA always intended to confer rewards upon the four DNOs in the upper quartile of its efficiency benchmark similarly cannot justify the change to the IQI. First, nine out of 14 DNOs overall received ‘rewards’ in respect of their business plans following GEMA’s IQI change, not just the four DNOs with the best business plans: namely the four fast-tracked DNOs in the WPD group, as well as the five further DNOs that received upfront rewards. Moreover, the remaining five DNOs all received reduced penalties (and higher allowances) as a result of the change.186 In any event, BGT contended that it was perverse to adjust the IQI mechanism simply in order to ensure that a certain number of DNOs benefited under the mechanism. The purpose of the mechanism was to reward high-quality and well-justified business plans, not to guarantee rewards to at least four DNOs.187

(d) The change cannot be justified by reference to GEMA’s efficiency adjustments for RPEs or SGBs:

(i) The SGB adjustment was made because of deficiencies in DNO business plans. There was no justification for adjusting the IQI to save DNOs from the consequences of their failure to prepare robust

183 BGT’s Notice of Appeal, paragraph 4.59.
184 BGT’s Notice of Appeal, paragraph 4.60(a).
185 BGT’s Notice of Appeal, paragraph 4.60(b).
186 BGT’s Notice of Appeal, paragraph 4.62(a).
187 BGT’s Notice of Appeal, paragraph 4.62(b).
business plans in relation to smart grids. The adjustment runs contrary to the purpose of the IQI.\(^\text{188}\)

(ii) The DNOs should not be rewarded for poor RPE forecasts. They were aware of the relevance of RPEs to the consideration of expenditure and to the IQI. GEMA’s RPE updates were based on date for 2012/13 and 2013/14. By the time they submitted their business plans, the DNOs should have already had a reasonable view of 2012/13 data and some sight of 2013/14 developments.\(^\text{189}\)

(iii) Even if it were appropriate to compensate for the RPE and SGB adjustments, the change in the IQI is ‘out of all proportion’ to the net impact the adjustment would have on DNO out-turn costs under the proposed IQI before the change. BGT relies on a report by AlixPartners which seeks to demonstrate that the effect of the change to the IQI is to increase DNO revenues by 17 times more than would be needed to compensate for the net impact of the adjustments on the operation of the IQI.\(^\text{190}\)

(iv) It is to be expected that circumstances might change between the submission of business plans and the final Decision. Those changes could go in either direction, providing a benefit or disbenefit to DNOs. This accords with the regulatory ‘fair bet’ principle, and there is no justification for making an ex post adjustment to the IQI simply because it turns out to disadvantage the DNOs. It is likely that other factors over the period of the control will operate to their benefit.\(^\text{191}\)

6.33 BGT also raised, in its Notice of Appeal, a procedural challenge to GEMA’s approach to the IQI, alleging that the reasons provided by GEMA at both the consultation stage and in its Final Determinations were not adequate to enable effective engagement.\(^\text{192}\)

**Summary of GEMA’s response to appeal ground 3**

6.34 At paragraph 217 of its Response to BGT’s Notice of Appeal, GEMA summarised its general stance on the adjustment to the IQI, as follows:

(a) … under the IQI scheme originally proposed in the Strategy Decision, ex-ante rewards would certainly have been paid to

\(^{188}\) BGT’s Notice of Appeal, paragraph 4.62(d).

\(^{189}\) BGT’s Notice of Appeal, paragraph 4.62(e).

\(^{190}\) BGT’s Notice of Appeal, paragraph 4.62(f).

\(^{191}\) BGT’s Notice of Appeal, paragraph 4.62(g).

\(^{192}\) BGT’s Notice of Appeal, paragraph 4.128(c).
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.

6.35 GEMA’s response to the specific criticisms in BGT’s Notice of Appeal under appeal ground 3 can be summarised as follows:

(a) GEMA made clear that its decision to change the baseline was not intended to incentivise the DNOs as regards the preparation of business plans for the current price control, but rather to ‘preserve the inherent component of GEMA’s original IQI policy of rewarding some DNOs which had forecast more efficient costs’.193 Doing so was ‘important to maintain the credibility of the incentive with DNOs and other network operators subject to it for later price controls’.194 GEMA elsewhere emphasised that the reason it was ‘inherent’ in the IQI mechanism that some DNOs would receive rewards was because GEMA’s view of efficient costs would be reached following a ‘comparative benchmarking process whereby [GEMA] set its benchmark view at the upper quartile of DNOs’ submissions. Given that [GEMA’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.’195

(b) GEMA noted that while the change to the IQI break-even point itself gave rise to a higher cost to consumers in RIIO-ED1, the change must be seen in the light of around £750 million of cost savings achieved through its approach to RPEs and SGBs. Overall, GEMA contended that the changes had resulted in a reduction in allowed revenues of £372 million over RIIO-ED1, to the benefit of consumers.196

193 GEMA’s Response, paragraph 219(c).
194 GEMA’s Response, paragraph 221(b).
195 GEMA’s Response, paragraph 214. GEMA expressly relies, at this juncture, on the statement in the Strategy Decision (Overview) at paragraph 6.22, cited above.
196 GEMA’s Response, paragraph 221(a).
The adjustment would also encourage the submission of good business plans in future price controls. If DNOs perceived that GEMA might ‘move the goalposts’ following the submission of business plans so as to eliminate any rewards for the provision of good cost information, then there would be less incentive to provide high-quality forecasts.\(^{197}\)

It was rational, and well within GEMA’s area of judgement, to adjust the break-even point to recognise the effect of its new treatment of SGBs and RPEs; to offset the additional £290 million of costs to consumers resulting from the IQI change against the £700 million of costs savings which were achieved through the comparative cost assessment process;\(^{198}\) and to conclude that the change would encourage the submission of better information in future price controls.\(^{199}\)

GEMA explained that its initial intention was to confer rewards upon those DNOs in the upper quartile of its efficiency benchmark, and that, at the Draft Determinations stage, it adjusted the IQI break-even point to 102.9% ‘to ensure that this was achieved’. Subsequently, at Final Determinations, the break-even point was retained at 102.9% which meant that, on the basis of the cost assessment carried out at that stage, three DNO groups received an ex ante reward under the IQI.\(^{200}\)

It was also rational and within GEMA’s area of judgement to ensure that some DNOs could benefit from the IQI scheme even after the SGB and RPE adjustments had been made. It would have been ‘contrary to the purpose of the IQI’ if no rewards had been received.\(^{201}\) As to BGT’s contentions as to the number of DNOs that benefited from the IQI change, GEMA conceded that all slow-track DNOs were advantaged by the adjustment of the break-even point to 102.9 in that they received either rewards or reduced penalties. However, BGT’s reference to the benefits received by the fast-tracked DNOs is irrelevant: those DNOs were not subject to the IQI, but rather received a separate ex ante reward in lieu of an IQI reward.\(^{202}\)

It was fair for GEMA to adjust the break-even point in the IQI given the change in the basis of its assessment of SGBs after business plans had been submitted, in order to preserve the ‘original intent’ of its incentive

---

\(^{197}\) GEMA’s Response, paragraph 221(c).

\(^{198}\) GEMA contended that it did not seek to ‘attribute’ the broader savings to customers to the change in the break-even point; rather, it made the point that the IQI as a whole contributed to those savings.

\(^{199}\) GEMA’s Response, paragraph 222(a)(i)–(iii).

\(^{200}\) GEMA’s Response, paragraph 222(b).

\(^{201}\) GEMA’s Response, paragraph 222(c)–(d).

\(^{202}\) GEMA’s Response, paragraph 222(e).
scheme and so as to ensure that companies were more likely to submit high-quality information for future price controls.\textsuperscript{203}

(h) On the same basis, it was fair to adjust the IQI break-even point to reflect the change in treatment of RPEs, given that this change in the basis of cost assessment occurred after business plans had been submitted.\textsuperscript{204} GEMA also noted that when the DNOs submitted their business plans, they did not have access to the most recent data that GEMA itself used to set the RPE assumption.\textsuperscript{205}

(i) Contrary to BGT’s contention at paragraph 4.62(f) of its Notice of Appeal that the impact of the IQI change was disproportionate, GEMA noted that the reduction to DNOs’ expenditure allowances resulting from the SGB and RPE adjustments was approximately £750 million, which more than offset the effect of the adjustment to the IQI break-even point, which resulted in a net one-off benefit of £290 million to the DNOs.\textsuperscript{206} GEMA calculated that the overall effect of the combined changes was a reduction in the slow-track DNOs’ allowed revenues of £372 million over RIIO-ED1. In addition, the reduction in costs of £750 million (including capex) over RIIO-ED1 would reduce the DNOs’ regulated asset base, resulting in lower revenues in future price controls.\textsuperscript{207}

(j) As to BGT’s reference to the ‘fair bet’ principle at paragraph 4.62(g) of its Notice of Appeal, GEMA agreed that it was ‘broadly to be expected’ that circumstances might change between the submission of business plans and the final decision; however, the decision to adjust the IQI break-even point was not the result of ‘changing circumstances’, but rather of GEMA’s decision to change the way it calculated efficient costs.\textsuperscript{208}

6.36 In her second witness statement submitted as part of GEMA’s response, Anna Rossington expanded on GEMA’s reasoning for a recalibration and, in doing so, referred back to the rationale during the Strategy Consultation mentioned in paragraph 6.18 above:

At the slow-track assessment of DNOs’ business plans, all DNOs were assessed by Ofgem to have presented inefficient forecasts for SGBs and RPEs. In order to ensure that cost allowances took account of, and consumers benefitted from, the additional

\textsuperscript{202} GEMA’s Response, paragraph 222(f).
\textsuperscript{204} GEMA’s Response, paragraph 222(j).
\textsuperscript{205} GEMA’s Response, paragraph 222(j).
\textsuperscript{206} GEMA’s Response, paragraph 223(a)–(b).
\textsuperscript{207} GEMA’s Response, paragraph 223(c).
\textsuperscript{208} GEMA’s Response, paragraph 224(b).
efficiencies that we identified in these areas. Ofgem, however, changed its cost assessment approach, to include the efficient cost of RPEs and additional SGB savings (above what was included in the DNOs’ plans) after [original emphasis] its calculation of the upper quartile. If we had retained the approach we used at fast track in relation to the treatment of these forecasts within the IQI, the additional efficiencies would not have been reflected in the resulting allowance as a result of the rebasing and upper quartile process. Ofgem’s change in approach from fast-track to slow-track on how it assessed SGBs and RPEs meant that it moved away from the holistic approach it intended when it published its Strategy Decision.

Ofgem’s change in approach to SGBs and RPEs ‘changed the goal posts’ insofar as it changed the approach to cost assessment once the business plans had been submitted.

**Summary of BGT’s Reply to appeal ground 3**

6.37 In its Reply, BGT noted that while much of the Response was concerned with justifying the IQI approach in general, this was not an answer to BGT’s case, given that BGT supported the use of the IQI and was concerned only with the changes to the IQI which were made after business plans had been submitted.209

6.38 BGT’s Reply focused on two ‘key erroneous assertions’ which, in BGT’s view, underlay much of GEMA’s reasoning, namely that:

(a) it was clear from the Strategy Decision that GEMA would set its benchmark view of efficient expenditure at the upper quartile of the DNOs’ submissions, and consequently that it was inherent in the IQI design that some DNOs would receive rewards and an IQI adjustment was necessary to preserve credibility and the incentive properties of the IQI; and

(b) the costs of the IQI adjustment need to, or can logically, be offset against savings achieved by GEMA’s approach to SGBs/RPEs or via the comparative cost assessment process more widely.210

6.39 Regarding (a), BGT noted that the ‘goalposts’ were never set at upper-quartile performance. Rather, as GEMA noted in its Response at paragraph 213, the IQI was designed so that ‘DNOs would earn rewards for the submission of

---

209 BGT’s Reply, paragraph 75.
210 BGT’s Reply, paragraph 78.
business plans which were more efficient than the Authority’s view of efficient costs’. While upper-quartile benchmarking was to be the starting point for assessing efficient costs, BGT pointed to various extracts from GEMA’s published materials on RIIO-ED1 that made clear that GEMA would depart from that starting point where necessary, eg on the basis of concerns about the quality of the data submitted by the DNOs.\(^\text{211}\) In BGT’s view, it was precisely such concerns which led GEMA to make the SGB and RPE adjustments.\(^\text{212}\)

6.40 In those circumstances, BGT contended that the DNOs could never have legitimately expected that the IQI would be based ‘mechanistically’ on an upper-quartile assessment.\(^\text{213}\) BGT argued that it was therefore not an ‘inherent’ feature of the IQI that some DNOs would receive a reward even if their forecasts failed to match GEMA’s assessment of efficient costs.\(^\text{214}\) Indeed, BGT also made the further point that the original structure of the IQI was that upper quartile benchmarking would be applied on the basis of all 14 DNOs (including the fast-tracked WPD DNOs). It was therefore entirely compatible with the design of the IQI in those circumstances that the fast-tracked companies could have been the sole occupants of the ‘upper quartile’, meaning that no slow-track DNOs would receive an IQI reward at all.\(^\text{215}\) BGT also submitted that it was not necessary that some DNOs be rewarded for the incentive effect of the IQI to work; it would always be more favourable for DNOs to submit relatively less bad information.\(^\text{216}\)

6.41 BGT also denied that the IQI adjustment was necessary to preserve credibility or incentive properties. In BGT’s submission, a non-adjustment to the IQI would have been true to GEMA’s objective of rewarding the provision of high-quality information and deter DNOs from providing inflated cost forecasts. This would strengthen the incentive to provide good information in the future rather than undermine it. In contrast, making an IQI adjustment and paying rewards despite the provision of poor information by the DNOs risked undermining the future efficiency of the IQI.\(^\text{217}\)

6.42 As to (b), BGT contended that it was unsound to have sought to offset the costs of the IQI adjustments against the benefits to consumers of (i) the SGB and RPE adjustments and/or (ii) the overall cost benchmarking exercise, in

\(^{211}\) BGT’s Reply, paragraphs 85 & 86.
\(^{212}\) BGT’s Reply, paragraph 87.
\(^{213}\) BGT’s Reply, paragraph 88.
\(^{214}\) BGT’s Reply, paragraph 90.
\(^{215}\) BGT’s Reply, paragraph 92.
\(^{216}\) BGT’s Reply, paragraph 93.
\(^{217}\) BGT’s Reply, paragraphs 96 & 97.
circumstances where there was ‘no causal link’ between the two. In both cases, the benefits would still have accrued to consumers even if the IQI adjustment had not been made.218

6.43 BGT also provided further argumentation in support of its contention that GEMA’s adjustment to the IQI was out of all proportion to the net impact that this would have given the structure of IQI rewards. Further detail was provided in a second report by AlixPartners, which also responded to GEMA’s assertion (in the second witness statement of Anna Rossington) that the analysis in the first AlixPartners report was ‘manifestly incorrect’.219

6.44 Finally, BGT responded to GEMA’s submissions on the ‘fair bet’ principle. In particular, in relation to RPEs, GEMA’s change of approach was ‘mainly’ the result of new information coming to light, so it was not correct to say that GEMA’s adjustment was not the result of ‘changing circumstances’. In relation to SGBs, while the change in approach was compelled by the collective inadequacy of the DNOs’ business plans, they should not be allowed to gain an advantage under the IQI for their poor forecasting.220

Summary of third party submissions on appeal ground 3

6.45 As well as BGT’s and GEMA’s submissions, we received submissions on the IQI from a number of interested parties.

Joint submission by the slow-track DNOs

6.46 The slow-track DNOs’ joint submission on BGT’s appeal included a section addressing this ground of appeal. In a number of respects, the DNOs’ submissions overlapped with the points made by GEMA in its Response. To that extent, the summary below does not attempt to cover every point made by the DNOs in their joint submission.

6.47 The DNOs group their response to the points raised by BGT into five broad issues:

(a) First, the DNOs note that GEMA always planned to set the IQI to provide additional income to the best-performing DNOs, to ensure the effectiveness of the IQI.221 This corresponded to GEMA’s argument in the

---

218 BGT’s Reply, paragraphs 100–103.
219 BGT’s Reply, paragraphs 104 & 105
220 BGT’s Reply, paragraphs 106 & 107.
221 DNOs’ joint response, paragraphs 156–161.
Response that it was ‘inherent’ in the IQI design that some DNOs would receive an upfront reward.

(b) Second, the DNOs contended that GEMA’s approach in setting the form of the IQI matrix is very materially to the benefit of consumers.\footnote{DNOs’ joint response, paragraphs 162–171.} The DNOs point to the fact that the revised business plans submitted by the slow-track DNOs involved a reduction in proposed total of £743 million as compared with the plans submitted at the fast-track stage, and that this drove a reduction in GEMA’s own view of efficient expenditure of £625 million. The net result was that the final allowed expenditure of the slow-track DNOs was £17.45 billion, some £1.33 billion less than the slow-track business plans and £2.1 billion less than the expenditure in the fast-track business plans submitted by the slow-track DNOs. Like GEMA, the DNOs contended that the effect of the IQI change must be seen in the context of these broader cost savings. The DNOs also echoed GEMA’s contention that if GEMA were to overturn its decision to reward the best-performing DNOs under the IQI, this would have deterred DNOs from revealing efficiencies in future. The same would be true – the DNOs suggest – if the CMA were to reverse the IQI adjustment.

(c) Third, the DNOs submitted that BGT misunderstood GEMA’s approach to IQI which was, rightly, to ensure that the DNOs were incentivised to submit good business plans.\footnote{DNOs’ joint response, paragraphs 172–178.} The DNOs put forward a rationale for the IQI change which was not raised by GEMA itself in its Response, namely that before setting the specific IQI at the Draft Determinations stage, there existed a ‘cliff-edge’, ie a ‘disproportionate gap’ between a notional 100% efficient DNO and the same DNO if it had not been fast-tracked (eg because of some other deficiency in its business plan not related to efficient expenditure). Thus (i) a fast-tracked DNO judged to be 100% efficient received a 2.5% reward under the strategy decision at ED1 (and other price controls), whereas (ii) a slow-track DNO judged to be 100% efficient received no reward under the IQI break-even point as envisaged at fast-track, despite having a plan that was equally efficient as that of the notionally 100% efficient fast-tracked DNO. The DNOs contended that a ‘cliff-edge’ of this nature would be damaging to incentives in that a DNO might be encouraged (i) to under-bid in order to secure fast-track status; or (ii) not to declare potential efficiencies. In setting the specific IQI that it did, however, GEMA removed this ‘cliff-edge’ (such that a slow-track DNO judged to be 100% efficient would receive a reward of 1.7%, much closer to the 2.5% fast-track reward), thereby ensuring that the DNOs do not
have an incentive to ‘underbid’ their cost forecasts to gain a fast-track reward.

(d) Fourth, the DNOs contended that BGT’s claim that nine out of 14 received rewards in respect of their business plans overlooked that four of the DNOs were fast-track DNOs and as such were irrelevant in the context of this appeal. They also pointed out the fact that five slow-track DNOs benefited from additional income in the Final Determinations reflected GEMA’s decision to equalise incentive properties between licensees in the same group. In particular, four slow-track DNOs were identified as receiving additional income (ie an upfront reward) under the specific IQI as set by GEMA. However, GEMA’s ‘grouping policy’ led to this reward being spread across five DNOs in three ownership groups. The DNOs said that GEMA made it clear at the outset of RIIO-ED1 that equalising incentives across DNO groups would be in consumers’ interests as it would avoid perverse incentives to distort cost allocations between DNOs in the same group. This was a point which was, again, not specifically raised by GEMA in its own Response.

(e) Fifth, the DNOs presented a table summarising the evolution of GEMA’s approach to the IQI in several other price control determinations. In particular, the DNOs said that GEMA had made changes to the additional income element and the incentive rate of the IQI after the strategy consultation in both RIIO T1 and GD1.

(f) Sixth, the DNOs submitted that there was no evidence that DNOs were not responding to the incentives of the IQI matrix in proposing their plans in the areas of SGBs and RPEs. While GEMA considered that the DNOs’ plans were deficient in these respects, it recognised that the bulk of the plans ‘still contained much of merit’. GEMA had a number of options available to it when setting the final IQI (summarised in Table 2 at p58 of the DNOs’ joint submission), including an approach suggested by SSE whereby RPEs would be excluded from the IQI but SGBs would be included in the upper quartile calculation, resulting in only two licensees earning an upfront reward under the IQI. The DNOs contended that each of these options – other than that suggested by BGT itself – would be within GEMA’s ‘reasonable range of regulatory discretion to achieve its policy intent’ of ensuring that ‘DNOs with the most informative and efficient plans would receive additional income’. BGT’s approach,
however, would not achieve this objective, since it would have the result that no slow-track DNOs would receive upfront rewards.

6.48 In their comments on the GEMA hearing on the IQI, the DNOs provided information showing that, between the Strategy Consultation and initial proposals, GEMA had increased the additional income element of its IQI in RIIO-T1 and RIIO-GD1; and increased the incentive rate in RIIO-GD1 from 60% to 65%.

6.49 In addition to the DNOs' joint submission, a number of DNOs provided separate individual submissions on this ground of appeal.

Electricity North West Limited – 20 April 2015

6.50 ENWL’s individual submissions on the IQI were limited to addressing BGT’s assertion (Notice of Appeal, paragraph 4.56) that ‘the Authority’s change to the IQI cannot advance the purpose of the IQI, which is to encourage DNOs to produce good business plans’.

6.51 We note that ENWL’s submissions in this regard were directed at the question of whether the IQI itself provided an incentive to produce good business plans. However, BGT’s ground of appeal was focused on GEMA’s change to the IQI mechanism after those plans had been submitted. To that extent, ENWL’s submissions on this point are of limited assistance.

Eastern Power Networks plc, South Eastern Power Networks plc and London Power Networks Plc

6.52 UKPN submitted that (a) notwithstanding the changes made by GEMA, the IQI continued to incentivise DNOs to submit accurate business plans, and (b) GEMA’s approach was appropriate in the light of the ‘justifiable discrepancies’ between the business plans submitted by the DNOs and GEMA’s own assessment.

6.53 UKPN described the way in which the IQI (along with other aspects of the RIIO model) acts as an incentive to the DNOs to submit accurate expenditure assessments to GEMA. Again, given that BGT’s appeal under this ground was focused on the change to the IQI mechanism rather than the incentive qualities of the IQI mechanism per se, we found these submissions to be of limited assistance.

6.54 UKPN also addressed the justification for GEMA’s decision to recalibrate the IQI in the light of the adjustments it made in respect to SGBs and RPEs. UKPN referred to GEMA’s statement that it would ‘ensure that by Draft
Determinations the actual efficiency incentive rates that companies would face would not lie significantly outside our desired range’. Against that background, UKPN characterised GEMA’s recalibration of the IQI as consistent with ‘one of the advantages that the Authority has seen in IQI since its introduction in 2004, ie that it enables the Authority to place more reliance on DNOs’ cost forecasts as opposed to its own views or those of consultants’, and noted that the change to the IQI comprised an acceptance that ‘some degree of discrepancy’ between the business plans submitted by the DNOs and GEMA’s own assessment was ‘understandable and acceptable’ and should not be penalised.

6.55 UKPN further noted that a ‘sizeable’ part of the 13% ‘gap’ between its business plan submissions and GEMA’s assessment of efficient costs could be explained by reference to two factors, namely the additional information which became available to GEMA on the subject of RPEs and SGBs, and various other ‘departures’ by GEMA from UKPN’s own view of its efficient costs. UKPN submitted that it would be ‘unduly heavy-handed and punitive’ for GEMA to have penalised it (by declining to recalibrate the IQI) on the basis of these decisions.

Other interested parties

6.56 In addition, we received submissions from EDF Energy and Citizens Advice:

(a) In a letter of 22 April 2015, EDF Energy urged us to consider whether GEMA’s explanation of how the IQI would be used throughout the RIIO-ED1 process was made sufficiently clear to the DNOs, noting that if this was not the case, then the incentive properties of the IQI (on which BGT rely) would have been weak anyway. In those circumstances, EDF Energy noted that any adjustments to the IQI made by GEMA would not have affected its incentive quality, but may have been justified as a means to a deliver a ‘fair and acceptable package of price control proposals’.

(b) We were also provided with some observations on the IQI from Citizens Advice. Although Citizens Advice did not engage with GEMA on the subject of the IQI during the RIIO-ED1 process, its submissions of 22 April 2015 record its agreement with BGT’s argument that GEMA should not have adjusted the IQI after the DNOs had already submitted their business plans, given that, as it argued, the whole point of the IQI was to make sure that those plans were as competitive as possible from the outset.
(c) Citizens Advice also referred us to the GEMA Guidance on Code Modification Criteria, which state that, as a ‘general principle … rules ought not to change the character of past transactions, completed on the basis of the then existing rules’. In Citizens Advice’s view, the relevant ‘rule’ was as stated in the RIIO-ED1 strategy decision (paragraph 6.22), namely that GEMA would set the break-even point in the IQI so that a DNO that forecasted in line with its view of the upper quartile and achieved that forecast would earn its cost of capital. Citizens Advice noted that if it was indeed the case that DNOs who did not achieve upper quartile performance were nonetheless being rewarded as a result of the ex post adjustment to the IQI, this would appear to conflict with the statement from GEMA’s guidance.

**Our assessment of appeal ground 3**

6.57 We consider that there are two key issues which arise for our determination in respect of this ground of appeal:

(a) First, was GEMA wrong per se to have adjusted the IQI scheme after the DNOs had submitted their slow-track business plans, in the light of the significant alterations that GEMA had made to its approach to the assessment of RPEs and SGBs?

(b) Second, was GEMA wrong to make the specific adjustment to the IQI that it actually made at the final determination stage (ie was the nature or quantum of the adjustment wrong)?

6.58 BGT’s appeal was principally directed at the question of principle in point (a). However, as set out above, it also sought to challenge the nature of the adjustment actually made, in relation to the consistency of the adjustment with GEMA’s purported rationale for the adjustment, namely to ensure that companies in the ‘upper quartile’ of GEMA’s costs assessment would qualify for an upfront reward under the IQI mechanism.

**Justification for the decision to adjust the IQI per se**

6.59 It was not in dispute that, as a result of the adjustments that GEMA made to its assessment of efficient expenditure in relation to RPEs and SGBs, no slow-track DNO would have received such an upfront reward if GEMA had not recalibrated the IQI in some way. The differences between the parties were centred on whether the circumstances of the RPE and SGB adjustments justified an adjustment to the IQI and whether to do so was broadly consistent with the original IQI policy. Related to this question of consistency is the
different positions of the parties on the incentive effects of either recalibrating or not recalibrating the IQI.

6.60 BGT noted in its Notice of Appeal that given that the IQI adjustment took place after the submission of revised business plans at the slow-track stage, any change to the IQI mechanism could not have an incentive effect in relation to the accuracy of those RIIO-ED1 business plans. GEMA made clear in its hearing that it did not rely on any such incentive effect. There was therefore a consensus on this point and we accept that any incentive effect from the IQI in RIIO-ED1 had been achieved.

6.61 Both parties recognised that the decision on whether or not to adjust the IQI had the potential to affect incentives in future price controls. BGT argued that the recalibration was not warranted to preserve future incentives for the submission of efficient business plans, and that the effect of *ex post* adjustments to the IQI was to weaken the incentives of the DNOs in subsequent price controls to submit their best estimates. By contrast, GEMA, and the slow-track DNOs, argued that not to have recalibrated would have affected incentives in future price controls for DNOs and other entities which GEMA regulated, as it would have undermined GEMA’s regulatory credibility.

6.62 The effect on future incentives of the decision whether or not to recalibrate the IQI depends, in our view, on the extent to which such a decision should be understood as consistent with the IQI policy and, by implication, the reasonable expectations of the DNOs.

6.63 BGT placed substantial reliance in the course of the appeals process on the fact that GEMA had not unconditionally committed to rewarding some (or any particular number of) slow-track DNOs through the IQI mechanism via an upfront reward, and that since all of the slow-track DNOs fell short of GEMA’s view of efficient expenditure as a result of the RPE and SGB adjustments, there was nothing inconsistent about a situation in which no slow-track DNOs received such upfront rewards. In that regard, BGT noted that a number of GEMA’s comments in the strategy documentation were subject to caveats, and that GEMA retained a discretion to make its own efficiency assessment as opposed to solely relying on the comparative benchmarking exercise, as indeed it did in relation to RPEs and SGBs.

6.64 By contrast, GEMA argued that it would have been ‘contrary to the purpose of the IQI’ if no rewards had been received. In its view, recalibration preserved the original intent of the incentive scheme. GEMA noted that the SGB and RPE adjustments represented changes to the way it calculated efficient costs not simply changing circumstances. As such, it had moved away from the holistic approach it had intended when it published its Strategy Decision.
6.65 We do not agree with BGT that GEMA was wrong to have avoided a situation in which, as a result of the exercise of its discretion to make adjustments after the benchmarking process, no slow-track DNOs were eligible for an upfront reward. We note that BGT’s suggested approach would involve treating the IQI as only ensuring rewards to DNOs by reference to some ‘absolute’ standard of efficiency, as opposed to by reference to relative efficiency as between the DNOs.

6.66 We note that, as pointed out in Anna Rossington’s second witness statement, GEMA had moved away from the holistic approach set out in its strategy documents by applying further adjustments after the upper quartile benchmarking exercise. This also suggests to us that there was a case for a relaxation of the rigid application of the original IQI approach that DNOs that submitted a forecast which exactly matched GEMA’s own assessment of efficient expenditure would be able to achieve a return equal to their cost of capital.

6.67 In our view, it is consistent with the intention of the IQI, as set out in the RIIO Handbook and the RIIO-ED1 Strategy Decision, that GEMA had the discretion, taking into account the circumstances of its SGB and RPE adjustments, to consider whether an IQI recalibration was appropriate and, if it reasonably judged that it was, to apply one. It is not our view that an IQI (or equivalent) mechanism should always be adjusted in any case where DNOs collectively submit business plans which are deficient in some respect, or wherever GEMA adjusts its view of efficient expenditure on the basis of some collective shortcoming in those plans. Rather, we consider that in the circumstances of this case, it was consistent with GEMA’s policy statements to consider whether to do so.

6.68 In its response to our provisional determination, BGT said that our provisional assessment had not engaged with its argument that the IQI recalibration was not required to preserve future incentives. In its closing submissions, BGT argued that the recalibration would not have been warranted, even if (contrary to BGT’s view) GEMA had created clear expectations that a minimum number of DNOs would earn rewards. BGT said that GEMA had previously been very clear that changing the break-even point in the IQI would not affect its inherent incentive properties, and argued that GEMA had not explained why DNOs would not respond to the incentive properties of the IQI to produce efficient business plans in future price controls.

6.69 We do not consider these points to raise material additional considerations. Changing the break-even point does not change the inherent incentive properties of the IQI in the sense that – other things being equal – the incentive compatibility properties of the IQI can be achieved with a wide range
of different break-even points. Different break-even points will, however, have different ‘income’ effects.\textsuperscript{227} Unanticipated changes of approach within a price control process that have such income effects can affect the credibility of regulatory commitments made in relation to future price controls. Such changes can, therefore, affect the incentives by which DNOs respond to those regulatory commitments. As we set out in paragraphs 6.61 and 6.62, we consider that both parties recognised that the decision over whether or not to adjust the IQI had the potential to affect incentives in future price controls, with the key difference between the parties being the extent to which such a decision should be understood as consistent with the IQI policy that had been expected to apply.

6.70 In our view, GEMA was correct to consider and to attach some weight to, the implications for future price controls of not adjusting the IQI as a result of the SGBs and RPEs adjustments which it had decided to make. We accept that it was an inherent component of the original IQI policy and benchmarking process that it would reward DNOs which had forecast more efficient costs than others. This was an inevitable consequence of the upper quartile benchmarking process that GEMA had set out in its Strategy Decision as forming the basis for its view of efficient costs. Once it adjusted beyond that upper quartile benchmarking by further reducing its own view of efficient costs, it was open to GEMA to consider how this would affect future incentives absent an adjustment to the penalty/reward element. As GEMA pointed out in its response, this consideration was relevant to its credibility with ‘DNOs and other network operators subject to it for later price controls’.\textsuperscript{228}

6.71 Given our view that GEMA was not wrong to consider whether its adjustments should be taken into account in the way that it applied its IQI mechanism, we assess the particular circumstances. First, we note that the effect of GEMA’s reduction in its own view of efficient expenditure has a ‘knock on’ effect in relation to both the interpolation and the efficiency incentive rate elements of the IQI. Both of these elements are unaffected by the ex post adjustment of which BGT complains. The context for consideration of whether GEMA was justified in a recalibration is whether the DNOs should receive a further penalty as a result of the upfront penalty/reward element of the IQI. We note that the combined IQI negative effect after the RPE and SGB adjustments on

\textsuperscript{227} The equation that determines the level of upfront reward or penalty that DNOs receive under the IQI includes a constant term that represents an equal payment to every DNO. Increasing (decreasing) this constant term will mean that all DNOs will be better (worse) off to the same extent. Such a change can be understood as horizontally shifting the incentive curve that all DNOs face under the IQI without affecting its shape.

\textsuperscript{228} GEMA’s Response, paragraph 221(b).
the DNOs, absent any recalibration of the IQI break-even point, would have been £290 million.

6.72 The context of the RPE and SGB adjustments is also relevant. The adjustments were announced at draft determination stage, without being presaged in any of the earlier documentation on RIIO-ED1. In our view, in the light of such a substantial and un-foreshadowed shift in approach on RPEs/SGBs, GEMA was not wrong to take the view that at least some kind of IQI adjustment was appropriate. This is especially the case in the light of the fact that:

(a) GEMA’s decision to set an ex ante allowance for RPEs gave rise to material forecasting difficulties for the DNOs. GEMA had identified particular concerns in relation to the forecasting of RPEs during the RIIO-ED1 process. In its Draft Determinations, GEMA noted that while it has used an ex ante RPE forecast before, there had been a change in the trajectory of input price indices in aggregate since 2010/11 and for some indices since 2004/05. GEMA said that this indicated that there may be increased uncertainty in a forecast of RPEs which may cast doubt over the use of an ex ante forecast for an eight-year control.

GEMA considered the uncertainty associated with forecasting RPEs as raising sufficiently material issues that – following the Draft Determinations stage – GEMA initiated a new and separate consultation on whether there was a better way to deal with RPE uncertainty. In the event GEMA retained its ex ante RPE approach in the Final Determinations.

(b) Similarly, the slow-track DNOs’ forecasts on SGBs were made in the context of significant uncertainty about the savings which could be made in this area. GEMA materially modified its approach to SGBs not only at Draft Determinations stage, but also again at the Final Determinations, when it ceased to rely on external evidence in order to quantify its proposed SGB adjustment, but rather engaged in a further benchmarking exercise by reference to the DNOs’ own business plans.

6.73 In the absence of any recalibration, the slow-track DNOs’ totex allowances would all have been substantially reduced overall as a result of the RPE/SGB adjustments (after interpolation), and then further reduced in that all DNOs (absent any IQI recalibration) would have been subject to an upfront penalty. The further reduction in the upfront reward/penalty would have been on the

---

229 Draft Determinations, paragraphs 4.24.
230 Final Determinations, paragraph 2.1.
basis that the DNOs’ submitted expenditure forecasts exceeded GEMA’s revised assessment of efficient expenditure. The inherent uncertainty and forecasting difficulties relating to the SGB and RPE adjustments were relevant factors in GEMA’s decision whether to recalibrate.

6.74 In our view, GEMA was justified in taking into account the approach to the IQI and benchmarking in its strategy documents, including the intention to reward the relative quality of DNOs’ forecasts, when considering the potential effect on incentives for future price controls and its regulatory credibility of not recalibrating. There was, in our view, nothing wrong with GEMA considering a recalibration taking into account these factors when doing so. The circumstances of the SGB and RPE adjustments, in particular the forecasting difficulties and the cumulative effect of the IQI mechanism on top of the SGB and RPE adjustments, were such that its action to ensure that the slow-track DNOs did not all receive a further, upfront penalty as a result of the RPE/SGB adjustments was consistent with its policy intentions. The decision to recalibrate was therefore not wrong, in our view, on any of the prescribed statutory grounds.

6.75 As considered below, however, there is a separate question as to whether the nature and quantum of GEMA’s recalibration to the IQI mechanism was wrong in the circumstances of this case.

The scale of the IQI adjustment

6.76 The primary focus of BGT’s arguments in relation to this ground concerned the principle of whether GEMA was right to have recalibrated the IQI at all. However, BGT also commented on the scale of the IQI adjustment in its Notice of Appeal:

(a) BGT argued, by reference to some analysis of RPEs, that the scale of GEMA’s recalibration was out of all proportion to that of the net impact of the RPE and SGB adjustments that it was seeking to address.231

(b) BGT raised a concern over the number of DNOs that had received rewards following GEMA’s recalibration.232

6.77 BGT did not comment further on this latter point in its Reply, but did develop its argumentation in Closing Submissions, commenting that:

---

231 BGT’s Notice of Appeal, paragraph 4.62(e).
232 BGT’s Notice of Appeal, paragraph 4.62(a).
... it is not the case that GEMA’s approach simply ensures rewards for four DNOs. It ensures rewards for four Slow-Track DNOs, which in turn means that six networks are in reward territory. ... The cut-off point is therefore considerably closer to the median than the upper quartile. Indeed, NPG receives an upfront reward even though its two networks are ranked 6th and 8th in terms of efficiency. Whatever the rationale GEMA has applied when relaxing the IQI matrix, it is clear that it is not consistent with, and is more generous than, giving upfront rewards for networks above the upper quartile.

6.78 BGT also made the more general comment at its hearing, and in its response to our provisional determination, that its position was that GEMA may recalibrate the IQI, but that any recalibration should reflect the principles outlined in the RIIO-ED1 strategy decision.

6.79 In its closing submissions, BGT also argued that GEMA had not properly considered making a more limited adjustment, and that – even if some change to the IQI were necessary – GEMA had not restricted itself to making the change that would impose the smallest possible cost on consumers. BGT pointed to an alternative approach that it had presented to GEMA in its response to the Draft Determinations, under which GEMA would have modified the DNOs’ submitted figures on the assumption that the DNOs had submitted forecasts in relation to RPEs and SGBs that were in line with GEMA’s views. BGT estimated that GEMA’s approach resulted in the slow-track DNOs receiving £262 million of additional totex and £135 million of additional upfront rewards relative to BGT’s alternative, although BGT did not provide the calculations that underpin its estimates. This proposal was not referred to in BGT’s Notice of Appeal or in its Reply (both of which were accompanied by a report from AlixPartners providing more detailed analysis of aspects of IQI).

6.80 While BGT pointed to its option as demonstrating that GEMA had not considered properly alternative approaches that could have resulted in a more limited adjustment, BGT also explicitly highlighted that GEMA had followed up on receipt of written details of BGT’s alternative option with a bilateral meeting at which BGT presented the approach and its analysis. We are not persuaded that BGT’s evidence shows a lack of engagement with, or proper consideration of, the alternative approach that BGT had put forward. GEMA did not assume that DNOs had submitted forecasts in relation to RPEs and SGBs that were in line with its own view when setting revenue allowances and calculating upfront rewards and penalties. In its presentation of this option in its closing submissions, BGT did not articulate why such an assumption might
be justified. We do not therefore consider BGT to have shown that its alternative approach merited consideration further than that given to it by GEMA.

6.81 We consider BGT's other points relating to the scale of the recalibration below by examining first, the extent to which other aspects of the IQI should have been understood as having an offsetting effect when GEMA considered the scale of its IQI recalibration, and second, the consistency between GEMA’s rationale for recalibrating the IQI and the scale of the recalibration that it actually applied.

**Offsetting effects from other aspects of the IQI**

6.82 BGT argued that, even if some form of IQI recalibration were appropriate, GEMA’s approach resulted in a change that was out of all proportion to the impact that it was intended to address. In particular, BGT relied on analysis by AlixPartners that sought to demonstrate that the effect of the IQI recalibration was to increase DNO revenues by 17 times more than would be needed to compensate for the net impact of the RPE and SGB adjustments on the operation of the IQI.

6.83 The AlixPartners analysis considered a particular scenario: what would the net impact of the IQI be on a DNO if the latest information showed that costs will be lower than the DNO had forecast in its business plan? The effects of such a change (other things equal) considered in the report can be described as follows:

(a) Forecast costs (based on the ‘old’ information) would exceed GEMAs view (based on the ‘new’ information that costs will be lower). As a result the DNO would face an upfront penalty.

(b) The DNO’s allowance (associated with this part of totex) will be higher than GEMA’s (new information) view as the allowance would be based on a 25% weighting of the (higher) forecast costs, as a result of interpolation.

(c) Actual costs would be lower than forecast costs and lower than the DNO’s allowance, and so the DNO would get an incentive reward.

6.84 AlixPartners argued that the net impact of the upfront penalty (in (a)) and the incentive reward (in (c)) would be negative for the DNO, but only modestly so. It is the comparison between the scale of this modest negative net impact and the impact of GEMA’s recalibration that underpins the ‘out of all proportion’ assessment.
6.85 We are not persuaded that this analysis should have a material bearing either on our assessment of whether in principle a recalibration was wrong, or on whether the scale of the recalibration that GEMA applied was wrong. The analysis focused on a context where there was no substantive difference in view between the DNOs and GEMA: the difference between the DNO forecast and GEMA’s view arises simply because the DNO view was formed at an earlier point in time.

6.86 While this kind of timing issue clearly had some relevance in the context of RPEs, we consider that there were highly material differences of view over what the relevant allowances/savings in relation to RPEs and SGBs should have been. As we highlighted in paragraph 6.72 above, while the circumstances associated with the RPE and SGB adjustments differed, in both cases there was considerable uncertainty with which to contend, and the extent of this uncertainty was central to the differences of view that resulted.

Consistency between GEMA’s rationale and the scale of the recalibration that GEMA actually applied

6.87 In arriving at our view that GEMA was not wrong to have decided to recalibrate the IQI, we found it sufficient to consider the purpose of the recalibration in relatively general terms. However, in order to judge whether the scale of GEMA’s recalibration was wrong, we find it necessary to examine more precisely what the recalibration was intended to achieve.

6.88 We begin this examination by considering how statements that GEMA made during the RIIO-ED1 process, and in the context of the appeal, can assist with identifying what the recalibration should be intended to achieve. We then consider how what GEMA did at the Draft and Final Determinations stage fits with this.

- What the IQI recalibration was intended to achieve

6.89 In its Response, GEMA said that its intention was initially to confer rewards upon the DNOs in the upper quartile of its efficiency benchmark, that in its Draft Determinations it adjusted the IQI break-even point to 102.9% to ensure this was achieved, and that the same break-even point was retained at Final Determinations. We note that GEMA had made a number of comments during the RIIO-ED1 process that drew a link between its use of an upper

---

233 GEMA’s Response, paragraph 222(b).
quartile approach and its approach to upfront rewards and penalties under the IQI. For example, in its Strategy Decision, GEMA said that:

We do not consider that it is appropriate to relax the IQI matrix so that a company that is forecasting a higher cost than our upper quartile benchmark is able to break-even.

We believe that how we determine the upper quartile has to be taken into consideration as well. In past price reviews DNOs have criticised us for applying upper quartile benchmarking at a very disaggregated level, resulting in a ‘cherry picked’ answer, which no one DNO can achieve across the board. Our cost assessment approach for RIIO-ED1 takes a more holistic approach to determining efficiency and as such our view of the appropriate rewards/penalties available in the IQI reflects this.234

6.90 Also, when explaining the reason for recalibrating the IQI in its Draft Determinations, GEMA said that it had reviewed the design of the IQI in the light of the adjustments that it was making (for RPEs and SGBs), after setting its upper quartile efficiency benchmark. However, in its Draft Determinations, GEMA did not explain why it considered the scale of the recalibration it was proposing to be appropriate, other than by saying that it had been set so that ‘the best performing DNO groups receive a reward’.235

6.91 GEMA applied the same recalibration at Final Determinations, but did not explain why this level was considered appropriate other than by saying the following:

While we received mixed responses, we consider that it is still appropriate to reward companies that had provided information that helped our comparative benchmarking. We therefore make no adjustment to the IQI matrix from draft determinations for the break-even point.236

6.92 Given the lack of clarity over why GEMA considered the scale of its recalibration to be appropriate, we explored this matter further with GEMA at its oral hearing. GEMA focused heavily on its use of upper-quartile benchmarking as the justification for its IQI recalibration. In some cases, GEMA referred in general terms to its use of an upper quartile approach meaning that some DNOs would be expected to earn a reward:

235 Draft Determinations, paragraph 4.56.
236 Final Determinations, paragraph 4.96.
I think it is a fact that by saying specifically that our view of efficient cost would be based on an upper quartile of a Totex assessment we were by definition saying that our view of efficiency would be within the range of what the companies had forecast.

I think there was a very clear link running through all our statements that it was a Totex based approach at which the upper quartile would be taken. That, therefore, you know sort of meant that under the IQI multiple DNOs could be expected to get a reward.

... we were always going to use this upper quartile assessment of efficient cost and that by definition meant that there would be a number of companies who were more efficient than our benchmark.

However, GEMA also specifically set out that it considered its use of an upper quartile approach to mean that four out of 14 DNOs would be expected to be in ‘reward territory’: ‘It was a judgment call in trying to hold true to … an element of the commitment that we had given or implied for the IQI, which was that there would be approximately four companies in reward territory. We thought that still held appropriate.’

GEMA also said that because the IQI rewards and penalties are applied according to DNO groups, then four companies above the upper quartile could translate to two groups or three groups depending on where they sit. In seeking to clarify the position at the hearing, we asked whether the top four companies were all slow-track DNOs, and GEMA told us that they were. GEMA also confirmed that had the top four companies been fast-track companies, then none of the slow-track companies would have received a reward.

In relation to the fast-tracked DNOs, GEMA clarified that having fast-tracked the WPD group:

We then retained that group’s data within the comparative benchmarking, because it provides useful comparative data, but we do recognise that we actually expect it not to necessarily be the most efficient company when you are judging it against the resubmitted plans, because everybody else has had another go at it.

We also questioned the extent of the recalibration directly:
THE CHAIRMAN: Okay, and you went only so far as was necessary in recalibrating to bring four companies within and no further?

ANNA ROSSINGTON: Yes, exactly.

6.97 In its closing submissions, GEMA confirmed the position, as set out in the oral hearing, that: ‘GEMA did consider a number of options and selected close to the minimum adjustment that achieved its objective – which was to ensure around 4 DNOs received an ex ante reward.’

6.98 So far as we can ascertain from the evidence that GEMA provided over the course of the appeals process, therefore, our understanding is that GEMA’s intention in recalibrating the IQI was to ‘hold true’ to the indications it had given (in its Strategy Decision) that IQI upfront rewards would be calculated by reference to companies in the ‘upper quartile’ of GEMA’s efficiency assessment, and that the break-even point was shifted to ensure that four out of 14 companies still obtained rewards. Although we note this precise justification does not emerge clearly from the Draft or Final Determinations themselves, it does also appear to be consistent with the understanding held by the DNOs, as evidenced by comments made at their joint hearing in the BGT appeal. In that regard, Thomas Sharpe QC, appearing on behalf of the DNOs noted:

It was an expectation by using upper quartile that a certain number of companies would automatically be in reward territory. [Ms Rossington] clarified that this would mean that four companies overall would be in reward territory. As Professor Stern responded ‘upper quartile, four companies, it is two sides of the same coin’ and we respectfully agree with that. GEMA set the matrix to allow the upper quartile expectation to be honoured.

6.99 Similarly, Ms Walls noted that the DNOs’ expectation, based on GEMA’s RIIO-ED1 strategy document, was ‘always’ that ‘the best-performing DNOs on a relative basis, and that relative basis including all 14 DNOs’ final plans, would receive a reward that would be relative to the upper quartile performance.’

6.100 We note that the DNOs’ joint response argued that the fast-track DNOs were irrelevant in the context of this appeal and the consideration of how many DNOs received upfront rewards under the IQI (as set out in paragraph 6.47(d) above). However, we find this view to be inconsistent with the Strategy Decision and with GEMA’s evidence.
• How does what GEMA did fit with its reasoning for the recalibration?

6.101 GEMA recalibrated the IQI by increasing the cut-off point below which DNOs earn an upfront reward to 110.4% of GEMA’s view of efficient expenditure. This had the effect of increasing the break-even point to 102.9%, where the break-even point takes account of the impact of applying interpolation and the efficiency incentive rate (the other two components of the IQI) as well as the impact of and upfront reward/penalty.\(^{237}\)

6.102 GEMA identified that an increase in the cut-off point for upfront rewards of 10.4 was the appropriate scale of recalibration in its Draft Determinations, given the IQI scores that its cost assessment exercise had generated at that time. GEMA then decided to apply the same cut-off point in its Final Determinations, notwithstanding the different set of IQI scores that its cost assessment exercise had generated at that point.

6.103 When considering the appropriateness of the scale of the recalibration, we examine the relationship between what GEMA did, and the underlying reasoning that we were provided with for the scale of the recalibration, at both the Draft and Final Determinations stages.

• What GEMA did at Draft Determinations

6.104 Table 9 below shows the IQI score for each DNO group in GEMA’s Draft Determinations, and the associated upfront rewards and penalties given the IQI recalibration. It can be seen that, based on the position at Draft Determinations, using a cut-off point of 110.4 would have resulted in two DNO groups receiving an upfront reward (and we note that WPD was the fourth-ranked group on the basis of GEMA’s Draft Determinations assessment). This is consistent with GEMA’s comments at the clarification hearing that it considered it appropriate to get two groups to be able to earn a reward. We consider the appropriateness of this judgement below. We note that because GEMA calculated the upfront rewards and penalties on the basis of the DNO group scores, the Draft Determinations position would have resulted in three slow-track DNOs earning a reward (ENWL, SSEH and SSES). Based on the position at Draft Determinations, the slow-track DNOs in aggregate would have been subject to a net upfront penalty of £29 million under the IQI.

---

\(^{237}\) The break-even point is equal to 102.9% as a DNO which forecast costs of 102.9% of GEMA’s view of efficient costs, and spent in accordance with this forecast, would earn its cost of capital and no more, other things equal (as the gain that it earned as a result of its upfront reward would be offset exactly by the loss that it made from the application of the efficiency incentive rate to the difference between its actual totex and its totex allowance, with the latter set on the basis of interpolation).
Table 9: Draft Determinations – IQI scores and upfront rewards/penalties by DNO group

<table>
<thead>
<tr>
<th>Rank</th>
<th>DNO Group</th>
<th>IQI score</th>
<th>Upfront reward/penalty (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ENWL</td>
<td>106</td>
<td>13</td>
</tr>
<tr>
<td>2</td>
<td>SSEPD</td>
<td>110</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>NPg</td>
<td>111</td>
<td>–5</td>
</tr>
<tr>
<td>4</td>
<td>SPEN</td>
<td>112</td>
<td>–10</td>
</tr>
<tr>
<td>5</td>
<td>UKPN</td>
<td>114</td>
<td>–32</td>
</tr>
<tr>
<td></td>
<td><strong>Total slow-track DNOs</strong></td>
<td></td>
<td><strong>–29</strong></td>
</tr>
</tbody>
</table>

Source: GEMA (30 July 2014), RIIO-ED1: Draft determinations for the slow-track electricity distribution companies, Business plan expenditure assessment, Table 2.8, p12.

6.105 Table 10 shows the IQI scores at Draft Determinations for each DNO (as opposed to DNO group), including the WPD DNOs. It can be seen that the cut-off point of 110.4 that GEMA applied fell between the fifth and the sixth DNOs at Draft Determinations. That is, at Draft Determinations, the cut-off point was set such that five DNOs had a score that bettered it (i.e., was below it). As we describe further below, on the basis of upper quartile logic that both GEMA and the DNOs put to us, we would have expected no more than four DNOs to have had a score below the (recalibrated) cut-off point.

Table 10: Draft Determinations – IQI scores by DNO

<table>
<thead>
<tr>
<th>Rank</th>
<th>DNO</th>
<th>IQI score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SPD</td>
<td>104.0</td>
</tr>
<tr>
<td>2</td>
<td>ENWL</td>
<td>106.3</td>
</tr>
<tr>
<td>3</td>
<td>SSES</td>
<td>107.3</td>
</tr>
<tr>
<td>4</td>
<td>EMID</td>
<td>108.2</td>
</tr>
<tr>
<td>5</td>
<td>NPgY</td>
<td>110.2</td>
</tr>
<tr>
<td>6</td>
<td>SWALES</td>
<td>110.5</td>
</tr>
<tr>
<td>7</td>
<td>SPN</td>
<td>111.9</td>
</tr>
<tr>
<td>8</td>
<td>EPN</td>
<td>112.4</td>
</tr>
<tr>
<td>9</td>
<td>NPgN</td>
<td>113.2</td>
</tr>
<tr>
<td>10</td>
<td>SSEH</td>
<td>114.3</td>
</tr>
<tr>
<td>11</td>
<td>WMID</td>
<td>116.5</td>
</tr>
<tr>
<td>12</td>
<td>LPN</td>
<td>116.9</td>
</tr>
<tr>
<td>13</td>
<td>SPMW</td>
<td>119.9</td>
</tr>
<tr>
<td>14</td>
<td>SWEST</td>
<td>122.2</td>
</tr>
</tbody>
</table>

Source: GEMA (30 July 2014), RIIO-ED1: Draft determinations for the slow-track electricity distribution companies, Business plan expenditure assessment, Table 2.5, p11.

- **What GEMA did at Final Determinations**

6.106 Table 11 below shows the IQI score for each DNO group in GEMA’s Final Determination, and the associated upfront rewards and penalties given the IQI recalibration. It can be seen that using a cut-off point of 110.4 resulted in three DNO groups receiving an upfront reward (and we note that WPD was the fifth-ranked group on the basis of GEMA’s Final Determinations assessment). This outcome clearly goes beyond adjusting the cut-off point until two groups are in reward territory (which was one outcome GEMA had said it considered appropriate to achieve). As GEMA calculated upfront rewards and penalties on the basis of the DNO group scores, the Final Determinations resulted in five DNOs earning a reward (ENWL, SSEH, SSES, NPgY and NPgN).
Applying a cut-off point of 110.4 at Final Determinations meant that the slow-track DNOs in aggregate were subject to a net upfront penalty of £3 million under the IQI. This compares with an aggregate net penalty of around £290 million that would have applied if there had been no recalibration.

Table 11: Final Determinations – IQI scores and upfront rewards/penalties by DNO group

<table>
<thead>
<tr>
<th>Rank</th>
<th>DNO group</th>
<th>IQI score</th>
<th>Upfront reward/penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ENWL</td>
<td>104</td>
<td>20</td>
</tr>
<tr>
<td>2</td>
<td>SSEPD</td>
<td>107</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>NPg</td>
<td>110</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>SPEN</td>
<td>113</td>
<td>-14</td>
</tr>
<tr>
<td>5</td>
<td>UKPN</td>
<td>113</td>
<td>-32</td>
</tr>
<tr>
<td></td>
<td>Total slow-track DNOs</td>
<td></td>
<td>-3</td>
</tr>
</tbody>
</table>

Cut-off point of 110.4 falls between the IQI scores of the 3rd and 4th DNO group

Source: GEMA (28 November 2014), RIIO-ED1: Final determinations for the slow-track electricity distribution companies, Business plan expenditure assessment, Table 2.9, p12.

Table 12 shows the IQI scores at Final Determinations for each DNO (as opposed to DNO group), including the WPD DNOs. It can be seen that the cut-off point of 110.4 that GEMA applied fell between the sixth and the seventh DNO at Final Determinations. That is, the cut-off point was set such that six DNOs had a score that bettered it (ie was below it). As we describe further below, we would have expected no more than four DNOs to have had a score below the (recalibrated) cut-off point.

Table 12: Final Determinations – IQI scores by DNO

<table>
<thead>
<tr>
<th>DNO</th>
<th>Group</th>
<th>IQI score</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENWL</td>
<td>ENWL</td>
<td>103.8</td>
</tr>
<tr>
<td>SPD</td>
<td>SPEN</td>
<td>103.9</td>
</tr>
<tr>
<td>SSES</td>
<td>SSEPD</td>
<td>105.3</td>
</tr>
<tr>
<td>SWALES</td>
<td>WPD</td>
<td>107.4</td>
</tr>
<tr>
<td>EMID</td>
<td>WPD</td>
<td>108.9</td>
</tr>
<tr>
<td>NPgY</td>
<td>NPg</td>
<td>108.9</td>
</tr>
<tr>
<td>SSEH</td>
<td>SSEPD</td>
<td>110.8</td>
</tr>
<tr>
<td>NPgN</td>
<td>NPg</td>
<td>111.2</td>
</tr>
<tr>
<td>SPN</td>
<td>UKPN</td>
<td>111.9</td>
</tr>
<tr>
<td>EPN</td>
<td>UKPN</td>
<td>112.9</td>
</tr>
<tr>
<td>LPN</td>
<td>UKPN</td>
<td>115.6</td>
</tr>
<tr>
<td>WMD</td>
<td>WPD</td>
<td>116.5</td>
</tr>
<tr>
<td>SWEST</td>
<td>WPD</td>
<td>120.0</td>
</tr>
<tr>
<td>SPMW</td>
<td>SPEN</td>
<td>121.7</td>
</tr>
</tbody>
</table>

Cut-off point of 110.4 falls between the 6th and 7th DNO IQI score

Source: GEMA (28 November 2014), RIIO-ED1: Final determinations for the slow-track electricity distribution companies, Business plan expenditure assessment, Table 2.5, p14.

- The relevance of DNO and group-level scores to the scale of recalibration

The view that DNOs reasonably could have expected their totex to have been assessed through upper quartile benchmarking was central to GEMA’s reasoning as to why recalibration was appropriate. On GEMA’s view, this expectation implied that it would also have been reasonable to expect that some DNOs, and some DNO groups, would be in ‘reward territory’. As we highlighted in paragraphs 6.98 and 6.99 above, the DNO submissions at their hearing were consistent with the DNOs having held such expectations. Given
this, we consider what an expectation of the use of an upper quartile benchmarking approach could be understood reasonably as implying in terms of the number of DNOs and DNO groups that would be in ‘reward territory’.

6.110 We note that GEMA’s upper quartile benchmarking was applied to DNOs (not DNO groups), and involved the comparative assessment of all 14 DNOs. That is, the four fast-tracked DNOs were included in the upper quartile benchmarking process in addition to the ten slow-track DNOs. GEMA had made this clear in its Strategy Decision.238

6.111 GEMA used the upper quartile benchmarking of DNO totex levels to generate its view of efficient totex for each of the 14 DNOs. Absent the RPE and SGB adjustments, the submitted levels of totex, relative to GEMA’s upper quartile view of the efficient level, would have given IQI scores for each of the 14 DNOs that were distributed around 100.

6.112 Using GEMA’s upper quartile benchmarking approach, it would follow that four out of the 14 DNOs would be expected to have an IQI score of less than 100.

6.113 However, we do not consider that this would imply that any particular number of DNOs or DNO groups would be expected necessarily to earn an upfront IQI reward nor have we found evidence in the GEMA submissions to justify such a view. As GEMA applied rewards and penalties on the basis of the DNO group scores (not the DNO scores), the extent to which a DNO group (and thus the DNOs within that group) would receive a penalty would depend on the weighted average of the IQI scores of the DNOs in the relevant group. Whether or not a given group, or any particular number of groups, earns a reward would depend therefore not simply on whether they had one or more DNOs in ‘reward territory’, but also on the scores of other DNOs in the group.

6.114 In order to generate an outcome that is consistent with what GEMA’s upper quartile benchmarking approach would have been expected to generate, we consider that an approach that sought to draw the cut-off point such that four DNO scores were below it would be appropriate.

6.115 Consistent with this, we would have expected GEMA’s recalibration at Draft Determinations to have applied a cut-off point somewhere between 108.2 (the IQI score of the fourth-ranked DNO in Table 9) and 110.2 (the score of the fifth-ranked DNO) such that only four DNOs were below the cut-off point. In practice, GEMA set the cut-off point at 110.4. Also, we would have expected GEMA to have reset the cut-off point for its Final Determinations between the

---

fourth- and fifth-ranked DNOs given the IQI scores that applied at that stage (that is, between 107.4, the IQI score of SWALES, and 108.9, the IQI score of EMID, as shown in Table 11).

Responses to our provisional determination

6.116 In its response to our provisional determination, GEMA said that:

The Authority does not object to the CMA’s provisional conclusion that the nature and quantum of the IQI recalibration was wrong in the circumstances of this case, and in particular that the Authority’s recalibration was not consistent with an upper quartile approach in that it set the cut-off point between the sixth and seventh most efficient DNOs as opposed to the fourth and fifth.

6.117 All of the slow-track DNOs disagreed with our provisional determination on the scale of the recalibration. NPg argued that GEMA’s judgement not to ‘true up’ the IQI cut-off point at Final Determinations was proportionate, and that it was entirely reasonable for GEMA to evaluate the effects of recalibrating the IQI at the group level, as IQI incentives applied across a DNO group as a whole for important regulatory policy reasons. ENWL made similar points.

6.118 We do not agree. GEMA’s approach to recalibration was aimed at delivering an outcome that it considered consistent with prior expectations concerning how the IQI would work. The impact of applying a given cut-off point is dependent on what the IQI scores are, and those scores changed materially between Draft and Final Determinations. The approach described in the Strategy Decision involved the upper quartile being applied at the DNO, not the group, level, notwithstanding the fact that upfront rewards and penalties were calculated and applied subsequently at the group level.239

6.119 ENWL, NPg and UKPN all argued that the scale of the recalibration was consistent with GEMA’s policy aim of rewarding the best-performing slow-track DNOs, and within the scope of GEMA’s regulatory discretion. NPg argued that GEMA’s public statements at the time of the IQI recalibration did not suggest that it intended to follow a prescriptive rule, but were instead making a broader judgement. NPg said that a prescriptive rule would be undesirable as it could produce nonsensical outcomes, and that even if there was a ‘four companies rule’, GEMA had exercised its discretion to act in a

---

239 The use of an upper quartile approach will determine where the cut-off point is set relative to the distribution of DNO IQI scores, but the level of upfront reward/penalty earned by any given DNO will be determined by the IQI score of its respective DNO group.
way that was more flexible and proportionate than such a rule implies, for sensible reasons.

6.120 We are not persuaded by these points. GEMA’s choice of IQI cut-off point had a material impact on consumers and on DNOs. The IQI recalibration resulted in a position where, in aggregate, the DNOs faced a net penalty of £3 million, as compared with a net penalty of around £290 million that would have applied had there been no recalibration. While our view is that GEMA was justified in recalibrating the IQI, the analysis above shows that GEMA went further than necessary to generate an outcome that was consistent with its adoption of an upper quartile approach to setting its own view of efficient expenditure.

6.121 In our provisional determination, we noted that a cut-off point of 108 would have been between the fourth- and fifth-ranked DNOs at Final Determinations but would have resulted in a materially different set of rewards and penalties applying. In particular, with a cut-off point of 108, the slow-track DNOs would, in aggregate, have faced a net penalty that was £68 million higher than the level which resulted from GEMA’s recalibration. That is equivalent to 0.4% of GEMA’s view of efficient totex for RIIO-ED1.

6.122 ENWL, SPEN, SSEPD and UKPN all argued that it was necessary to consider linkages with other aspects of the RIIO-ED1 price controls. ENWL said that it was important to consider all three elements of the IQI and that GEMA had set the break-even point at a level that was more onerous than the most efficient DNO: on this assessment, no DNO was in reward territory. SPEN also noted that GEMA’s decision meant that no slow-track DNO would earn its cost of capital if it spent in line with its forecast, and said this was the most stringent application of the IQI by GEMA to date. SPEN argued that the break-even point was far more significant to the DNOs and to GEMA than the cut-off point, as below the break-even point a DNO did not earn its cost of capital if it spent in accordance with its forecast. SPEN said that, as far as it was aware, there had been no express reference to the cut-off point in any of GEMA’s Strategy Decision, Draft Determinations or Final Determinations documents, with this reflecting that GEMA’s focus was on the break-even point.

6.123 SSEPD made a broader argument that the approach taken in the provisional determination illustrated the substantive and procedural problems that arose from a failure to consider matters ‘in the round’. It said that the three elements which made up the IQI mechanism were directly linked to the output of the cost efficiency assessment process, and that when considering the case for reopening the IQI recalibration exercise under the BGT appeal it was necessary to assess the overall output of the IQI mechanism in the light of our conclusion on SGB in the NPg appeal. UKPN also argued that our...
determination in the NPg appeal should be taken into account when considering the case for IQI recalibration.

6.124 We note that the only change that GEMA made when recalibrating the IQI was to adjust the cut-off point, with this having the direct effect of changing the upfront rewards/penalties for the slow-track DNOs. This change can be expressed in terms of how it affects the break-even point under the IQI, and GEMA expressed the change in this way in the Draft Determinations. However, we were not presented with evidence that suggests that GEMA’s changes to the cut-off point were intended to result in the break-even point being at any particular level. Rather, the rationale for the scale of the adjustment was presented in terms of the extent to which slow-track DNOs would earn upfront rewards/penalties consistent with the use of an upper quartile approach to efficiency assessment and this is determined by the cut-off point. We do not therefore consider that these DNO observations concerning the break-even point, and the overall stringency of the IQI that GEMA applied, raise material additional points that affect our assessment.

6.125 Further, we do not consider that our determination in relation to the NPg appeal should affect our assessment of the IQI recalibration in this appeal. Our determination in the NPg appeal applies only to NPg. We considered the implications that our determination in relation to SGBs should have for the application of the IQI to NPg, as part of the NPg appeal.

6.126 Finally, we note BGT’s criticism of GEMA’s level of engagement on the IQI adjustment. For the avoidance of doubt, we did not consider that the evidence demonstrated that there were procedural flaws which were, in themselves, sufficient to render the decision wrong on any of the grounds advanced by BGT.

Conclusion on appeal ground 3

6.127 In our view, GEMA’s intention was to recalibrate in a way that was consistent with the upper quartile approach that it had maintained in its presentation of the IQI since the Strategy Consultation. This suggests that the four most efficient DNOs would have an IQI score lower than the cut-off point. We accept that this would have been a reasonable approach given what GEMA had said during the consultation on RIIO-ED1 and how it presented its defence to us during the appeal. We do not consider it wrong for GEMA to have made an adjustment taking into account the overall outcome of its cost assessment process.

6.128 However, our assessment of the recalibration at Final Determinations is that what GEMA did was not consistent with an upper quartile approach, nor with
any specific approach that we can infer from what GEMA said during the RIIO-ED1 process or this appeal. Specifically, it set the cut-off point between the sixth and seventh most efficient DNOs based on the efficiency scores at the end of the process. Under an upper quartile approach, a cut-off point between the fourth and fifth most efficient DNOs would have been expected. GEMA’s approach resulted in the DNOs being significantly better off in aggregate than would have been expected under an approach that was consistent with GEMA’s upper quartile reasoning.

6.129 In response to our provisional determination, NPg and SPEN challenged the legal relevance of our assessment of what GEMA was seeking to achieve when recalibrating the IQI. They both noted that section 11E(4)(d) EA89 provides that one of the statutory grounds on which an appeal may be allowed is where ‘the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b)’, and that the relevant statement of effects pursuant to section 11A(7)(b) is in GEMA’s notice dated 3 February 2015. SPEN said that section 11E(4)(d) EA89 did not permit an appeal to be allowed on the basis of an alleged intended effect that was not clearly articulated in the section 11A(7)(b) statement. In this respect, we note that section 11A(7)(b) does not expressly provide that the effect must be stated in the Decision. Further, we do not interpret paragraph 8 of the Decision as excluding consideration of effects stated in the Strategy Decision and Final Determinations.

6.130 We consider that, given the circumstances, it is appropriate to look beyond GEMA’s notice of 3 February 2015 in order to identify the effect that should be understood as relevant for the purposes of the statutory ground under 11E(4)(d) EA89. GEMA’s notice of 3 February 2015 makes no reference at all to the IQI recalibration, and thus does not disclose an effect that could be subjected to scrutiny. We do not consider the absence of an identified effect in that document should mean that the statutory ground under section 11E(4)(d) ceases to be applicable.

6.131 We note that GEMA’s notice of 3 February 2015 explicitly states that:

...in summary, the reasons why the Authority is making these licence modifications is to give effect to the policy set out in the Strategy Decision and in the Final Determinations.
Schedule 3 sets out the reasons and effects of the modifications in more detail.\textsuperscript{240}

SPEN argued that the relevant statement of effects was to be found in Schedule 3 of the notice. However, consistent with the above excerpt, we also considered it appropriate to examine the Strategy Decision and the Final Determinations.

6.132 Consideration of this matter was complicated by a number of factors. GEMA’s explanation of its justifications for the scale of its recalibration in the Draft and Final Determinations was generalised, as was its explanation of the calculation that was involved. There was no substantive justification at Final Determinations for the decision to apply the cut-off point at 110.4 that was capable of interrogation or challenge. In these circumstances, we consider that we could and should take into account the submissions and oral evidence to ascertain what the effects stated were. Nevertheless, the written evidence that we received and the clarification at the hearings is, in our view, broadly consistent in terms of explaining what GEMA was seeking to achieve from the recalibration, namely, an outcome in terms of upfront rewards and penalties that was consistent with the application of the upper quartile approach presented in GEMA’s Strategy Decision.

6.133 Given this, we consider that it is open to us to find that the scale of the recalibration was wrong in that the modifications failed to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b), notwithstanding the fact that the relevant effect was not explicitly identified in GEMA’s notice of 3 February 2015.

6.134 In any event, our examination of the IQI scores at Draft and Final Determinations and GEMA’s explanations demonstrate, in our view, that the effect of the recalibration of the IQI, as applied at Final Determinations, went beyond what GEMA was seeking to achieve as set out in the Strategy Decision. As such, by setting the cut-off point in the Final Determinations at 110.4, it was more generous than it needed to be in order to fulfil GEMA’s policy objective and this had a greater effect on the final price control than was appropriate taking into account the justification provided. Given this, we also consider that the IQI recalibration was wrong in that GEMA failed properly to have regard to the interests of consumers when determining the scale of the recalibration to be applied and/or was disproportionate to the aim of the recalibration and thus wrong in law.

\textsuperscript{240} Ofgem (3 February 2015), RIIO-ED1 Modifications to amend the special conditions of the electricity distribution licence held by the slow-track licensees, paragraphs 7 & 8.
6.135 We therefore determine that the scale of the recalibration was wrong. Accordingly, we uphold BGT’s appeal, to this limited extent, on ground 3.

Remedy

6.136 If the CMA allows, to any extent, an appeal in relation to a price control, it must do one or more of the following:

(a) quash the decision (to the extent that the appeal is allowed);

(b) remit the matter back to GEMA for reconsideration and determination in accordance with any direction given by the CMA;

(c) substitute the CMA’s decision for that of GEMA (to the extent that the appeal is allowed) and give any directions to GEMA or any other party to the appeal.

6.137 Given the nature and scale of the error that we have identified, we do not consider it appropriate to remit the matter back to GEMA for consideration and redetermination.

6.138 Our view is that we should therefore substitute our own decision on the appropriate level of the cut-off point.

6.139 Our provisional view was that the recalibration that would have been consistent with what GEMA was seeking to achieve, that is, the minimum necessary to bring four DNOs into reward territory reflecting the upper quartile, would be to have set the cut-off point between the fourth and fifth most efficient DNOs at Final Determinations. This would have been at an efficiency score of around 108 (such that – as can be seen from Table 11 – four DNOs would be below the cut-off point).

6.140 In response to our provisional determination, GEMA said that we should set the cut-off point exactly equal to the upper quartile of the DNO IQI scores at Final Determinations, which GEMA said was 107.77. BGT also considered that we should set the cut-off point equal to the upper quartile, but it said that the upper quartile was equal to 106.9.

---

241 Section 11F(7) of EA89 provides that for the purposes of section 11E, a decision is a price control decision, in relation to the modification of a condition of a licence, if the purpose of the condition is, in the CMA’s opinion, to limit or control the charges on, or the revenue of, the holder of the licence. GEMA’s decision in the present case clearly constitutes a price control decision as here defined, since it limits or controls the DNOs’ revenues over the period of the price control.

242 Section 11F(2) of EA89.
We consider that setting the cut-off point equal to, rather than roughly in line with, the upper quartile would be a more precise way of applying the logic we have followed. In practice, there is no unique method of calculating the upper quartile. Microsoft Excel has two functions that calculate quartiles: QUARTILE.INC and QUARTILE.EXC. The upper quartile figure presented in GEMA’s response to our provisional determination was calculated using QUARTILE.INC, and the figure presented by BGT is consistent with applying QUARTILE.EXC to the same DNO IQI score data.

We consider it appropriate to set the cut-off point equal to 107.77. GEMA used an upper quartile approach in its RIIO-ED1 totex modelling based on QUARTILE.INC and that has not been challenged. We consider that the cut-off point should be set in line with the upper quartile as GEMA typically calculates it, as it is this basis of calculation that would have underpinned expectations concerning the implications of applying an upper quartile approach to the assessment of efficient expenditure levels for RIIO-ED1.

The impact on upfront rewards and penalties of applying a cut-off point of 107.77 is shown in Table 13. As can be seen, applying a cut-off point of 107.77 would increase the net upfront penalty that applies across the slow-track DNOs by £78 million (excluding the corresponding tax adjustments) compared to GEMA’s Final Determinations.

| Source: GEMA, Final Determinations, Business Plan Expenditure Assessment, Table 2.9 and CMA analysis. |

| ENWL     | 20  | 12  | −8 |
| NPg      | 3   | −11 | −13 |
| UKPN     | −32 | −58 | −27 |
| SP       | −14 | −28 | −14 |
| SSE      | 20  | 4   | −16 |
| Slow-track DNOs | −3  | −81 | −78 |

Applying a cut-off point of 107.77 would result in a reduction in revenues over the eight years of RIIO-ED1 of on average around £1 million for each of the
DNO groups as compared with the position set out in our provisional determination (which was based on a cut-off point of 108). Given the limited nature of these differences, the absence of concerns raised in response to our provisional determination, and the relatively modest impact overall that recalibrating the IQI based on a cut-off point of 107.77 would have on DNO allowances, we do not consider that this decision raises financeability considerations.

6.146 In response to our provisional determination and proposed remedies, we received responses from DNOs suggesting that additional changes to GEMA’s approach would be appropriate as a remedy in the light of our provisional decision. We also received a submission from SPEN that a change should be made to the tax calculation. We have reviewed these submissions and do not consider any further changes are appropriate.

Implementation

6.147 The change in the cut-off to 107.77 has a number of effects on the licence modification implemented by GEMA for RIIO-ED1. The change to the level of the upfront reward/penalty for each of the slow-track DNOs results in a revised level of allowed revenue for each of the DNOs, both as a direct result of the change to the revenue associated with the totex allowance, and also the consequential tax effects.

6.148 Our amendments result in a change to the PU term which restricts the revenue for the slow-track DNOs. We are implementing this change through an Order, which is published alongside this final determination. Along with our decision, the Order includes a number of small consequential changes to the slow-track DNO licences, which are intended to ensure the effective implementation of our amendments to the IQI.

6.149 We calculated the impact on the revenue and other terms within the licence using GEMA’s ED1 Price Control Financial Model and associated supporting analysis provided by GEMA. The impact on slow-track DNO revenue for RIIO-ED1 is a decrease of approximately £105 million. This is greater than the adjustment to the IQI penalty/reward of £78 million shown in Table 13. The model was used to calculate the gross revenue adjustment required such that the net effect, after account is taken of tax, is equal to the £78 million.

---

243 We considered points raised by SSEPD and UKPN in paragraphs 6.123 and 6.125.
244 We assume that the effect of our order will be that the future Annual Iteration Process and, where appropriate, any future changes to the RIGs will be implemented to be consistent with our decision.
245 There are also small changes to revenue to reflect re-profiling between years.
6.150 We have also made an amendment to NPg’s totex allowance as a result of our determination of NPg’s appeal. We are publishing a single order to reflect the combined outcome of the two appeals on NPg’s licence.

7. **Ground 4: transitional arrangements for change in asset life policy**

**Background**

7.1 BGT’s fourth ground concerned the provisions in ED1 to put in place transitional arrangements in the implementation of GEMA’s stated asset life policy. As part of its RIIO review across both the gas and electricity sectors, GEMA reconsidered the appropriate level of ‘asset lives’ for the purpose of calculating depreciation. Asset lives have an impact on prices for regulated services, as they represent the period over which investors are repaid for investments in new regulated assets. Shorter asset lives mean that consumers repay investors faster. This has a long-term timing effect (ie an intergenerational effect); it means higher bills in the short term, but lower bills in the long term.

7.2 GEMA’s approach within RIIO was based on the assumption that there were benefits with moving to an approach where asset lives were aligned with economic lives. In theory (and in the longer term), this would result in prices being better aligned to true economic costs, with asset values and annual depreciation both representing economic values (ie values that would be consistent with a competitive market).

7.3 However, the effects of any change in asset life are complicated where current asset values are different from notional economic values. The DNOs’ RAVs represent a roll-forward of the sale values at privatisation. When combined with asset lives which are shorter than economic asset lives, this results in asset values which are below economic values.

7.4 As part of its RIIO decision, GEMA decided to seek to implement a change to asset lives whilst reflecting this additional complexity. It proposed to implement the following:

(a) a move to economic asset lives in all sectors;

(b) a case-by-case approach to defining suitable asset lives; and

---

where necessary, to implement transitional mechanisms to address any consequent financeability issues.

7.5 Any increase in asset lives would have reduced charges to consumers in the short term and increased charges to consumers in the long term. This would therefore have resulted in lower revenues for DNOs in the short term, and higher revenues based on increased asset values in the long term.

7.6 GEMA recognised that, during the period whilst depreciation and revenues were below current levels, there could be an adverse impact on the companies' finances. Based on DNO proposals, it proposed to allow an interim period during ED1 where asset lives would be shorter than economic lives, which it characterised as a 'transition' to longer asset lives.

7.7 This would not have eliminated the adverse effect of lower revenues in ED1 and subsequent price controls, but would have mitigated those effects. GEMA's approach to transition was to mitigate the impact on companies of the reduction in charges in the short term (to restore financeability). Since the change in asset lives represented an intergenerational effect, the increase in charges in the shorter term would also have mitigated the longer-term increases faced by future consumers.

7.8 In the context of RIIO-ED1, GEMA's process was:

(a) Following advice from a consortium led by Cambridge Economic Policy Associates (CEPA), GEMA estimated that the expected technical or economic asset lives of DNO assets were between 45 and 55 years.

(b) In March 2011, GEMA decided to apply a 45-year asset life from the beginning of RIIO-ED1, but for new assets only.

(c) GEMA acknowledged that this change in depreciation policy for new assets could have financeability implications for individual DNOs and invited them to set out and justify the transitional arrangements they believe necessary to ensure financeability in their business plans.

(d) All slow-track DNOs proposed a straight-line eight-year transition over the duration of the price control.

(e) GEMA implemented a straight-line eight-year transition for all slow-track companies.

---

247 Strategy Decision, paragraphs 9.5–9.7.
249 GEMA Decision Letter March 2011.
7.9 This transition ameliorated the effect of the change to asset lives on DNOs, ie it resulted in the change reducing charges by a smaller amount than would otherwise have been the case. It was this transitional arrangement that BGT appealed. BGT did not appeal the overall approach of changing asset lives to 45 years.

Summary of BGT’s appeal ground 4

7.10 BGT’s fourth ground of appeal was that GEMA erred in deciding to introduce transitional arrangements in relation to its change in asset life policy. BGT argued that GEMA’s decision to make this adjustment:

(a) was contrary to GEMA’s duties to protect the interests of consumers, to promote efficiency, and to target its activities only at cases where action is needed;

(b) gave inappropriate and unsupported weight to subsidiary considerations of financeability; and

(c) was procedurally flawed, and therefore wrong in law.

7.11 BGT argued that having identified economic depreciation as the correct policy, GEMA should have implemented it as quickly as possible unless it could have demonstrated a strong countervailing justification, which BGT said it had not done. BGT said that GEMA failed to offer any explanation or analysis – either at the consultation stage, or in support of the Decision – to show why transitional arrangements were necessary for any individual DNO or for the sector as a whole.

7.12 BGT provided additional evidence within the AlixPartners Report. BGT’s evidence identified the impact of GEMA’s transitional arrangements for change in asset life policy to be that consumers would have had to pay £590 million more than they should in RIIO-ED1, as compared with the change in asset life policy with no transition arrangements (with consumers also paying more in ED2 and ED3, and less over the four price control periods from 2039 to 2070).

7.13 The AlixPartners analysis disputed any need to have concerns around financeability, on the basis that as a share of total charges, the impact of the
change in charges was small, and it was not therefore realistic that it could have a material impact on financeability. This is illustrated in Figure 6.

Figure 6: AlixPartners analysis of the effect of transition on DNO revenue

![Graph showing the effect of transition on DNO revenue](source: AlixPartners Economic Expert Report (March 2015), Figure 8.1)

7.14 Taken together, BGT argued that GEMA had identified the economically right level of depreciation, that there was no financeability case for transition, and it was therefore wrong for consumers to pay more than the economic level of depreciation in RIIO-ED1. The alternative is described by BGT as current consumers overpaying for the assets, and that this is for the benefit of future consumers.

7.15 BGT also had procedural concerns – in particular that GEMA, in its Draft Determinations, included only two sentences to support a change which had an effect of over £500 million. BGT argued that this was not transparent and not proportionate to the scale of the issue. It stated that GEMA had provided additional supporting explanation only in a letter provided on 3 February 2015, subsequent to Final Determinations.

7.16 In its Response to our provisional determination, BGT provided additional arguments relating to its procedural concerns. It considered that:

(a) GEMA had failed to demonstrate it had followed adequate process, and that precedent (such as the CAT in Vodafone v Ofcom) indicated that the CMA should have found that GEMA’s process was deficient;

254 Draft Determinations, paragraph 3.52: ‘The DNOs have all proposed transition arrangements for asset lives from 20 to 45 years in equal steps over the eight years of RIIO-ED1 to assist financeability. We consider their proposals are sensible.’
(b) GEMA had failed to provide ‘good reasons’ for its transitional arrangements, and that precedent had established it was necessary as a starting point for GEMA to provide why a transition was required.

7.17 In addition, in BGT’s view, the evidence provided by GEMA at its hearing demonstrated that a key reason for the decision had been withheld from stakeholders during the price control process, and this further supported its case that GEMA had not followed an adequate consultation exercise.

Summary of GEMA’s response to appeal ground 4

7.18 GEMA responded to the specific claims made by BGT in its initial Response to the Notice of Appeal, and then provided a further clarification at the hearing.

7.19 GEMA argued that the adoption of the transitional arrangements was neutral in net present value terms: taken together, consumers would not pay more (or less) as a result of the introduction of the transitional arrangements.\(^{255}\) It considered that BGT’s arguments ignored the interests of future consumers and narrowly focused on the situation of existing consumers – GEMA needed to have regard to future as well as existing consumers.\(^{256}\)

7.20 GEMA noted that the higher costs which would be paid by future consumers were a logical economic consequence of the move to a 45-year depreciation period, given the difference between current asset values and economic asset values. Given that the problem of future upward pressure on prices was evident and could be mitigated now, it proposed that the correct and responsible regulatory response was to take appropriate mitigating measures in RIIO-ED1.\(^{257}\)

7.21 GEMA reflected that there was a risk of ‘intergenerational unfairness’ which was, contrary to BGT’s views, in practice mitigated in the transitional arrangements. GEMA calculated that only approximately £600 million in allowed revenues would be deferred from RIIO-ED1 consumers to future generations, rather than over £1.1 billion without transition.\(^{258}\)

7.22 In relation to financeability, GEMA argued that it had made it clear on several occasions (including in the RIIO Handbook) that transitional arrangements

\(^{255}\) GEMA’s Response, paragraph 243(a).
\(^{256}\) GEMA’s Response, paragraph 243(b).
\(^{257}\) GEMA’s Response, paragraph 244(c).
\(^{258}\) GEMA’s Response, paragraph 243(b).
might be necessary, and that the slow-track DNOs presented analysis in their business plan resubmissions that transitional arrangements were necessary to secure financeability. While the effects of transition on credit metrics (including PMICR) within the control period were limited, they were nonetheless real. Therefore, in the light of potential investor concerns around cash flows arising from the reduced cost of equity allowances, and given weak ratios for ENWL in particular, GEMA considered that an immediate transition to 45-year asset lives would have unnecessarily heightened such concerns.

7.23 GEMA recognised that there were material adverse impacts on DNO cash flows from the change to new asset lives. The reductions in depreciation allowances and increases in DNO RAVs would have made an important group of credit metrics that refer to ‘funds from operations’, or FFO, substantially worse. The financeability issue would have arisen entirely as a result of an alteration to the regulatory framework. In that context, it was proper, responsible and in accordance with GEMA’s duties to have regard to issues of financeability.

7.24 In relation to procedural criticisms, GEMA argued that its consultation in the area of asset depreciation periods was extensive and included lengthy engagement during the development of the RIIO framework; a specific consultation in relation to asset lives for the electricity distribution sector between January and March 2011, which referred to the possibility of transitional arrangements managed over one price control period; and a preference for transitional arrangements managed over one price control within the RIIO-ED1 strategy decision.

7.25 In support of its position, GEMA provided further analysis in a witness statement from Ian Rowson. GEMA provided analysis of the effects of moving to 45 years with and without the transition. It demonstrated that, in particular at the level of depreciation, the impact could indeed be material. Figure 7 demonstrates that depreciation is projected to fall sharply over the next two to three price control periods as a result of the change in asset lives, with or without transition.

---

259 GEMA’s Response, paragraph 246(a).
260 GEMA’s Response, paragraph 246(b). At fast track GEMA had said that it considered there was sufficient headroom in these metrics and that transitional arrangements were not justified for WPD.
261 GEMA’s Response, paragraph 246(c).
262 GEMA’s Response, paragraph 246(d).
263 GEMA’s Response, paragraph 246(e).
264 GEMA’s Response, paragraph 246(h).
Further to this analysis of depreciation, GEMA also calculated the corresponding effect on regulatory costs (and, therefore, charges). The analysis suggested that the depreciation effect above could result in a sharp fall in DNO total costs in the coming price control periods. This would be offset by an increase in the longer term, as asset values increased due to slower asset depreciation.
Figure 8: GEMA’s analysis of the long-term effects on revenues of the change in asset lives

Source: First witness statement of Ian Rowson.

7.27 GEMA concluded that this analysis all supported its case that it was manifestly reasonable to mitigate the speed of this effect through transition.

**Summary of the DNOs’ joint response to appeal ground 4**

7.28 The DNOs’ joint response largely supported the points made by GEMA in defence of using the transitional arrangements for the change in asset life policy. The slow-track DNOs emphasised that GEMA was achieving a fair balance between existing and future consumers, and provided further analysis of the scale of the impact of the transition. The DNOs also highlighted that GEMA’s approach was consistent with its approach to changing asset lives in prior regulatory decisions.

7.29 The slow-track DNOs stated that BGT was prioritising existing consumers over future consumers and this was at odds with the regulatory duties of GEMA. The response also commented that GEMA had placed appropriate weight on financeability issues highlighted by the DNOs in reaching its decision on the transitional arrangements. The DNOs expanded further on the
process followed by GEMA to establish that there was a financeability issue to be addressed.\textsuperscript{265}

**GEMA’s evidence at the hearing**

7.30 At its hearing, we asked GEMA about its rationale for moving to asset lives of 45 years and, in particular, its views on the impact on future consumers of a materially higher asset value. This was important to BGT’s appeal, as BGT’s case was that if the move was ‘right’, GEMA should have implemented it straight away, as otherwise consumers would pay too much in ED1.

7.31 In response, GEMA provided a new argument which it had not included in the RIIO-ED1 process or its Response. GEMA confirmed that it did have some concerns about the end point, i.e., the medium-term use of 45-year indexation. Therefore, in addition to the evidence provided in the Notice of Appeal, it confirmed that it was likely to review the end point. This reflected the pictures presented above from GEMA’s analysis, which demonstrated that there would be a sharp decline in revenues over ED2 and ED3. GEMA stated that it had concluded that there was a risk to financeability in the medium term, and therefore that a more substantive review would be appropriate.

7.32 As a result, GEMA stated that in coming to its decision on a transition for ED1, it was also having regard to the need for such a review of medium-term effects. It was not only looking at the appropriate transition on the assumption that the 45-year asset life would be implemented in full from ED2. For example:

> It was becoming clearer to us that it would not be in the consumer interest to […] dive headlong into this deep valley of depreciation and that a transitional period would provide us with a somewhat softened approach, which would allow us time to reflect before we reached RIIO-ED2 as to how to take this forward.

**Summary of BGT’s Reply to appeal ground 4**

7.33 In its Reply, BGT stated that GEMA’s Response had still failed to provide adequate justification for the need for transitional arrangements. BGT suggested that the points made by GEMA regarding intergenerational equity were mischaracterised and flawed. BGT suggested that future revenue was being bought forward and that this was not in consumer interests. BGT commented that GEMA’s points on financeability were not convincing. BGT

\textsuperscript{265} DNOs’ joint response, Section E.
suggested that there had been procedural flaws arising from the lack of consultation on the proposed transitional arrangements.

**Our assessment of appeal ground 4**

7.34 BGT’s ground 4 is different from the other grounds in that it does not challenge a decision made by GEMA on the appropriate regulatory mechanism to apply in a particular area, but challenges the decision not to implement a particular step immediately.

7.35 This was a material decision. GEMA’s use of a transition resulted in depreciation being over £500 million higher in ED1 than if it had moved immediately to 45-year asset lives for new assets. However, the context of the relatively higher depreciation charges in ED1 was that they represented a mitigation of what would otherwise be a reduction in charges of over £1.1 billion as a result of the decision to change the approach to asset lives.

7.36 BGT argued that, having decided to move to a 45-year asset life policy, GEMA should have implemented it as quickly as possible.

7.37 Notwithstanding GEMA’s evidence at the oral hearing which cast some doubt on whether it would implement this policy in full in the long term, we first consider the impact on consumers and financeability of the approach explained in GEMA’s RIIO-ED1 documentation. As such, we consider BGT’s claim that the use of a transition was contrary to GEMA’s duties: to protect the interests of consumers; to promote efficiency; and to target its activities only at cases where action is needed.

7.38 The effect of GEMA’s re-profiling was to smooth the effect of the change to a 45-year asset life policy during RIIO-ED1. As Figure 8 shows, the annual cost to consumers of the change to a 45-year asset life policy would result in significant inter-generational effects without a transition. The graph shows that the annual costs would reduce in the period to around 2035 before rising sharply by the time the 45-year asset life policy would be fully reflected in economic asset values. Given the scale of these effects on different generations of consumers, it does not therefore seem unreasonable for GEMA to have considered the need for a transition.

7.39 BGT also argued that GEMA gave unsupported weight to financeability concerns.

7.40 As with the impact on consumers, given the scale of the effect on revenue and depreciation, it seems to us to be appropriate for GEMA to have assumed that some impact on financeability could occur over the coming periods under
the move to a 45-year life. The principle of applying a transition appears to us a legitimate option for addressing those financeability concerns.

7.41 BGT’s evidence, which demonstrated only a moderate effect on overall revenue, does not seem to us to address directly the question of whether there was an impact on financeability that related to the level of key financial ratios. GEMA indicated throughout the process of the change in ED1 asset lives that it would consider the effect on financial ratios of its policy, and would consider representations from DNOs. It therefore appears consistent that GEMA should consider the option of a transition to mitigate the effect on financeability.

7.42 Therefore, assuming full implementation of the 45-year asset life policy, the proposed transition appears to be a suitable way of offsetting financeability risks and spreading the impact of increased costs to consumers over different generations by creating a shallower trend in price rises to customers in the longer-term with increased costs to current consumers.

7.43 We recognise that the analysis presented by BGT demonstrated that the transition only partly mitigated the effect. This does not mean that GEMA was wrong in implementing a transition. The transition applied by GEMA was based on evidence from the DNOs about what would address the financeability concerns identified by GEMA, and what could be implemented by changes in the timing of revenues between periods.

7.44 BGT’s Notice of Appeal claimed that GEMA gave unsupported weight to financeability concerns and, at the same time, insufficient weight to the interests of current consumers. In considering the approach to the change in depreciation, GEMA was necessarily balancing the interests of current and future consumers, and also the financing considerations of DNOs in the short and long term. It seems to us that GEMA balanced the interests of current and future consumers in deciding to apply a transition, and that this was based on evidence from firms that financeability issues may otherwise occur. Whilst there may have been other ways in which GEMA could have balanced these interests, we do not agree that this gave undue or unsupported weight to financeability concerns.

7.45 In summary, we consider that GEMA was not wrong to consider a transition. Having received and assessed evidence from DNOs that there may be financeability issues in future periods in the absence of a transition, GEMA then implemented a transition. We agree that the approach taken by GEMA was only one of a number of alternative paths that it could have followed to address issues around financeability or inter-generational effects. However, we have seen no evidence that GEMA was wrong in choosing the approach
that it did. In particular, we consider that the expectation of a sharp decline in revenue and consequent financeability concerns are adequate reasons for implementation of a transition, and BGT did not provide evidence that GEMA’s assumptions in choosing its particular approach to transition were flawed.

**Alleged procedural flaws**

7.46 BGT claimed that GEMA’s approach was procedurally flawed, and therefore wrong in law.

7.47 We accept that there are some legitimate concerns about the underlying 45-year asset life policy and the rationale for it. This was brought into question by both the analysis within GEMA’s witness statement and also the oral hearing evidence. The change in asset life would potentially put companies under significant financial strain in the intervening periods, followed by a material increase in equity and asset value.

7.48 This does not show, in itself, that the use of a 45-year life was wrong, as it may have advantages in terms of the prices reflecting economic values which should be balanced against these risks. However, it highlights significant disadvantages with the policy and it is not clear that these have yet been fully assessed. We note that GEMA’s choice of asset life was based on analysis from its advisers, a consortium led by CEPA that included relatively limited scenario analysis of the financial effects of the choice of asset lives – assuming a significant increase in assets would offset the shorter-term effects and excluding effects after 2050.266

7.49 While we were surprised to receive the new evidence from GEMA at the hearing which, for the first time, provided a separate justification for the transition (that the underlying long-term policy was likely to be revisited), we consider that GEMA’s evidence was credible. The option of undertaking a review within the period is, in our view, a sensible response to the identification of concerns with the underlying policy, as any conclusions should not affect the level of investment or the delivery of outputs within the RIIO-ED1 period. Furthermore, in a context where a review is to take place, there is a strong argument in support of transitional arrangements which soften the impact in ED1 of the risks associated with the long-term policy.

---

266 CEPA’s analysis also excluded certain other output measures, such as the financial effects of a change in asset lives.
Therefore, the evidence that GEMA may further review the underlying policy does not appear to us to demonstrate that GEMA’s approach to setting depreciation levels in ED1 was wrong in circumstances where:

(a) either GEMA continues to move towards a 45-year asset life – in which case transitional arrangements appears to us to be an appropriate option that would offset the significant revenue reductions and increased stresses on financeability which would otherwise occur beyond ED1; or

(b) GEMA revisits the change in asset life prior to ED2. If such a review were to occur, we would expect a review only to result in a mitigation of the effect of the change. In other words, we expect that any review would result in a decision either to maintain the move to 45-year asset lives, ie revert to (a), or to increase the depreciation charge in ED2 relative to the depreciation charge consequent to a change to 45 years for all assets.

In either case, it does not seem to us to be wrong to implement the depreciation profile used by GEMA for the reasons proposed by BGT.

In general, we consider that GEMA’s approach did not include as much consultation or impact analysis of the effects of the move to 45 years from 20 years as might have been expected. GEMA’s 2011 consultation included no analysis of the financial effects of the change, or the relative effects on different generations of consumers.\(^{267}\) The transition was a practical consequence of the overall strategy, but the case provided by GEMA in the Draft Determinations for that overall strategy was, as BGT noted, limited.

However, as GEMA pointed out in its Response, it had carried out a specific consultation in relation to asset lives for electricity distribution and made available the CEPA report on which it had relied for its overall policy. There was therefore an opportunity to raise concerns about the evidence base for the policy and query the need for transitional arrangements over one price control period, a preference for which had been flagged in GEMA’s consultation. We are not persuaded therefore that there were flaws in the process for introducing the transitional arrangements such that GEMA’s final decision was wrong.

It seems to us that the evidence the DNOs had provided to GEMA was applied by GEMA correctly in making its proposal for a transition. GEMA provided an indication to all parties that it would consider representations in respect of transitional arrangements. As part of the business plans, GEMA received proposals from DNOs. GEMA accepted these proposals and put

\(^{267}\) GEMA (2011), ‘Open letter consultation on the regulatory asset lives for electricity distribution assets’.
forward a consultation on the approach. It proposed an adjustment at the industry level, to reflect that a change in asset lives has an effect on all DNOs.

7.55 To conclude that GEMA was wrong in law in this respect, we consider that we would need to be satisfied that there was a failure of process which was sufficient to undermine the substance of the Decision in respect of the transitional asset lives arrangements. BGT contended that GEMA could have provided it with more information on the supporting evidence behind its proposal for a transition. However, it does not seem to us that the absence of this information had a material effect on BGT’s ability to respond to the consultation or on the quality of evidence available to GEMA in making its decision, to a sufficient extent as to call into doubt the validity of that decision. For example, the approach to depreciation rates is part of GEMA’s price control methodology which has been subject to public consultation, and BGT was able to estimate the impact of the transition with its Notice of Appeal.

7.56 This is in contrast to the Vodafone v Ofcom case cited in BGT’s reply to our provisional determination, where a lack of technical understanding of the relevant issues was found to result in an inadequate process. In the case of BGT’s ground 4, GEMA identified the process by which it had identified the need for transitional arrangements, and then explained those proposed arrangements. This provided BGT with an opportunity to make the case for alternative transitional arrangements and provide analysis of the effect of such alternative arrangements.

7.57 In summary, we consider that BGT identified some shortcomings relative to best practice in GEMA’s consultation process, but that these were not sufficient in this case to demonstrate that either BGT was not able to respond to the consultation or that it did not understand what GEMA had proposed. We therefore do not conclude that there were procedural flaws that amounted to an error in law.

Conclusion on appeal ground 4

7.58 We therefore determine that GEMA was not wrong, on any of the statutory grounds advanced by BGT, to implement a transition between 20-year and 45-year asset lives, rather than moving to 45-year asset lives immediately. Accordingly, we dismiss BGT’s appeal on ground 4.
8. **Ground 5: Change in cost of debt indexation**

*Background*

8.1 BGT’s fifth ground concerned GEMA’s approach to calculating the indexation of the cost of debt. The cost of debt was a component of the WACC which, in turn, was used in calculating DNOs’ allowed revenue. The RIIO-ED1 framework introduced for the first time an index for the cost of debt based on a long-term trailing average of market interest rates. Under the indexation process, the cost of debt was updated each year for changes in the index. This compared with previous approaches which involved forecasting a fixed cost of debt for the price control period. BGT did not challenge the principle of using an index; it challenged the index used.

8.2 GEMA revised its approach to indexation following its Strategy Decision and a separate consultation on the other component of the WACC, the equity market return. In its Strategy Consultation, GEMA had proposed that the cost of debt assumption included in the allowed return should be based on a ten-year simple trailing average cost of debt index. Its proposed index was the iBoxx non-financials 10+ maturity series for a range of broad ‘A’ and broad ‘BBB’-rated non-financial companies in the economy. This index comprises a large number of regulated and non-regulated companies. In addressing responses to the Strategy Consultation, some of which noted that this proposed approach did not take account of embedded debt efficiently incurred more than ten years ago, GEMA maintained its position but remained open to proposals to modify the index.268

8.3 In its Draft Determinations, GEMA proposed revisions to its approach to the index, having reviewed the representations.269 Specifically, it proposed a trailing average of benchmark bond yields that would extend each year from a ten-year period in 2015/16 to a 20-year period by 2025/26. It described this as a ‘trombone’. GEMA said that its revised approach would offer the sector a ‘close match between cost of debt allowances and actual debt costs across a wide range of future interest rate scenarios’.270

8.4 GEMA said that several DNOs had presented evidence in their slow-track business plans that the original ten-year trailing average index was forecast to under-recover their interest costs during ED1. GEMA’s analysis confirmed this

---

269 *Draft Determinations*, paragraph 5.11.
270 *Draft Determinations*, paragraph 2.27. This revised approach was proposed after GEMA’s decision to fast-track WPD, and therefore WPD has the same ten-year trailing average as was implemented in RIIO-T1 and GD1.
evidence and concluded that ‘the 10-year trailing average index does not meet the criteria we used for RIIO-T1 and GD1. In particular, we tried to ensure that introducing an index made the forecast interest costs of a typical network operator and its cost of debt allowances broadly equivalent.’

8.5 GEMA confirmed that the revised index would still be based on the iBoxx non-financials 10+ maturity series for a range of broad ‘A’ and broad ‘BBB’ credit ratings. It would now, however, be for a longer period.

8.6 GEMA said that under the revised approach, the index would not affect allowances for the slow-track DNOs in the first year of RIIO-ED1 since it started with a ten-year trailing average. Subsequent years would have progressively longer trailing average periods.

8.7 In its Final Determinations, GEMA confirmed the approach as proposed in its Draft Determinations.

**Summary of BGT’s appeal ground 5**

8.8 BGT presented five core criticisms of GEMA’s approach to the cost of debt indexation:

(a) The change in approach leads to an allowance for additional debt costs and this was not in consumers’ interests, absent any strong countervailing justification.

(b) Aligning the allowance to actual costs failed to assess if the DNO debt costs were efficient. BGT argued an efficiency assessment was possible and was necessary and proportionate. GEMA failed to consider if other factors, such as actual DNO gearing levels, led to the original fixed ten-year approach not recovering actual costs.

(c) GEMA ignored the benefits that DNOs have experienced known as the ‘halo effect’ – this described DNOs’ ability to outperform the chosen index (iBoxx).

(d) The modified index gave greater weight to the higher interest rate environment prior to 2008. The trombone approach led to unequal weights in timing (higher in the early years). This was not an issue with the original ten-year trailing approach.

---

271 Draft Determination, paragraph 5.10.
Reducing risks arising from future interest rate uncertainty benefited investors, but not consumers.

8.9 BGT estimated the additional costs for consumers to be around £120 million over the RIIO-ED1 period. BGT also criticised GEMA on its procedure by expressing a view it had ‘failed to provide sufficient reasons for departing from its original approach’, given that the Draft Determinations adopted a different approach to that set out in the Strategy Consultation and subsequent Strategy Decision.

Summary of GEMA’s response to appeal ground 5

8.10 In its Response, GEMA explained the likely impact of its approach on consumers. It argued that consumer benefits would include protection for existing and future consumers resulting from a stable and predictable regulatory environment that secured investor confidence and thereby facilitated low financing costs. It also noted that an index approach removed the possibility of forecasting errors that had historically often benefited investors rather than consumers.

8.11 In summarising its Response to BGT’s Notice of Appeal, GEMA said:

(a) The decision to move away from the ten-year index set out in the Strategy Decision was the result of GEMA 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, GEMA said it was clear that the ten-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 was a better solution in terms of costs to consumers than the proposals from the DNOs, in response to the original ten-year trailing average, which involved an immediate move to a longer index.

(b) The 10- to 20-year trombone still, in GEMA’s view, under-provided for the DNOs’ cost of debt, but by a margin that it considered was reasonable and justifiable. There was no basis on which this could be considered as being too generous and 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 did not mean that it was not in

\[272\] BGT’s Notice of Appeal, paragraph 4.128 (e).
\[273\] GEMA’s Response, paragraph 261.
consumers’ interests. Consumers’ interests had to be considered broadly and included 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 commitment.

8.12 GEMA also challenged the procedural issues raised by BGT and emphasised that it was reasonable for it to change its approach, after consultation, from that indicated at the initial strategy stages. It provided evidence in the form of a witness statement from Ian Rowson (Ian Rowson’s second witness statement) which provided additional clarification about GEMA’s reasoning in implementing the trombone index.

8.13 GEMA stated that its approach was to consider efficiency of debt at the industry level, not to assess the efficiency of individual companies or their debt portfolios. In support of its Draft Determinations, it provided analysis of the proposed ‘trombone’ approach at the industry level, which we replicate below:

**Figure 9: GEMA’s interest rate scenario modelling results**

![Graph showing GEMA's interest rate scenario modelling results](Source: GEMA Draft Determination ‘Financing Issues’ Annex, Figure 2.1 (30 July 2014)).

8.14 GEMA’s modelling of future interest rates looked at four scenarios based on a nominal level of interest rates between 3.5 and 7.5%. GEMA noted that:

(a) In referring to the left-hand chart: the ten-year index in particular would expose DNOs to relatively high levels of risk, with an expectation of significant under provision for DNOs’ forecast cost of debt towards the second half of the RIIO-ED1 period except under the highest market interest rate scenarios.

(b) In terms of the right-hand chart: the trombone index starting with a trailing average period of ten years would slightly under-provide for DNOs’ forecast cost of debt. Hence GEMA concluded it was not a perfect match,
but more reasonable. GEMA noted that its revised approach to the cost of debt should be considered alongside the cost of equity and other wider considerations in terms of determining financeability considerations and the overall weighted cost of capital.

8.15 GEMA commented that its approach was consistent with the position that financing decisions are for the companies to take, and the regulator’s role is not to review the efficiency of each debt issuance. In terms of protecting consumers from any poor or imprudent financial decisions from individual DNOs, GEMA added that it had measures designed to protect consumers against inefficient debt issuance:

- a notional gearing approach;
- ring-fencing protections; and
- a requirement for DNOs to maintain an adequate investment grade rating.

8.16 In principle, these should protect both consumers and debt providers from any unusual corporate activity with respect to debt costs. GEMA noted that its position was consistent with its previous regulatory approach and consistent with those of other utility regulators.

Summary of third party responses to appeal ground 5

8.17 The joint submission from the DNOs largely supported the points made by GEMA in defence of using the trombone approach. The DNOs submitted a report by NERA that provided analysis which further supported points made by GEMA in its Response. The NERA report also provided further analysis of the halo effect, including analysis which suggested that the correct level of the halo effect was in fact lower than assumed by GEMA, and close to zero.274

8.18 Citizens Advice submitted that the effects of the trombone had not been shown to be positive for consumers, in particular given the increased maturity would result in a longer period before lower interest rates would be shared with consumers.275

Summary of BGT’s Reply to appeal ground 5

8.19 In its Reply, BGT said that GEMA had failed to address the central criticism made by BGT that the trombone had been introduced without adequate

---

275 Citizens Advice’s response to BGT’s Notice of Appeal.
assessment of the efficiency of the DNOs’ financing costs. BGT argued that the justification of the trombone was weak, absent this efficiency assessment.

8.20 It provided a second report challenging GEMA’s supporting analysis. This challenged GEMA’s interpretation of the relevance of the KPMG analysis of debt efficiency and pointed to what it alleged was a lack of consideration of the wide range of observed financing costs.

8.21 BGT also cited a Moody’s Report that had estimated the impact of the trombone in ED1 at £250 million compared with the estimate of £120 million in BGT’s Notice of Appeal.276

Our assessment of appeal ground 5

8.22 In reviewing this ground, we note that there is a degree of consensus between BGT and GEMA on the consequences of moving to the trombone from a simple trailing average. BGT has also not challenged the use of an index. The parties disagree, however, on the justification for the change and the overall impact on consumers.

8.23 We consider the likely effect of the trombone on the cost of debt in the context of GEMA’s justification for it. We then assess the particular criticisms in BGT’s Notice of Appeal and GEMA’s Response.

Effect of the trombone compared to the ten-year trailing average

8.24 The three charts in Figures 10 to 12 below seek to illustrate the difference between the original ten-year index and the revised ‘trombone’ approach for the slow-tracked DNOs; and the likely consequences for the cost of debt. The figures illustrate the trends in the actual cost of debt since 2004, together with projected cost of debt in ED1, and how these translate into averages to be used for indexation. We have adopted simplified trends in interest rates broadly matching actual historical levels and a central view of forward projections.

8.25 Under GEMA’s trombone approach, the average in each year is based on all the years since 2004; under the alternative proposed by BGT, the average is always over ten years, and earlier years ‘fall out’ of the index later in the period. The resultant consequences are that, under the trombone approach:

- the pre-2010 high interest costs are tracked for longer;

---

276 Moody’s (11 March 2015), Final Determination appeals create uncertainty but major changes unlikely.
• since it is a longer index, the value of the index is less sensitive to future interest rate changes; and

• the indices are expected to diverge in the second half of ED1; however in the longer term (beyond ED1), the rates under the two indices may be more likely to converge.

8.26 Figure 10 illustrates that, for the first year of the ED1 price control period, GEMA’s change in index has no impact. Under both the original proposal (ten-year trailing) and under the trombone approach, the period of the iBoxx index that is tracked is 2004 to 2014.

Figure 10: Illustration of trombone and original ten-year index at year 1

Source: CMA analysis.

8.27 Figure 11 below shows that when the midpoint of the eight-year RIIO-ED1 control period is reached, the original ten-year index would have shifted to the right as it would have tracked the debt index for 2008 to 2018. Under the trombone, the index start date remains at 2004 and now tracks debt costs for 14 years (ie from 2004 to 2018). Thus the index is averaged over a longer
period and produces a higher debt cost allowance than the ten-year approach. The difference is relatively small.\textsuperscript{277}

Figure 11: Illustration of trombone and original ten-year index at year 4

Year 4 of ED1: 10-year moved to right. Trombone 14 years. Original 10-year would have used 2008–2017. Trombone uses 2004–2017

8.28 Figure 12 below illustrates the position at the end of the eight-year RIIO-ED1 price control period. If the original ten-year had been used, interest rates to 2012 would have fallen out of the index as the relevant ten-year index would have been 2013 to 2023. A consequence of this would be that the pre-2010 high interest rate peak would not affect the financing costs in ED1 allowed revenues. By comparison, under the trombone, they are retained although the influence of this peak period on the average is reduced as the relevant trombone period has been extended to 18 years. The combined effect is that the relative difference in allowed debt costs between the original ten-year trailing average and the trombone has become increasingly material.

\textsuperscript{277} The difference is expected to be small as, absent sharp and unexpected changes in interest rates, the average interest rate for the period given additional weight under the trombone (2004 to 2008) is expected to be relatively similar to the average interest rate within the period given weight in both indices (2008 to 2018).
Figure 12: Illustration of trombone and original ten-year index at year 8

Final (8th) year of ED1: ten-year further right. Trombone 18 years

Source: CMA analysis.

8.29 This analysis is consistent with the GEMA analysis that it performed in coming to the figures within its Draft Determinations.

8.30 Figure 13 illustrates the projected trends in the two indices during the ED1 and ED2 control periods. The relative difference in the allowed cost of debt increases in the latter period of ED1. It is based on this relative difference that BGT estimated to be around £120 million over the RIIO-ED1 period. Based on the scenarios for future interest rates in Figures 9 to 11 above, the difference between the indices then starts to decline during ED2.
Figure 13: Cost of debt allowance

Source: CMA analysis.

Justification for the trombone

8.31 GEMA did not challenge BGT’s estimate of £120 million of the effect of the trombone in RIIO-ED1. It did, however, argue that this was a misleading view of the impact. GEMA argued that the trombone was necessary because it was in line with the commitment in the RIIO handbook to remunerate ‘efficiently incurred debt costs’.

8.32 Our review of DNOs’ historical debt supports the view that the trombone was likely to reflect the rates at which this embedded debt was incurred. We note that DNOs did not issue much debt within the period of 2008 to 2010. However, DNOs did issue debt prior to 2004, at a time when prevailing rates were higher and more comparable with the higher rates in 2008 to 2010 which are retained in the trombone for longer as shown above. Therefore, while the trombone did not reflect the actual timing of DNO debt issuance, the trombone appears to be a reasonable proxy for the embedded debt costs of DNOs. We also note that the average maturity of DNOs’ actual debt is close to 20 years and therefore more consistent with the maturity of the ED1 trombone. As a result, the exposure of DNOs (and consumers) to changes in interest rates under the trombone is more consistent with the actual level of issuance expected during ED1 at the industry level.

8.33 On this basis, the trombone would appear to meet GEMA’s broad objective to cover DNO debt costs at the industry level, assuming that DNOs are able to raise new debt in ED1, on average, at a level consistent with the iBoxx index. Therefore, we agree with GEMA that the trombone was designed in a way that was consistent with its stated objectives for indexation. We note this was
not intended to apply at the company level and some DNOs have a much higher embedded cost of debt than the trombone.

8.34 In the rest of this section, we take account of these considerations in assessing BGT’s specific criticisms of GEMA’s approach. First, we consider BGT’s criticism that it was not sufficient for GEMA to justify significant incremental costs by reference to the recovery of actual costs absent any analysis as to whether those costs had been efficiently incurred. We then consider its estimate of the halo effect under which BGT contends that DNOs are likely to outperform the index going forward.

Assessment of efficiency

8.35 BGT argued that GEMA had failed in its duty to ensure consumers only pay for efficient costs by failing to undertake an efficiency assessment of the individual DNOs. It argued that such an assessment was possible to do and was necessary and proportionate. BGT highlighted the range in debt costs of the DNOs and presented this as evidence that it was appropriate to investigate if those with high relative debt costs had efficient financing arrangements in place.

8.36 We note from our own review of DNOs’ historical debt costs that there is a wide range of debt costs. For example, two DNO groups will not recover their actual financing costs under the trombone; and other DNO groups would have potentially outperformed the ten-year index.

8.37 In assessing GEMA’s approach to considering the efficiency of DNOs’ incurred debt, we do not attach significant weight to the confidential report by KPMG on one DNO’s debt issuance and GEMA’s assessment that this confirmed the debt reviewed was efficiently incurred. Elsewhere, GEMA argued that it was not able to review the individual debt positions of DNOs.

8.38 We attach more weight to the argument which recognises the challenges with identifying an effective efficiency test at the industry level. It is a common regulatory approach for sector regulators to consider debt costs at an industry level rather than an individual company level. In this light, GEMA’s approach seems broadly consistent with accepted regulatory practice.

8.39 We also consider whether there were appropriate incentives in place under the trombone approach for DNOs to secure efficient financing costs going forward within RIIO-ED1. A feature of the indexation approach was that if the DNOs outperformed the iBoxx index, the market benchmark, then they retained this benefit for the remainder of the control period. This is consistent
with the outperformance incentives in place at previous price controls when GEMA’s approach was based on setting an ex ante cost of debt allowance.

8.40 GEMA noted at its hearing that there were also strong incentives to avoid under-performance. It commented that:

If a company takes out particularly expensive debt, more expensive than it needs to, then it will effectively suffer the consequences or very substantially suffer the consequences for the lifetime of that debt. They are quite strongly incentivised to manage their debt costs in that way.

We agree in principle with this approach to incentives.

8.41 In terms of protecting consumers from any poor or imprudent financial decisions from individual DNOs, GEMA commented that its approach was consistent with the position that financing decisions were for the companies to take. The regulator’s role was not to review the efficiency of each debt issuance. GEMA added that it had measures designed to protect consumers against inefficient debt issuance:

- a notional gearing approach;
- ring-fencing protections; and
- a requirement for DNOs to maintain an adequate investment-grade rating.

8.42 In principle, these measures should protect both consumers and debt providers from any unusual corporate activity with respect to debt costs. GEMA noted that its position was consistent with its previous regulatory approach and consistent with those of other utility regulators. We agree.

8.43 Taking all of these points into consideration, we consider that the use of the trombone is consistent with the objective of promoting efficient finance.

_Halo effect_

8.44 We consider BGT’s argument that GEMA had ignored the existence of the ‘halo effect’ – a term used to describe the DNO’s ability to outperform the chosen market index (the iBoxx) that forms the basis of the cost of debt allowance.

8.45 The ‘halo effect’ is important as it directly affects whether the new debt assumption is reasonable. If, on average, DNOs can be expected to outperform the iBoxx index over ED1, then the use of the index (unadjusted)
could be wrong as it would result in consumers paying more than necessary for the portion of the index which relates to debt issued over ED1.

8.46 We reviewed the evidence supplied of the halo effect by BGT, GEMA, and also NERA\textsuperscript{278} on behalf of the DNOs. Given the different values suggested, we also undertook our own analysis.

8.47 In its Notice of Appeal and subsequent representations, BGT referred to a value of 50 basis points that GEMA had previously quoted, in error, at its Draft Determinations. In its Final Determinations, GEMA estimated that the size of the halo effect since 2012 was around 20 basis points. BGT did not undertake its own assessment of the halo effect.

8.48 Any analysis of the halo effect needs to be treated with some caution, since it depends on factors such as the time period selected for the analysis; the approach taken with any outlier observations; differences between debt in the regulated entity and that at a Group Company level (non-regulated business); together with the approach taken with some debt that has unusual lengths of maturity (either short or very long).

8.49 We compared the cost of debt of the individual DNOs’ actual financing arrangements, and those to the market index rates on the date of issuance. We then compared the average of the iBoxx index\textsuperscript{279} (green flat line) over a ten-year time period and the average of the DNO debt costs (blue flat line) over this same period. This is shown below in Figure 14, the difference between the two flat lines being the assessed average ‘halo effect’ of 0.2%. This is broadly consistent with the 20 basis points estimated by GEMA.

\textsuperscript{278} NERA (17 April 2015), Cost of Debt Indexation at RIIO-ED1: A response to the AlixPartners Report.

\textsuperscript{279} In this chart the iBoxx index is the daily value, as published by Markit.
We reviewed the trends within our analysis, which suggest that there has been a change in the extent of the halo effect over time. The average value of the halo effect appears to have been reduced since the financial crisis in the period 2008 to 2009, with a number of the bond issues in recent years being above the index. A number of factors may influence this reduction, including changes to the credit ratings and capital structures of the DNOs, together with changes to external market conditions. This is illustrated in Figure 15 below where the halo effect is around 45 basis points for debt issued by the DNOs up to the end of 2009 (illustrated by the blue line), but then there is, on average, no halo effect (a zero value, as shown in the green line) thereafter.
8.51 Such findings are consistent with the NERA analysis that was undertaken on behalf of the DNOs.

8.52 In summary, our analysis of the level of the halo effect estimated a value of around 20 basis points (0.2%), with halo values on longer-term bonds taken out in the last five years appearing to indicate zero or small negative halo values (ie a cost of debt at or higher than the iBoxx index would indicate). These negative values are likely to reflect changes in the wider financial market conditions. For example, relative to the iBoxx, the DNOs’ long-term financing arrangements are at a higher cost since the recession and this suggests added caution may be evident in financial markets following recent financial volatility.

8.53 An historical halo effect of around 20 basis points does not mean that this is the likely value for the future ED1 period. The halo effect could increase, either due to increased certainty over the ED1 settlement, or due to other changes in financial market conditions. However, our analysis of trends in the halo effect did not lead us to be overly concerned that high values were prevailing or would do so in the future.

8.54 In summary, our analysis suggests that GEMA’s assessment of the halo was adequate, and recent data suggests that the halo has been diminishing (ie

---

Figure 15: Analysis of ‘halo effect’ differences pre and post period of financial volatility in markets

Source: CMA analysis of actual DNO debt positions and the iBoxx index.

DNOs have been less able to outperform the index). We do not therefore consider that GEMA was wrong in assuming a zero halo effect for new debt (net of issuance costs) or that GEMA failed to take account of any halo effect.

**Consumer interests**

8.55 We note that GEMA’s approach, in particular at the Draft Determinations, focused on the benefits to investors. It considered that there were material benefits from regulatory consistency, and in particular the longer-term approach to matching broadly the actual DNO debt costs at an industry level when determining the allowed cost of debt.

8.56 Whilst GEMA did not quantify any consumer benefits, it referred in evidence to two potential effects, which we consider in this section:281

(a) improved regulatory stability will tend to result in a lower cost of capital environment, through a lower overall perception of risk within the sector; and

(b) lower financial risk, combined with strong incentives on financing costs can translate into a lower cost of debt environment which can be passed to consumers at future reviews.

8.57 It is difficult to draw a precise link between regulatory stability and individual elements of the cost of capital. However, as illustrated in Table 14, the cost of capital in ED1 is low relative to previous price controls. The cost of debt component has fallen, due to market conditions, but the overall WACC has continued to decline over and above that would result from market movements alone.

**Table 14: Cost of capital allowances over past three price controls**

<table>
<thead>
<tr>
<th></th>
<th>DPCR4</th>
<th>DPCR5</th>
<th>RIIO-ED1 (slow-track)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of debt</td>
<td>4.1</td>
<td>3.6</td>
<td>2.6 provisional</td>
</tr>
<tr>
<td>Notional gearing</td>
<td>57.5</td>
<td>65</td>
<td>65</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>5.5</td>
<td>4.7</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Source: CMA analysis of GEMA last three Final Determinations for the DNOs.

8.58 This pattern is consistent with GEMA’s position that it promoted a stable regulatory environment that resulted in lower financing costs which, by implication, benefited consumers. We note that GEMA provided supporting

---

281 [GEMA’s Response](#), paragraph 278.
commentary from Moody’s about the tangible benefits of a stable regulatory regime on financial risk.

8.59 GEMA’s analysis suggested that the cost of debt was around 10 to 15 basis points (0.1 to 0.15%) higher on average with the trombone compared to an allowance based on the 10-year trailing index. The precise value depended on future interest rate levels. However, we agree that the cost of debt effect was small relative to the potential benefits of stability, to the extent that GEMA’s approach was perceived to have contributed to the declines in the observed WACC over time. We therefore agree with GEMA that the trombone can provide consumer benefits through improved regulatory stability, reducing DNOs’ exposure to future interest rate uncertainty.

8.60 We also consider the impact of the use of the index on the cost of debt. We identify above that there are strong incentives to outperform the index. As a result, DNOs may, on average, achieve financing costs on new debt below the index, either due to an increased ‘halo effect’, or through the choice of timing for issuance of debt during ED1.

8.61 There is no direct mechanism for consumers to share the benefits from any individual DNO outperforming the iBoxx index during the ED1 price control period. However, there may be an effect on charges in ED2 and beyond. At its hearing, GEMA stated that:

If the industry as a whole outperforms the index then that we would see as good news, because that potentially creates a set of circumstances where we can say as with all good incentive mechanisms we would have the opportunity then to pass that benefit back to consumers. It is a really important principle that we established at the time of our RIIO decision that we would at each price review check to ensure that the cost of debt index remained a fair estimate of the costs of debt.

8.62 Our view is that, when considering the effect of the trombone on consumers, we should take into account this potential benefit from lower future debt costs. We note that this could in theory occur under any approach to indexation, but the use of an index which is consistent with GEMA’s regulatory principles is likely to strengthen the incentives.

8.63 We note BGT’s estimate was that consumers would pay around 50 pence extra per year as a result of the higher expected level of the trombone index in the ED1 period compared with the original ten-year trailing index proposed.

---

282 CMA analysis of data provided by GEMA in support of Figure 9 above.
The scale of this effect needs to be considered in the context of the longer-term consumer benefits which should result from an index which more broadly matches industry debt profiles, provides incentives to DNOs to reduce their debt costs, and will also increase investor confidence.

8.64 Taking all this in the round, we consider that there are long-term benefits to consumers of regulatory consistency and hence a low cost of capital environment, and these can be reasonably expected to outweigh any additional costs from the trombone in ED1. We also consider that GEMA has made the case that the trombone will contribute to those long-term benefits. As a result, we do not consider that BGT demonstrated that the trombone was contrary to the interests of consumers.

8.65 Whilst BGT asserted that GEMA failed to provide sufficient reasons for its revised approach to the cost of debt index, we do not consider that GEMA’s procedural approach had serious shortcomings. GEMA explained the revised approach in its Draft Determinations which were in turn subject to consultation before the Decision was made.

**Conclusion on appeal ground 5**

8.66 We therefore determine that GEMA’s decision on the cost of debt indexation was not wrong on any of the statutory grounds. Accordingly, we dismiss BGT’s appeal on ground 5.

9. **Determination on costs**

**The CMA’s costs**

9.1 As we noted in our provisional determination, when determining an appeal, we must make an order requiring the payment of the costs incurred by the CMA in connection with that appeal.\(^{283}\)

9.2 Given that BGT’s appeal has been partially allowed, we are required to make an order that the CMA’s costs should be paid by one or more parties, in such proportions as we consider appropriate in all the circumstances.\(^{284}\)

9.3 In our provisional determination, we indicated that if our provisional view on the substance of BGT’s appeal were maintained at final determination, we would be minded to make an order requiring GEMA to pay 20% of the costs

---

\(^{283}\) EA89, Schedule 5A, paragraph 12(1).

\(^{284}\) EA89, Schedule 5A, paragraph 12(2)(c).
incurred by the CMA in connection with the appeal, and requiring BGT to pay 80% of those costs.

9.4 In the light of our final determination, which maintains the substantive conclusions on this appeal that were set out in the provisional determination, we consider that a costs order of this form remains appropriate in all the circumstances. In reaching that decision, we have had regard to the CC’s decision on costs in the E.ON case, where the CC held that, in making a split order in respect of its own costs, it should seek to reflect the substance of the appeal, and the time and effort expended by the CC in connection with the substance of the appeal.\(^{285}\) Although the statutory provisions on costs which the CC was applying in E.ON were somewhat different from those that we must apply in the present context,\(^{286}\) we find the E.ON decision to be of assistance as regards the approach we should take in respect of payment of the CMA’s costs.

9.5 We consider that each of BGT’s five grounds of appeal occupied a broadly similar amount of the CMA’s time and effort. Given that we allowed the appeal on only one of those five grounds, our view is that an order requiring BGT to pay 80% of the CMA’s costs, and requiring GEMA to pay 20% of those costs, properly reflects the substance of this appeal.

9.6 In its response to the BGT provisional determination, GEMA agrees in principle that an order in respect of the CMA’s costs should reflect the proportion of the appeal which has been dismissed/allowed. However, GEMA contends that a more appropriate order in line with that approach would be to require GEMA to pay 10% of the CMA’s costs, and BGT to pay the remaining 90%, on the basis that (in GEMA’s submission) we have only allowed BGT’s appeal on ground 3 on a very limited basis. Although it is true that we did not find that GEMA was wrong per se to have adjusted the IQI mechanism), we do not consider that this justifies the order that GEMA proposes. We consider that it is right to regard BGT as having succeeded on this ground, taken as a whole, notwithstanding that certain of the specific arguments made were not accepted. Accordingly, we consider that BGT should not be liable for the CMA’s costs in respect of this aspect of the appeal.\(^{287}\)

\(^{285}\) E.ON decision on costs, paragraph 9.

\(^{286}\) In particular, the statutory provisions on costs that were under consideration in E.ON did not expressly provide for the possibility of a split order on costs, in contrast to the costs provisions in Schedule 5A to EA89. However, the CC considered that, in certain circumstances, a split order could nonetheless be made.

\(^{287}\) For similar reasons, we reject UKPN’s submission that GEMA should only be required to bear a proportion (specifically 24%) of the CMA’s costs in respect of ground 3. We do not think such an order would appropriately reflect the substance of the appeal.
9.7 BGT similarly agrees that we should look at each ground separately and consider how costs might appropriately be apportioned bearing in mind each party’s relative success. BGT also considers that we should consider the parties’ conduct when considering what order to make in respect of the CMA’s costs.

9.8 As to the question of the parties’ relative success, BGT contends that our order in respect of the CMA’s costs should reflect the fact that, although we have dismissed its appeal on four of the five grounds, nonetheless we have found that there have been significant flaws in GEMA’s consultation process in respect of the subject matter of those grounds. In that regard, BGT submits that GEMA should bear all of the CMA’s costs in respect of grounds 1, 3 and 4, and that the parties should share responsibility for the CMA’s costs in respect of ground 2 (although BGT accepts that it should be responsible for the CMA’s costs in respect of ground 5).

9.9 For the reasons given above, we agree that GEMA should bear the CMA’s costs in respect of ground 3 given that BGT’s appeal on that ground has been allowed. However, in respect of the other grounds, and notwithstanding the fact that the CMA has made certain procedural criticisms of GEMA’s approach, we remain of the view that the substance of the appeal, and specifically GEMA’s overall ‘success’ in defending these grounds of appeal, justifies an order requiring BGT to bear the CMA’s costs of the grounds of appeal in question. In addition, we consider that the procedural issues identified did not have any substantial impact on the time and effort expended by the CMA in determining the relevant grounds of appeal.

9.10 We accept, in principle, BGT’s contention that conduct is one of the issues which we can take into account in deciding what order is appropriate in all the circumstances, in a case in which an appeal is only partially allowed. However, we are of the view that the matters of conduct raised by BGT at paragraph 17(c) of its submissions on costs are not sufficient to justify any departure from the split order we proposed in our provisional determination, particularly in the light of the complexity of GEMA’s underlying decision and the necessary time constraints under which it was operating in responding to BGT’s appeal.

9.11 Having carefully considered the specific issues of conduct relied on by BGT, we consider that, with one exception, they did not materially affect the substance of the appeal, or the time/expense incurred by the CMA in connection with it. The exception is that, in respect of BGT’s ground 1, we did have significant difficulties in establishing the precise history of the issue of ‘double recovery’, notwithstanding the extensive attempts by both GEMA and the DNOs to explain the position, and that this did involve some additional
time/effort on the part of the CMA. However, we recognise that this ground raised some complexity, with competing views on each side, and we consider that GEMA made conscientious efforts to establish the relevant facts. We therefore do not consider that this justifies a departure from our proposed order.

9.12 As to ground 2, we do not consider that GEMA’s requirement that disaggregated data should be disclosed subject to a confidentiality ring had any material effect on the CMA’s determination of the appeal or the time and expense which the CMA expended.

9.13 As to ground 4, we accept GEMA’s submission that although it put forward a new justification for the transitional arrangements in the course of the appeal relating to the potential revisitation of the change in asset life policy, we accepted that the transitional arrangements would have been justified in any event. Again, therefore, and by reference to the substance of the appeal, we do not consider that this factor is sufficient to justify a departure from our proposed order in respect of the CMA’s costs.

9.14 We will therefore make an order that BGT should pay 80%, and GEMA 20%, of the costs incurred by the CMA in connection with this appeal.

**Inter partes costs**

9.15 In contrast to the position in respect of the CMA’s own costs, we are not required by the statute to make an order in respect of inter partes costs. However, we have a discretion to make such order as we think fit for requiring one party to the appeal to make payments to another party in respect of costs reasonably incurred by that other party.²⁸⁸

9.16 We drew the parties’ attention to this discretion in our provisional determination, and invited any party seeking such an order to make an application supported by a statement of costs, in accordance with paragraph 5.6 of the Guidance. Both GEMA and BGT have made such an application. Consistently with its submissions in respect of the CMA’s own costs, GEMA contends that we should order BGT to pay 80% of its costs, based on the fact that BGT has lost on 90% of its appeal and the application of the so-called ‘double-deduction’ rule. BGT, for its part, submits that the proper conclusion in this case is that there should be no order as to the parties’ costs raising a number of arguments relating to, inter alia, GEMA’s conduct and the apparent

---

²⁸⁸ EA89, Schedule 5A, paragraph 12(3).
practice’ of the CAT in cases involving other regulators. Alternatively, BGT seeks an order that GEMA should pay two-thirds of BGT’s costs.

9.17 In considering whether, and if so what, order to make as to the payment of inter partes costs, our starting point is the Rules which provide, at Rule 19.3, that when deciding what order to make, the CMA will have regard to all the circumstances, including (i) the conduct of the parties, (ii) whether a party has succeeded in whole or in part, and (iii) the proportionality of the costs claimed.

9.18 Further, the Guidance explains that the CMA will normally order the unsuccessful party to pay the costs of the unsuccessful party, but that it may make a different order, by reference to the specific factors in Rule 19.3.

9.19 In the present case, we do not consider that it is helpful to think in terms of one party being successful or unsuccessful by reference to the appeal as a whole. BGT raised five discrete grounds of appeal, each raising distinct issues, and we therefore consider that it is appropriate to approach the assessment of inter partes costs on an issue-by-issue basis, considering (a) which party was ‘successful’ in respect of a given ground and then (b) whether it is appropriate in all the circumstances for the unsuccessful party in respect of that ground to pay the successful party’s costs, having regard in particular to the factors in Rule 19.3.

9.20 That is not to say that we consider we are bound to make an ‘issues-based’ costs order. We agree with GEMA’s contention that it is preferable to make a single adjusted costs order. However, in making such an order, the starting point is that it should reflect the parties’ relative success by reference to the individual grounds of appeal.

9.21 In this appeal, we consider it is right to regard GEMA as the ‘successful’ party in respect of four of BGT’s five grounds of appeal. Although, as set out above, we made certain criticisms of GEMA’s decision-making process in respect of some of those grounds (eg in relation to the quality of GEMA’s consultation), we did not regard these criticisms as sufficient to justify allowing BGT’s appeal on the grounds in question. Accordingly, it is plainly right to treat GEMA as the successful party in respect of those grounds. We therefore consider that the starting point is that BGT should pay GEMA’s costs reasonably incurred in respect of those grounds. As to the factors in Rule 19.3 which might, in principle, justify a departure from that starting point:

(a) For the reasons given above in relation to the CMA’s own costs, we do not consider that the complaints made by BGT as to GEMA’s conduct are sufficient to justify a departure from that starting point.
(b) We consider that is not accurate to say that GEMA has succeeded only ‘in part’ in respect of grounds 1, 2, 4 and 5. Each of those grounds was dismissed in full, even if GEMA came in for a degree of criticism along the way. Accordingly, we do not accord this factor any significant weight in our consideration of inter partes costs.

(c) As to the question of the proportionality of the costs claimed by GEMA, we note that GEMA’s schedule of costs specifies a total figure of £798,070.48 for the costs incurred by GEMA in connection with BGT’s appeal for the period 2 March to 30 September 2015. Given the potentially significant implications of BGT’s appeal for GEMA’s decision, and, in particular, the potential effect on the overall level of the price control for all the ‘slow-track’ DNOs if BGT’s appeal were to succeed, we do not consider that this sum is disproportionate.

9.22 We did not find BGT’s reliance on the alleged practice of the CAT in relation to the costs of other price control appeals to be of assistance. We are required to reach a view on the appropriate costs order by reference to all the circumstances of this case, in the light of the specific statutory regime and our published guidance on the approach that we will take to costs issues. We do not consider the views of other tribunals, in different statutory contexts, to be useful precedents.

9.23 It follows that our inter partes costs order should reflect the fact that GEMA succeeded on four of the five grounds raised in BGT’s appeal. However, in the light of the recognised difficulties in making an issues-based costs order, and the fact that, in our view, the respective grounds of appeal occupied a similar amount of time in the course of this appeal and are likely to have involved broadly similar costs, we consider that a just order in all the circumstances would be to hold BGT responsible for 80% of GEMA’s reasonably incurred costs.

9.24 However, our order needs also to reflect the fact that BGT was the successful party in respect of the third ground of appeal relating to the IQI mechanism. In line with the approach set out above, we consider that it would be appropriate to hold GEMA responsible for 20% of BGT’s reasonably incurred costs. GEMA has contended that any inter partes costs order should reflect the fact that BGT only partly succeeded in respect of ground 3, and that GEMA should therefore only be responsible for a sum amounting to 10% (not 20%) of BGT’s costs. However, for the reasons given above in relation to the CMA’s costs, we disagree. BGT can properly be regarded as the successful party in relation to this ground of appeal as a whole, in that we have accepted BGT’s contention that GEMA was wrong in relation to the adjustment it made to the IQI (even if we did not go so far as concluding that no adjustment, at all, was
justified). None of the factors in Rule 19.3, in our view, justify a departure from the principle that GEMA should be responsible for BGT’s costs in relation to this ground of appeal. Again, we prefer to avoid a strict issues-based approach and instead take the view that an appropriate order would require GEMA to pay 20% of BGT’s reasonably incurred costs.

9.25 As noted above, we agree with GEMA that it is preferable to make a single adjusted costs order. However, the ‘double deduction’ rule referred to in GEMA’s costs submissions cannot be applied unthinkingly in circumstances where the costs claimed by the parties are not identical, although we note that the costs claimed in this case are fairly similar (with GEMA claiming a total of £798,070.48\(^{289}\) and BGT claiming a total of £941,960.83\(^{290}\)). Although we are satisfied that each party’s costs were proportionate (particularly in the light of the sums at stake in this appeal), the statute expressly requires us also to consider, albeit on an appropriately broad-brush basis, whether the costs claimed were reasonably incurred.

9.26 Considering, first, GEMA’s schedule of costs, BGT contends that certain of GEMA’s costs have not been reasonably incurred. It criticises the extent of the costs claimed by GEMA for work done by (a) both in-house lawyers, and (b) by experts.

9.27 As to the former, we do not agree with BGT’s submissions that the items in respect of which in-house legal costs are claimed could not properly have been incurred by an external solicitor for legal work. Moreover, we consider that GEMA’s utilisation of in-house lawyers, at comparatively low hourly rates, is likely to have saved costs overall. For instance, the hourly rate claimed for GEMA’s Principal Legal Adviser, at a total of 753 hours, is substantially lower than the hourly rate for the two Hogan Lovells partners that were also engaged by GEMA, but who spent less time on the case (a combined total of 240 hours). In the circumstances, and taken in the round, we do not consider that GEMA’s in-house legal costs were unreasonably incurred.

9.28 As to the latter, BGT contends that GEMA’s costs of engaging experts (in the claimed sum of £142,478.18) are not recoverable. We disagree with BGT that these costs should be disallowed in full. The fact that GEMA did not adduce expert reports in the proceedings is not, in our view, decisive. In circumstances where BGT itself considered it necessary to adduce and rely on extensive expert evidence, incurring a total of over £400,000 in so doing, we consider that GEMA was plainly entitled to seek the advice of its own experts even if it did not formally adduce expert reports in the proceedings. In

\(^{289}\) For the period 2 March to 30 September 2015.
\(^{290}\) For the period 3 February to 30 September 2015.
addition, with the exception of one BGT expert, GEMA’s experts’ hourly rates are all lower than even the next cheapest experts engaged by BGT. BGT also engaged three experts at hourly rates that substantially exceed the highest hourly rate claimed by GEMA. Again, and having particular regard to the substantial disparity between the expert costs claimed by GEMA and BGT, we do not consider that it is necessary to make a reduction in respect of the expert costs claimed by GEMA.

9.29 Turning to BGT’s costs, we note that while both parties engaged external solicitors, multiple counsel, and expert economists, there are a number of respects in which the costs claimed by BGT appear to go beyond what we might reasonably have expected when compared with GEMA’s schedule of costs. By way of illustrative example, GEMA’s leading counsel, Mr Saini QC, was engaged for just under 260 hours. In contrast, one of the three junior counsel engaged by BGT – Mr Holmes – was engaged at an hourly rate that was 60% higher (with an almost identical, albeit slightly higher, number of hours claimed). We have already noted above the substantial discrepancies in terms of the hourly rates claimed in respect of the parties’ experts.

9.30 Standing back, and seeking to arrive at an approach which does justice in the circumstances of this case, we are of the view that it would have been reasonable for BGT to incur the same level of costs in connection with this appeal as those incurred by GEMA itself. Essentially, this amounts to a finding that the costs claimed by BGT (£941,960.83) should be reduced by approximately 15%. Although this is necessarily a broad-brush approach, we consider that it is a fair one having regard to the matters set out above, and particularly having regard to the fact that the CMA cannot sensibly be expected to carry out the level of detailed costs assessment that would typically be carried out at the conclusion of ordinary court proceedings.

9.31 We note that there is very likely to have been some duplication of resources given the number of internal and external lawyers, and experts, engaged by both sides. However, so far as we are able to ascertain from the costs schedules provided, we are unable to say that this factor was more significant in relation to either of the two parties. In the circumstances we regard this as a neutral factor.

9.32 The net result is that we regard it is appropriate and just in all the circumstances to make a single adjusted order that BGT should pay 60% of GEMA’s reasonably incurred costs of £798,070.48. This reflects our conclusion that BGT has succeeded in respect of 20% of its appeal, together with our view that the amount of costs incurred by BGT in excess of those incurred by GEMA itself should be regarded as not reasonably incurred.
Third party costs

9.33 We note, finally, the observation by one of the DNOs, UKPN, that it ‘seems an unfair result’ that the Guidance does not permit the DNOs as interested third parties to recover their costs. In fact, the relevant restriction is a feature of the EA89 itself, which only permits the CMA to make inter partes costs orders in favour of a ‘party’, defined as meaning either the appellant itself, or GEMA.\textsuperscript{291} The CMA therefore has no jurisdiction to make a costs award in favour of non-parties. The CMA does not comment on the fairness, or otherwise, of that feature of the statutory regime.

\textsuperscript{291} EA89, Schedule 5A, paragraph 13(2).
Glossary

**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. 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.

**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 (eg its costs) to that of best practice or to average levels within the sector.

**BGT**
British Gas Trading Limited.

**BMCS**
Broad measure of customer satisfaction. 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.

**Capex**
Capital expenditure. Expenditure on investment in long-lived assets. For more information on what this includes, see Ofgem’s RIG’s Glossary.
CC  Competition Commission. (From April 2014, the functions of the CC were taken over by the CMA.)

CI  Customer supply interruptions per year.

CMA  Competition and Markets Authority.

CML  Duration of interruptions to supply per year.

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 connection.

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 (eg 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), which use broadly similar credit rating scales, with D being the lowest rating (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.

DECC  Department of Energy and Climate Change.

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

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

**DPCR5**
Distribution price control review 5. The price control review for the electricity distribution network operators covering the period from 1 April 2010 to 31 March 2015.

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

**EHV**
Extra high voltage.

**EMID**
Western Power Distribution (East Midlands) plc.

**ENWL**
Electricity North West Limited.

**EO**
Energy Ombudsman/Ombudsman service. Ombudsman Services provides an independent dispute resolution service for the communications, energy, property and copyright licencing sectors.

**EPN**
UK Power Networks (Eastern Power Networks) plc.

**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’.

**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. |
| **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 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. |
| **Gearing** | A ratio measuring the extent to which a company is financed through debt borrowing. Ofgem calculates gearing as the percentage of net debt relative to the RAV. |
| **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; and |
| | • 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 expenditure. |
| **GHG** | Greenhouse gas. A collection of gases which absorb infrared radiation and trap its heat in the atmosphere. |
| **HV** | High voltage. Voltages over 1kV up to, but not including, 22kV. |
| **HV network** | The **DNO** network that operates at all voltages above 1kV up to and including 20kV. |
| **IIS** | Interruptions Incentive Scheme: a scheme offering incentives for the **DNOs** to improve the number and duration of customer supply interruptions |
| **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. |
| **Indexation** | The adjustment of an economic variable so that the variable rises or falls in accordance with the rate of inflation. |
| **IQI** | The Information Quality Incentive is used to set the strength of the upfront efficiency incentives each company faces according to differences between its forecast and **Ofgem**’s assessment of its (efficient) expenditure requirements. The aim of the tool is to encourage companies to submit more accurate expenditure forecasts to **Ofgem**. |
| **IT&T** | **IT** and **Telecoms**. The purchase, development, installation, and maintenance of non-operational computer and telecommunications systems and applications. |
| **LCN fund** | Low carbon networks fund. A mechanism introduced under the fifth distribution price control review to encourage the **DNOs** to use the ED1 price control period to prepare for the role they will have to play as Great Britain moves to a low carbon economy. The fund has £500 million available for **DNOs** and partners to innovate and trial new technologies, commercial arrangements and ways of operating their networks. |
| **Low carbon economy** | An economy which has a minimal output of greenhouse gas emissions. |
| **LPN** | UK Power Networks (London Power Networks) plc. |
| **LV** | Low voltage. This refers to voltages up to, but not including, 1kV. |
| **NOCs** | Network operating costs. Collectively includes the activities of:
- trouble call
- atypicals – severe weather one-in-20 events
- inspections and maintenance
- tree cutting
- NOCs Other

**NPg**  
Northern Powergrid Group. Comprising **NPgN** and **NPgY**.

**NPgN**  
Northern Powergrid (Northeast) Limited.

**NPgY**  
Northern Powergrid (Yorkshire) plc.

**ONS**  
Office for National Statistics.

**Opex**  
Operating expenditure. The costs of the day-to-day operation of the network such as staff costs, repairs and maintenance expenditures, and overheads.

**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.

**Price control (control)**  
The control developed by the regulator to set targets and allowed revenues for network companies.

**QoS costs**  
Quality of service 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.

**RAV**  
Regulatory asset value. The value ascribed by Ofgem to the capital employed in the licensee’s regulated distribution 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. The RAV is indexed to **RPI** in order to allow for the effects of inflation on the licensee's capital stock.
RIIO Revenue = Incentives + Innovation + Outputs. Ofgem’s new regulatory framework, stemming from the conclusions of the RPI-X@20 project. It builds on 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 period is from 1 April 2015 to 31 March 2023.

RIIO-GD1 The price control review for the gas distribution network operators. This price control is from 1 April 2013 to 31 March 2021.

RIIO-T1 The price control review for the electricity and gas transmission network operators. This price control is from 1 April 2013 to 31 March 2021.

RLCAs Regional Labour Cost Adjustments – undertaken to normalise DNO totex data prior to benchmarking.

RLCDs Regional labour cost differences.

RPE Real price effects. Expected changes in input prices, eg wages, relative to the RPI.

RPI Retail prices index. The RPI is an aggregate measure of changes in the cost of living in the UK. It differs from the Consumer Prices Index (CPI) in that it 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.

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 the regulation of 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.

**SGBs**
Smart grid benefits – the reduced/avoided costs arising from the introduction of smart grids.

**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.

**SPD**
SPEN Energy Networks (Distribution) Limited.

**SPEN**
SPEN Energy Networks. Comprising SPD and SPMW.

**SPMW**
SPEN Energy Networks (Manweb) plc.

**SPN**
UK Power Networks (South East Power Networks) plc.

**SSEH**
Scottish and Southern Energy Power Distribution plc:
Scottish Hydro Electric Power Distribution plc.

**SSEPD**
Scottish and Southern Energy Power Distribution. Comprising SSEH and SSES.

**SSES**

**Supply chain**
Refers to all the parties involved in the delivery of electricity and gas to the final consumers, from electricity generators and gas shippers, through to electricity and gas suppliers.

**SWALES**
Western Power Distribution (South Wales) plc.

**SWEST**
Western Power Distribution (South West) plc.

**Totex**
Total expenditure. Totex generally consists of all the expenditure relating to a licensee’s regulated activities. It comprises total capex plus opex.

**Trombone**
The index applied to the cost of debt that commences as a 10-year index and extends up to 20 years.

**UKPN**
UK Power Networks comprising LPN; SPN; and EPN.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UQ cost benchmarking</strong></td>
<td>Upper quartile cost benchmarking refers to the approach of setting a benchmark at the 25th percentile (i.e., 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.</td>
</tr>
<tr>
<td><strong>WACC</strong></td>
<td>Weighted average cost of capital. 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.</td>
</tr>
<tr>
<td><strong>WMID</strong></td>
<td>Western Power Distribution (West Midlands) plc.</td>
</tr>
<tr>
<td><strong>WPD</strong></td>
<td>Western Power Distribution. Comprising WMID; EMID; SWALES; and SWEST.</td>
</tr>
</tbody>
</table>