In the Competition and Market Authority

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

British Gas Trading Limited

Appellant

v.

The Gas and Electricity Markets Authority

Respondent

NOTICE OF APPEAL

ENERGY LICENCE MODIFICATION

Appellant's name and address:

British Gas Trading Limited (BGT)
Millstream
Maidenhead Road
Windsor
Berkshire SL4 5GD

Appellant's legal representatives and address for receiving documents:

Towerhouse LLP
10 Fitzroy Square
London W1T 5HP
FAO Paul Brisby, Zach Meyers

Electronic address for receiving documents:

paul.brisby@towerhouse.co.uk (with a copy to zach.meyers@towerhouse.co.uk)

Appellant's counsel:

Josh Holmes
Stefan Kuppen

Monckton Chambers
1&2 Raymond Buildings
Gray's Inn
London WC1R 5NR

Table of Contents:

1. OVERVIEW 3

2. SUMMARY OF LEGAL FRAMEWORK 9

3. REGULATORY CONTEXT 17

4. THE AUTHORITY'S ERRORS 22

(1) Inappropriate mechanisms to return double-recovered revenues from the previous price control period 24

(2) Inappropriate incentive targets for IIS and BMCS 29

(3) Unwarranted ex-post change to information quality incentives 36

(4) Unwarranted transitional arrangements for change in asset life policy 42

(5) Unwarranted change in cost of debt indexation 49

(6) Procedural flaws 55

5. RELIEF AND PROPOSED DIRECTIONS 60

Appendices 63

Index to Appeal Bundles 66

REFERENCES to the accompanying appeal bundlers are given in the form **[BGx/y/z]** where 'x' is the bundle volume number; 'y' is the tab number; and 'z' (where relevant) is the page number.

1. OVERVIEW

1.1 This Notice of Appeal ('**NoA**') and application for permission to appeal is brought by British Gas Trading Limited ('**BGT**') pursuant to section 11C of the Electricity Act 1989 ('**EA89**').

1.2 BGT wishes to appeal the decision of the Gas and Electricity Markets Authority ('**the Authority**'),[1] published 3 February 2015, to modify the electricity distribution licences of 10 Distribution Network Operators ('**DNOs**', collectively '**the Slow-track DNOs**'), representing 5 of the 6 DNO groups in Great Britain[2] ('**the Decision**'). The Decision was taken pursuant to section 11A EA89 and is contained in a document addressed to the Slow-track DNOs, 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*'. A copy of the Decision is attached at **[BG1/2]**.

1.3 The Decision is intended to give effect to the revenue restrictions ('**the Price Controls**') set out in a series of documents entitled '*RIIO-ED1: Final determinations for the slow-track electricity distribution companies*', published by the Authority on 28 November 2014 ('**the Final Determinations**').[3] A copy of the Final Determinations is attached at **[BG2/35]**.

1.4 BGT makes this application pursuant to section 11C(2)(b) EA89 in its capacity as a person:

a. who holds an electricity licence under section 6(1) EA89. BGT holds a supply licence under section 6(1)(d) EA89; and

b. whose interests are materially affected by the Decision. As an electricity supplier, BGT is required to pay each of the Slow-track DNOs charges for the use of their respective electricity distribution networks (the '**Use of System Charges**'), the level of which is substantially set by the Decision.

---

[1] In this NoA, references to the Authority include references to the Office of Gas and Electricity Markets (Ofgem) or its staff in their capacity as delegates of the Authority.

[2] The price controls for the fifth group, Western Power Distribution, were determined early, in February 2014, under a fast track process (see §§3.13–3.16 below).

[3] See Decision at §7.

1.5 The Decision is vitiated by a number of errors, which enable the Slow-track DNOs to charge substantially more than is justified over the course of the Price Controls. The Decision therefore harms the interests of BGT, its customers, and consumers of electricity generally (irrespective of the identity of their electricity supplier).

1.6 In reaching the Decision, the Authority has therefore failed to have proper regard to its principal objective of protecting the interests of consumers; and appears to have given inappropriate weight to subsidiary considerations, including the need to secure that licence holders are able to finance their activities.

1.7 Contrary to fundamental regulatory principles and the Authority's own stated policy, the Price Controls are likely to earn even relatively poorly performing DNOs returns well in excess of their cost of capital (see section 4 below). The correction of the Authority's errors will result in substantial savings for consumers while still enabling efficient DNOs to earn at or above their cost of capital.

1.8 In addition, the Decision and the preceding consultation process suffer from a series of procedural defects. The Authority has repeatedly failed to set out sufficient reasons to justify its conclusions or allow effective engagement by stakeholders. The Decision is wrong for that reason also.

1.9 Specifically, BGT relies on the following errors:[4]

a. **Inappropriate mechanism to return double-recovered revenues from previous price control period***:* during the course of the previous price control period, some of the DNOs double-recovered certain revenues in error. Rather than requiring the double-recovered amounts to be repaid as soon as practicable, the Decision instead provides for that amount to be deducted from the Regulatory Asset Value ('**RAV**') of the DNOs in question, so that it will be gradually returned to consumers over a twenty year period. The Authority's approach is contrary to good regulatory practice, as it is inconsistent with the outcome that would have arisen had DNOs not double-recovered; it also cannot be (and has not been) properly justified by considerations of financeability; and it leads to an

[4] Each of these grounds is pleaded more fully below. A summary of the grounds and an assessment of the materiality of each ground can be found in Table 10.1 of the AlixPartners Report.

unwarranted transfer of value to future customers from current ones, who most closely resemble the cohort of consumers who have overpaid. The proposed mechanism thereby fails to have proper regard to the interests of consumers; and gives inappropriate and unsupported weight to considerations of financeability.

b. **Inappropriate incentive targets:** The authority proposes targets for the Interruptions Incentive Scheme ('**IIS**') and the Broad Measure of Customer Satisfaction ('**BMCS**') scheme that are based on old information and, as a result, are too lenient and are likely to lead to systematic unearned rewards across the sector. The targets do not reflect the current performance of DNOs. They apply improvement factors which fall well short of historic performance (in the case of IIS) or no improvement factors at all (in the case of BMCS). Rewards are also more easily obtained, and more substantial, than penalties. The incentives are therefore inappropriate and contrary to the interests of consumers.

c. **Unwarranted ex-post change to information quality incentives ('IQI'):** The IQI scheme seeks to encourage DNOs to prepare well-justified business plans during the process of preparing the Price Controls. After the DNOs had submitted their business plans, the Authority decided to adjust the IQI scheme to the benefit of DNOs. In doing so, the Authority erred. The adjustment plainly cannot improve the incentive qualities of the IQI during the present Price Controls, given that the DNOs submitted their plans before the adjustment was made. Nor is the adjustment merited, as the Authority seeks to suggest, by changes that the Authority made to the upper quartile efficiency benchmark to account for smart grid efficiencies and real price effects. Those adjustments themselves reflect collective deficiencies in the DNOs' business plans. In any event, the change to the IQI is far greater than would be necessary to address those changes. The adjustment to the IQI therefore results in significant additional costs to consumers with no offsetting benefit; and weakens the future incentive properties of the IQI scheme. The proposed change is irrational, disproportionate, and contrary to the interests of consumers.

d. **Unwarranted transitional arrangements for change in asset life policy:** The Authority proposes to apply an 8 year transitional period for all DNOs in respect of the introduction of a new, longer and more realistic, asset life assumption. The application of the transitional period imposes significant additional costs on current consumers; reduces economic efficiency; and is contrary to the principle of inter-generational equity. It is unwarranted in the absence of DNO-specific evidence that transitional arrangements are

necessary in order to ensure financeability, and cannot properly be justified by concerns about future pricing. The proposed arrangements therefore fail to have proper regard either to consumer interests or the Authority's duty to target regulation only at cases in which action is needed. They also give inappropriate and unsupported weight to considerations of financeability.

e. **Unwarranted change in cost of debt indexation:** The Decision estimates DNOs' cost of debt by means of a 'trombone' index with a trailing period that extends from 10 to 20 years over time. That represents a departure from the straight 10-year trailing index favoured by the Strategy Decision, and applied both in the fast-track price controls (see §§3.13–3.16 below) and in all of the other RIIO price controls to date (electricity transmission and gas distribution). The change comes at significant expense to consumers and is not supported by any analysis of appropriate countervailing benefits. No attempt has been made to assess the efficiency of current embedded debt costs. Also absent is any recognition that the DNOs' reduction in interest rate risk comes at the expense of consumers; or any explanation of why the associated extra costs represent value for money for consumers. It is not required to ensure future efficiently incurred debt costs are fully recovered. The Decision therefore fails to provide a sufficient basis for abandoning the original approach set out in the Strategy Decision and already applied to the fast-track DNOs.

f. **Procedural defects:** The Authority is required to act transparently; to consult on licence modifications; and to give reasons for its proposals and in response to representations received. In relation to the substantive errors identified above, the process has not been transparent. The Authority's reasoning during the consultation process and in the Decision is insufficient to understand what analysis, if any, underpins many of its conclusions. The Authority makes general reference to concepts such as 'financeability' or 'intergenerational equity', which are reflected in the statutory framework, but does not explain how they have been applied, and provides no supporting welfare assessment. As a result, and despite the appearance of extensive consultation, the process has not served to promote the effective engagement of the suppliers and consumers who are required to pay the rates set by the Price Controls.

1.10 By reason of those errors, taken individually or in combination, the Decision is wrong. BGT respectfully invites the Competition and Markets Authority ('**CMA**') to quash the Decision to

the extent that the appeal is allowed; to substitute the CMA's own decision for that of the Authority insofar as it is able to do so; and otherwise to remit the Decision to the Authority so that the errors may be corrected. More detailed submissions as to relief are set out in relation to each error; and in section 5 below.

1.11 The Decision represents the last step in the process of implementing for the electricity distribution market the '*Revenue = Incentives + Innovation + Outputs*' ('**RIIO**') framework, introduced by the Authority in 2010. BGT fully supports the principles underlying the RIIO framework; and broadly agrees with the strategic proposals for implementing the framework to the electricity distributors, set out in the Authority's '*Strategy Decision for the RIIO-ED1 Electricity Distribution Price Control*', dated 4 March 2013 ('**the Strategy Decision**') **[BG2/10]**.

1.12 BGT's appeal is therefore not addressed to the broad principles pursued by the Authority, but instead raises focused complaints regarding the implementation of those principles. Having sought to engage with the Authority throughout the implementation process, BGT considers that the Authority has departed materially from the sensible objectives underlying the RIIO framework, and has skewed the balance of risk and return inappropriately in favour of the DNOs to the detriment of consumers.

1.13 In consequence, BGT is concerned that the Price Controls are likely to perpetuate the historical experience in previous price controls set by the Authority, in which returns achieved by DNOs, and other distribution and transmission companies in the gas and electricity sectors, have substantially and systematically exceeded the regulated cost of equity.[5] As the House of Commons Energy and Climate Change Committee concluded in its report of 23 February 2015, entitled '*Energy Network Costs: Transparent and Fair?*' [**BG2/40**]:

> '*Ofgem has agreed price control settlements with the gas and electricity transmission companies and gas distribution companies until 2021 and with electricity distribution until 2023. We believe that the price controls are too generous and the targets are too low. We want Ofgem to utilise the RIIO price control frameworks to put more pressure on the networks to limit their costs and provide better value for consumers, for example through a mid-term review, ideally supported by an independent auditor to enable more accurate*

[5] See 1st Manning at §§18-30.

calculations of future price controls.'[6]

'RIIO is an improvement on its predecessor, and there are positive signs that the framework has brought about a more robust negotiation process involving a wider group of stakeholders. However, RIIO has not gone far enough in providing value for money for consumers of energy.'[7]

1.14 The errors identified in the Appeal are material. Table 10.1 of the AlixPartners Report sets out indicative assessments of materiality. In total, the AlixPartners Report estimates that the errors in the Decision, as set out in the NoA, allow recovery by the DNOs of up to **£1.369 billion** more in revenue than would be efficient, with no individual error contributing less than £32 million to that combined figure.

1.15 The effect on consumers is also appreciable. Electricity distribution accounts for nearly **20% of consumers' electricity bills**.[8] The errors may be expected to increase charges under the Price Controls by nearly 5%. The resulting impact on pricing will be felt most keenly by vulnerable consumers, a group which the Authority is required to keep in its consideration when conducting regulation.[9]

1.16 The remainder of the NoA is structured as follows:

a. Section 2 summarises certain aspects of the **legal framework**;

b. Section 3 sets out the **regulatory context**;

c. Section 4 sets out the substantive and procedural **errors relied on in support of the appeal**; and

d. Section 5 summarises in general terms the **relief sought** by BGT and sets out BGT's initial

---

[6] House of Commons Energy and Climate Change Committee, *Energy network costs: transparent and fair?*, 23 February 2015 **[BG2/40]** p 15.

[7] Id. **[BG2/40]**, p 26.

[8] 1st Manning §11.

[9] See section 3A(3) of EA89, reproduced at §A1.2 of Appendix A to the NoA.

proposals on case management.

1.17 In support of its appeal, BGT relies on the matters set out in the NoA (including the schedules and appendices) and on the following factual and expert evidence, which should be read as an integral part of the NoA:

a. the expert economic report of Derek Holt and Matthew Hughes of AlixPartners **[BG1/HH1]** (‘**the AlixPartners Report**’);[10] and

b. the first witness statement of Andrew Martin Manning **[BG1/AM1]** (‘**1st Manning**’).

1.18 The NoA, in combination with the supporting evidence, sets out BGT’s statement of case, its grounds of appeal, and the facts and reasons relied upon. All of the facts on which BGT relies were, in BGT’s belief, matters that the Authority was entitled to have (and could have had) regard to in relation to the Decision.

1.19 The Decision is a ‘*price control decision*’ within the meaning of section 11F(7) EA89, because the purposes of each of the relevant licence conditions modified by the Decision is to limit or control the revenue of the holder of the licence.

2. SUMMARY OF LEGAL FRAMEWORK

The Authority’s statutory objectives and duties

2.1 The applicable statutory framework is contained in the Electricity Act 1989 as amended by the Electricity and Gas (Internal Markets) Regulations 2011 implementing the EU Third Energy Package (principally, the Electricity Directive (2009/72/EC)). Extracts of relevant provisions are provided in **Appendix A** of the NoA.

2.2 The Authority is subject to a set of statutory objectives and duties, which are laid down in sections 3A to 3E EA89, including the following.

2.3 Section 3A(1) EA89 provides that—

[10] For clarity, references in the NoA to the economic expert report and marked [**BG2/HH1**] are references to the report exhibited to the joint witness statement of Derek Holt and Matthew Hughes.

‘*the principal objective of the [Authority] ... is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems*’. (Emphasis added.)

2.4 The relevant interests of consumers include, under section 3A(1A)(c), an interest in the fulfilment by the Authority of the objectives set out in Article 36 of the Electricity Directive, including at Article 36(f) the objective of—

‘*ensuring that system operators and system users are granted appropriate incentives, in both the short and the long term, to increase efficiencies in system performance ...*’ (Emphasis added.)

2.5 Section 3A(1B) EA89 stipulates that it is the Authority’s duty to carry out its functions in a manner ‘*best calculated to further the principal objective*’.

2.6 Under section 3A(2) EA89, in performing that duty—

‘*the Authority shall have regard to ... (b) the need to secure that licence holders are able to finance [their regulated] activities*’. (Emphasis added.)

2.7 In addition and subject to those duties, under section 3A(5), the Authority shall carry out its functions in a manner best calculated to–

‘*promote efficiency and economy on the part of the persons authorised ...*’. (Emphasis added.)

2.8 Under section 3A(5A), the Authority must also –

‘*have regard to –*

(a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed; and

(b) any other principles appearing to ... it to represent the best regulatory practice.’ (Emphasis added.)

The Authority's power to modify licences and its duty to consider representations

2.9 Under section 11A(1) EA89, the Authority has the power to modify the conditions of a particular licence or the standard conditions of a type of licence.

2.10 Under section 11A(2) when proposing to modify a licence, the Authority must give notice —

> *'(a) stating that it proposes to make modifications;*
> *(b) setting out the proposed modifications and their effect;*
> *(c) stating the reasons why it proposes to make the modifications;*
> *... .'*

2.11 Under section 11A(4A) –

> '*The Authority must consider any representations which are duly made.*'

2.12 Under section 11A(7), where the Authority decides to proceed with the modifications, the Authority must *inter alia* –

> '*(b) state the effect of the modifications,*
> *(c) state how it has taken account of any representations duly made, and*
> *(d) state the reason for any differences between the modifications and those set out in the notice by virtue of subsection (2)(b)*'.

Statutory appeals to the CMA

2.13 Section 11C(1) EA89 provides that:

> '*An appeal lies to the CMA against a decision by the Authority to proceed with the modification of a condition of a licence under section 11A.*'

2.14 Section 11E(2) provides that in determining an appeal the CMA must have regard, to the same extent as is required of the Authority, to the Authority's principal objective and duties as set out above.

2.15 Section 11E(3) further provides that the CMA in relation to the appeal may have regard to

matters to which the Authority was not able to regard as long as the Authority would have been entitled to have regard to them.

2.16 Section 11E(4) specifies the grounds for a successful appeal:

'The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—

(a) that the Authority failed properly to have regard to any matter mentioned in subsection (2) [including the Authority's principal objective and duties (see §2.14 above)]*;*

(b) that the Authority failed properly to give the appropriate weight to any matter mentioned in subsection (2);

(c) that the decision was based, wholly or partly, on an error of fact;

(d) that the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b);

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

The nature of the CMA's jurisdiction under section 11E(4) EA89

2.17 First, as is apparent from the text of section 11E(4) EA 89, statutory appeals before the CMA are directly concerned with the correctness of the Decision. The CMA's task is to ensure that the decision is compatible with, and correctly balances, the Authority's principal objective and its other duties under the statute; is factually and legally correct; and achieves its intended effect. The appeal is therefore a full appeal on the merits before an expert authority, which is required in determining the appeal to have regard to the same considerations as the Authority in coming to its decision.

2.18 Secondly, it follows that the scope of the appeal is both wider than, and fundamentally different from, the scope of a judicial review. As the Competition Commission ('**CC**') observed in relation to its parallel jurisdiction under section 175(4) of the Energy Act 2004 (at §5.3) in *E.ON UK Plc v Gas and Electricity Markets Authority (GEMA)* (CC02/07) [**BG2/46**], the statutory

grounds:

> '*… clearly differ from the judicial review grounds of illegality, irrationality or procedural impropriety. This is clear on the face of the legislation, and it is also consistent with the purpose of the section 173 jurisdiction* [the equivalent of section 11C EA89]*, which is <u>to subject GEMA to a greater level of accountability than would be the case in judicial review</u>.*' (Emphasis added.)

2.19 That approach was endorsed in the Government Response to the Department of Energy and Climate Change's consultation on the '*Implementation of the EU Third Internal Energy Package*', January 2010 [**BG2/1**], which preceded the introduction of the appeals process under sections 11C–11F EA89 (at §2.24):

> '... *in the case of E.ON UK Ltd v GEMA on Energy Code Modification UNC116 (CC 02/07), the Competition Commission took the view that the grounds for appeal enabled it to go beyond a narrower judicial review approach and to consider the merits of the case.* ***It is the Government's intention that the proposed grounds for appeal for licence modification decisions also enable the appeal body to take account of the merits of the case in a similar manner. The Government considers the Competition Commission's approach in relation to code modifications to be helpful in this regard.*** ' (Emphasis in the original.)

2.20 <u>Thirdly</u>, as the CC recognised in *E.ON v GEMA* [**BG2/46**] (at §§5.11-5.12), the CMA's role is not to substitute its judgment for that of the Authority simply because it would have taken a different view of a given matter. This accords with the CC's approach under its statutory jurisdiction to hear price control appeals in the telecommunications sector (see *Carphone Warehouse Group plc v Office of Communications* (Case 1111/3/3/09) [**BG2/49**] at §1.32):

> '*… In a case where there are several alternative solutions to a regulatory problem with little to choose between them, we do not think it would be right for us to determine that Ofcom erred simply because it took a course other than the one that we would have taken. On the other hand, if, out of the alternative options, some clearly had more merit than others, it may more easily be said that Ofcom erred if it chose an inferior solution. …*'

2.21 For the reasons developed in section 4 below, the errors identified in this appeal constitute serious flaws in the Decision, which render it a clearly inferior solution for consumers; and

they therefore require to be corrected.

2.22 Further, the CMA is entitled and required to scrutinise any purported exercise of discretion by the Authority to ensure that it accords with the legal framework and is supported by a proper and robust analysis of all of the relevant considerations. For example, when considering the weight to be given to the principal objective under s.3A of the EA89 and the Authority's other statutory duties, the following points must be kept in mind:

a. The structure of s.3A requires that priority be given to the protection of the consumer interest. The DNOs' need to ensure finance (to which the Authority makes frequent reference in the Decision) is a subsidiary consideration, which arises only insofar as it is shown to be of relevance to the consumer interest. There is no independent duty to enable DNOs to finance their activities.

b. In order for any weight to be given to considerations of financeability, it is necessary to show in concrete terms how they affect the consumer interest. Vague and unsupported references to financeability concerns are insufficient to justify departing from the immediate interest of current consumers in lower prices; and should be afforded no weight by the CMA.

2.23 <u>Fourthly</u>, the Authority's prospective analysis in the context of an *ex ante* price control merits particularly careful scrutiny:

a. As the Competition Appeal Tribunal has held, such analysis must be carried out with great care. Because the likelihood of error is greater in prospective analysis, that analysis must be proportionately more rigorous to account for this possibility: see *Hutchison 3G (UK) Limited v Ofcom* [2005] CAT 39 [**BG2/45**] at §33; see also the approach of the EU courts, as set out in Case C-12/03 P *Commission v Tetra Laval* [2005] ECR I-987 [**BG2/44**] at §39.

b. The importance of the price control regime, affecting the prices paid for an essential input by millions of consumers, also underlines the importance of careful oversight at the appeal stage. As the Competition Appeal tribunal observed in *Vodafone v Ofcom* [2008] CAT 22 [**BG2/47**] at §47:

'*It is the duty of a responsible regulator to ensure that the important decisions it takes,*

with potentially wide ranging impact on industry, should be sufficiently convincing to withstand industry, public and judicial scrutiny.'

c. The CMA's situation is analogous to that of the Competition Appeal Tribunal in the context of telecommunications appeals. In that context, the Tribunal has recognised that it '*is a specialist court designed to be able to scrutinise the detail of regulatory decisions in a profound and rigorous manner*': see *Hutchison 3G UK v Ofcom* [2008] CAT 11 [**BG2/47**] at §164. The CC has adopted the same formulation as to the standard of scrutiny which it applies when considering price control appeals: see e.g. the CC's determination in the 2011 mobile call termination appeals (cases 1180-1183/3/3/11), dated 9 February 2012 [**BG2/51**] at §1.30.

d. In undertaking such scrutiny, the CC has emphasised the importance of a regulator not relying too much on the views expressed to it by the company under regulation,[11] but instead conducting its own independent analysis of the issues. The CC has also underlined that, in the interests of ensuring that the regulator's analysis is transparent, '*benefits should be quantified where possible*': *E.ON v. GEMA* [**BG2/46**] at §6.157.

2.24 Fifthly, however, the CMA's powers in the case of energy licence modification appeals are in one important respect wider than in the case of a reference from the Competition Appeal Tribunal under the Communications Act. Under section 11C EA89, the CMA has overall control of the appeal, which includes a jurisdiction to hear appeals on points of law (see section 11E(4)(e)). As a matter of administrative law, that jurisdiction includes:

'*… not only matters of legal interpretation but the full range of issues which would otherwise be subject of an application to the High Court for judicial review, such as procedural error and questions of vires, … irrationality and (in)adequacy of reasons*' (*Nipa Begum v Tower Hamlets LBC* [2000] 1 WLR 306; 313E–F) **[BG2/42]**.

2.25 Sixthly, and in consequence, as the CC recognised in *E.ON v GEMA* [**BG2/46**] (at §5.18), the

[11] See e.g. the CC's determination in *Carphone Warehouse v. Ofcom* (LLU price control) [**BG2/49**]at §2.165, where the CC indicated that it was '*concerned that Ofcom may have had too much regard to BT's own forecasts, and thus that Ofcom may not have given the right weight to the various alternative measurement techniques that it applied… We think that this point is similar to the point made by CPW that the regulator's task is not to merely accept what BT thinks it could do*.'

CMA has jurisdiction to correct procedural as well as substantive errors by the Authority, which may constitute errors of law in their own right. The lawfulness of the Authority's procedures must be assessed having regard to its statutory duties:

a. to act transparently (see section 3A(5A)(a) EA89);

b. to consult prior to its decision (see section 11A(2)-(4A) EA89); and

c. to give a full account of its reasons, including: the purposes pursued by its decisions (s.11A(1)(c) EA89); the effect which it expects to follow from them (ss.11A(1)b) and 11A(7)(b) EA89); and its response to representations made in consultation (s.11A(7)(c) EA89)).

2.26 In *E.ON v GEMA* [**BG2/46**], the procedural defects identified were among the factors which led the CC set the contested decision aside (at §7.10f):

> '*... Further, we are persuaded that the Decision ... was not expressed in terms which satisfied GEMA's obligation of transparency under its 'better regulation' duties. ... We are therefore satisfied that the Decision is 'wrong' within the meaning of EA04, and that the appeal should be allowed.*'

2.27 BGT recognises that the present appeal requires an intensive scrutiny of the underlying merits of the Authority's Decision and may therefore be sufficient to cure procedural defects, insofar as the CMA is able – notwithstanding the concentrated timetable – to hear and address directly BGT's case on the substantive issues affected by those defects: see *TalkTalk v Ofcom* [2012] CAT 1 [**BG2/50**] at §§123-132. In such a case, it may nonetheless be appropriate for the CMA to offer general guidance to ensure that effective procedures are followed for the future.[12] In *E.ON v GEMA* [**BG2/46**], for example, the CC underlined the importance of detailed and properly supported reasoning in support of licence modifications:

> *'In our view, <u>the Decision contained insufficient material to support the conclusion that the [proposed modification] will, or is sufficiently likely to, deliver benefits to consumers, and</u>*

[12] See in that regard the CC's determination at §1.71 in *Carphone Warehouse v. Ofcom*, dated 31 August 2010 [**BG2/49**]: '*We consider that declarations as to our view of the proper regulatory approach will, where appropriate, provide useful guidance to regulators and lead to time and costs savings in future appeals.*'

insufficient explanation of the nature and extent of the benefits to be expected. This of itself means that the net benefit conclusion reached by GEMA ... is, in our view, not adequately supported by the material set out in the Decision, or by the arguments advanced by GEMA on this appeal.' (§6.164)

'GEMA must take particular care to ensure that its decision is expressed as clearly as possible, and must ensure that the arguments for and against its preferred course of action are dealt with clearly and comprehensively in the relevant consultation and decision documents. ... We would also suggest that GEMA's consultation process should be carried out with these considerations in mind ...' (§6.196).

3. REGULATORY CONTEXT

Industry structure

3.1 Background information about the electricity industry is set out in 1st Manning, at §§9–11. In summary, the industry includes:

a. *Electricity generators* – these entities produce the electricity delivered into the transmission system (or for some smaller generators, directly to distribution networks);

b. *Transmission system owners and the transmission system operator* – the former entities own the high voltage grids which transmit electricity from producers to different points in Great Britain; the latter entity (National Grid Electricity Transmission plc) operates the transmission system for Great Britain as a whole, and is responsible for balancing the supply and demand of electricity;

c. *Electricity distribution network operators (DNOs)* – the DNOs operate regional distribution networks to deliver electricity from the high voltage transmission grid to end users. There are 14 primary electricity DNOs in Great Britain; and

d. *Electricity suppliers* – these entities provide electricity to domestic and business customers. Electricity suppliers purchase electricity (from generators directly, or from the wholesale market) and arrange its delivery to customers.

3.2 BGT is an electricity supplier. Electricity suppliers pay both DNOs and the transmission system operators for the delivery of electricity to the electricity suppliers' retail customers. Electricity distribution charges are unavoidable input costs for all electricity suppliers, and as such are passed on to consumers as part of the electricity supplier's retail charges.

Licensing and conditions

3.3 Section 4 EA89 requires participants in the electricity market to hold a relevant licence, which may be granted by the Authority under section 6 EA89. Each of the Slow-track DNOs holds a 'Distribution Licence' under section 6(1)(c) EA89. BGT holds a 'Supply Licence' under section 6(1)(d).

3.4 Under section 7 EA89, the Authority has the right to attach conditions to a licence having regard to its statutory duties, including the furtherance of its principal objective of protecting the interests of consumers (see §§2.1–2.8 above for more detail on the Authority's principal objective and duties).

3.5 Section 7(2) EA89 further provides that conditions for Distribution Licences may include a requirement for licensees to enter into agreements on the use of electric lines and electrical plant, and determine the terms on which such agreements are to be entered into. Under section 7(4), the conditions rather than setting out the relevant provisions may refer to provisions set out in other designated documents.

3.6 Under Section 11A EA89 the Authority may make modifications of conditions of a licence or of the standard conditions of a type of licence.

Price controls for electricity distribution

3.7 As the Authority recognises, the DNOs are '*territorial monopolies*', and it is therefore necessary to '*regulate the revenues DNOs can recover from consumers and incentivise them to innovate and find new ways to improve their efficiency and quality of service – using the price control process*'.[13]

[13] Strategy Consultation – Overview [**BG2/8-A**], p 10.

3.8 The Authority has imposed revenue restrictions (and therefore price controls[14]) under existing conditions in the Distribution Licences. These conditions have applied since 1 April 2010 and are intended to be replaced from 1 April 2015. The process of developing those revenue restrictions and informally the restrictions themselves are referred to as Distribution Price Control Review 5 ('**DPCR5**').

3.9 In 2010, the Authority completed a detailed review of energy network regulation and determined to implement a new model for imposing revenue restrictions in the future, called the '*Revenue = Incentives + Innovation + Outputs*' model, or RIIO for short. Its reasons for adopting the RIIO price control model were set out in its report: '*RIIO: A new way to regulate energy networks – Final decision*' (October 2010) ('**the RIIO Final Decision**') [**BG2/3**].

3.10 The upcoming revenue restrictions for DNOs, including the ones for Slow-track DNOs subject of this NoA, are the first application of the RIIO framework to electricity distribution networks. They are referred to as '**RIIO-ED1**'. The RIIO-ED1 price controls are intended by the Authority to apply for an eight year period, from 1 April 2015 to 31 March 2013 ('**the RIIO-ED1 Period**').

Process leading to the Decision

3.11 The Authority conducted a number of consultations and required extensive input from the DNOs in the course of developing the RIIO-ED1 price controls. As the Authority explained —

> '… *one of the principal aims of the RIIO model is to encourage network companies to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers value*' (Strategy Consultation, Overview, p 8) [**BG2/8-A**].

3.12 The Authority required DNOs to set out these strategies in well-justified business plans. The Authority proposed to assess the quality of each DNO's business plan, with opportunities for business plans to be resubmitted based on feedback from the Authority. Those plans would then be used by the Authority (along with other available information) to form a view on expected efficient costs of delivering the outputs required by the RIIO-ED1 model. The process of determining the RIIO-ED1 price controls was split into a fast-track and a slow-track

[14] This NoA uses the terms price controls and revenue restrictions synonymously, as the practical effect of the imposed revenue restrictions is to control the prices or Use of System Charges DNOs are able to set.

process, as follows.

(i) The fast-track process

3.13 The Authority had proposed to allow the best performing companies to be 'fast-tracked', i.e. to agree the terms of their price control up to a year earlier. The Authority explained that it would do this where it was satisfied that—

> '*… the company's business plan is well justified and provides long-term value for consumers based on a high-level assessment of the plan and the company's track record for delivery. If a company is fast-tracked its settlement will match, or almost match, its own well-justified business plan.*' (RIIO Final Decision [**BG2/3**] at p 33).

3.14 The fast-track process thus offered DNOs significant advantages: earlier visibility on future revenues; a less involved and administratively burdensome price control process; a lower level of scrutiny of business plans; and ultimately a price control substantially driven by the respective DNOs' own business plan assumptions. Fast-tracked DNOs would also receive additional upfront revenues of 2.5% of total expenditure in lieu of the IQI applicable to the Slow-track DNOs (see §§4.51–4.53 below).

3.15 In the event, the Authority decided in February 2014 that only the business plans of one DNO group, Western Power Distribution ('**WPD**'), representing 4 of the 14 DNOs, were of a sufficiently high standard to be fast-tracked:

> '*... we think WPD's business plans are, overall, of sufficiently high standard that it is in the interest of consumers for us to accept them in full (subject to a cost of equity change, described below).*'[15]

3.16 The Authority made the relevant licence modifications in May 2014 [**BG2/28**]. Those modifications are not the subject of this Appeal.

(ii) The slow-track process

[15] [**BG2/23**] p 1.

3.17 The Price Controls applicable to the remaining 10 DNOs (the Slow-track DNOs) were then determined through a further process, comprising a number of consultations. That process was concluded by a statutory notice and consultation in December 2014 on the form of the proposed licence modifications, preceding the publication of the Decision itself on 3 February 2015. A detailed timeline of the process is set out at **Appendix B** to the NoA.

3.18 BGT (or members of its corporate group[16]) made submissions throughout the consultation process applicable to the Slow-track DNOs, and raised concerns in relation to each aspect of the Decision now raised in the appeal (in most cases, on several occasions).

3.19 The key stages of the process included:

a. a '*Strategy Decision for the RIIO-ED1 Electricity Distribution Price Control*' (the Strategy Decision) dated 4 March 2013, setting out the Authority's decision on the '*key elements of the regulatory framework*' and '*the outputs the DNOs will need to deliver and the incentives to encourage their delivery*' (Strategy Decision – Overview, [**BG2/10-A**] p 1);

b. a '*Draft Determinations Consultation for the Slow-Track Electricity Distribution Companies*' dated 30 July 2014 (the '**Draft Determinations**') [**BG2/32**], which explained the Authority's '*proposed settlements*' in respect of the Slow-track DNOs; and

c. a series of documents, referred to by the Authority as its '*Final Determinations*', dated 28 November 2014 (the Final Determinations) [**BG2/35**]. The documents are marked '*Final Decision*', and purport to set out the Authority's '*decision for the settlements (final determinations) for ten electricity distribution companies for the next price control (RIIO-ED1)*'.[17]

3.20 The Final Determinations were succeeded by the Decision itself, on 3 February 2015, the purpose of which is stated as being '*to give effect to the policy set out in the Strategy Decision and in the Final Determinations*' (Decision [**BG1/2**] at §7).

---

[16] For convenience, this NoA refers to each of the submissions made by BGT or member(s) of its corporate group as being made by BGT.

[17] See p.1, '*Overview*' document of the Final Determinations [**BG2/35-A**].

3.21 Each of the relevant consultation documents, BGT's submissions, the Strategy Decision and the Final Determinations are set out in the appeal bundles accompanying this NoA.

The RIIO-ED1 price control

3.22 A description of the relevant parts of the Price Controls can be found in 1st Manning §15–17; and in the AlixPartners Report.

3.23 In brief summary, the Price Controls restrict the revenue each DNO is allowed to earn from Use of System Charges in any given year. That revenue is broadly calculated to allow the DNO to recover its efficiently incurred costs, including a return on capital, adjusted up or down to reflect the DNO's performance against certain standards, aimed at improving performance. The annual allowed revenues per DNO are updated each year through the '**Annual Iteration Process**'.

3.24 The Decision implements the Price Controls through amendments to the licence conditions of the Distribution Licences of the DNOs, largely by amending or replacing the existing conditions that served to implement the preceding DPCR5 price controls.

4. THE AUTHORITY'S ERRORS

4.1 BGT sets out below the errors in the Decision that are relied upon in this appeal, relating to the following matters:

a. The mechanism selected by the Authority for returning revenues which had been double-recovered during the previous price control;

b. The incentive targets and/or incentive rates applied by the Authority under (i) the Interruptions Incentive Scheme (IIS); and (ii) the Broad Measure of Customer Satisfaction (BMCS) scheme;

c. The *ex-post* adjustment made by the Authority to the Information Quality Incentives;

d. The transitional period arrangements applied by the Authority to the change in asset life;

e. The Authority's approach to the cost of debt; and

f. The procedures applied by the Authority in reaching its decisions on the above matters.

4.2 The cumulative effect of the Authority's substantive errors is that the Price Controls are inappropriately calibrated and are likely to allow DNOs to earn revenues in excess of efficient levels. As the AlixPartners Report observes (at §§1.9.1-1.9.2]):

'*Baseline prices (i.e. prior to application of the incentive framework) are over and above those necessary to enable DNOs to finance their functions, leading to allocative, productive and dynamic inefficiency and a reduction in intergenerational equity.*

In addition, the proposed incentive schemes are excessively generous to DNOs, and can be expected to lead to returns over and above those required by efficient DNOs to finance functions or to deliver efficient network performance.'[18]

4.3 In the consultation for the Strategy Decision, the Authority stated its policy position on the appropriate level of returns to be achieved by DNOs during the course of the Price Controls as follows:

'*We regard an appropriately calibrated price control package as one in which RoRE* [Return on Regulated Equity] *upside (ie the reward available for the best-performing DNOs) provides the potential for double-digit returns on (notional) equity, and RoRE downside (ie the penalties that would apply to the worst-performing DNOs) is at or below the cost of debt.*'[19]

4.4 BGT agrees with that approach, which accords with the view expressed in the AlixPartners Report (at §3.1.3) that as a matter of regulatory principle—

'*The realisation of economic profits (i.e. those over and above the cost of capital) … should be a reward for exceptional performance by DNOs in terms of lowering costs and/or meeting customers' demand.*'

---

[18] Incidentally this accords with the House of Commons Energy and Climate Change Committee's view that '*the [RIIO] price controls are too generous and the targets are too low*': House of Commons Energy and Climate Change Committee, *Energy network costs: transparent and fair?*, 23 February 2015 **[BG2/40]** §19.

[19] '*Consultation on strategy for the next electricity distribution price controls - RIIO-ED1 - Financial issues*', 28 September 2012 [**BG2/8-F**] at §3.13; see also Strategy Decision: Financial Issues [**BG2/10-F**] at §§3.21–3.26, and Final Determinations: Overview [**BG2/35-A**] at §5.37.

4.5 However, the Authority has failed to achieve that goal. An analysis presented by BGT in response to the Draft Determinations [**BG2/32-A**], which is consistent with the analysis presented in the AlixPartners Report, indicates that the Authority has failed to ensure that only a reasonably efficient DNO earns its cost of capital and higher returns require higher efficiency.

4.6 As BGT's analysis indicates, the Price Controls in their current form mean that every Slow-track DNO can expect to earn returns above its cost of capital. An unprecedented extent of overspending versus allowances would be needed for returns to drop to what the Authority described as an appropriate downside (the cost of debt).[20]

4.7 In correcting the errors identified in the Grounds of Appeal, the AlixPartners Report at §10.1.5 estimates savings of nearly **£1.4 billion** for consumers could be realised during the RIIO-ED1 Period, while still enabling efficient DNOs to earn at or above their cost of capital.

(1) Inappropriate mechanisms to return double-recovered revenues from the previous price control period

The Authority's approach

4.8 While the Price Controls were being developed, BGT drew the Authority's attention to the fact that certain costs were being recovered twice by a number of DNOs during the previous price control period (DPCR5) (see 1st Manning at §§67–78).

4.9 DPCR5 treated certain services as excluded from the main revenue allowance for Use of System Charges ('**excluded services**'), on the basis that costs for those services were expected to be broadly incremental and specific to the respective service provided. DNOs were allowed to levy charges for excluded services in addition to Use of System Charges on a cost recovery basis. In the event, some DNOs claimed under excluded services certain costs that were already reflected in the revenue allowance for Use of System Charges.

4.10 The Authority recognised in the Final Determinations – Overview [**BG2/35-A**] that double-recovery had occurred during DPCR5, and that it was appropriate for the relevant revenues to

[20] 1st Manning at §48.

be returned in full to consumers in order to avoid funding the DNOs in question twice (§5.46).

4.11 Rather than requiring repayment in the context of DPCR5 itself, the Authority instead deferred the issue of how the revenues should be returned to be determined when setting the RIIO-ED1 price controls. In the Final Determinations, as implemented by the Decision, the Authority opted to do so by making a depreciating adjustment to the RAV of the relevant DNOs that would return excess revenues to consumers over a 20-year period. No provision was made for the payment of interest in respect of the period between the overcharge and the adjustment.

Errors in the Authority's approach

4.12 The Decision is wrong in its treatment of over-recovery of costs during DPCR5 for two important reasons:

a. First, it fails to have proper regard to the interests of consumers and to principles of best regulatory practice. Any over-recovery of costs should be adjusted for as soon as practicable by returning any overpayment to current consumers, who are the group of consumers best approximating the DPCR5 consumers who have been overcharged over the last price control. Any departure from that approach requires cogent justification, which has not been advanced in the current case.

b. Secondly, by departing from best practice and by effectively forcing consumers to provide financing to DNOs over a 20-year period the Authority risks setting an inappropriate incentive for DNOs to over-recover again in the future. See AlixPartners Report at §§4.2.7–4.2.8.

4.13 Charging for excluded services during DPCR5 recovered revenues in excess of costs, which was contrary to the relevant cost-recovery based Charge Restriction Condition ('**CRC**') in the DNOs' licenses.[21]

4.14 The standard approach under both the DPCR5 and ED1 price controls would be for the over-recovered revenues to be returned as soon as practicable. This would ordinarily be done by

[21] CRC 15.9; see Schedule to the DPCR5 Decision, Part B, item 15.9 (p 124) [**BG2/2**].

adjusting the allowed revenues for the following year (under DPCR5) or the year thereafter (in the case of ED1) to compensate for the overcharge, including interest on the over-recovered amounts.[22]

4.15 That approach accords with principles of best regulatory practice, as well as basic considerations of equity, which dictate that - absent good reasons to the contrary - revenues that have been charged to customers in error should be returned to consumers promptly, including an allowance for interest to reflect the period during which consumers were incorrectly deprived of funds.

4.16 The Authority's approach, by contrast, has been to lock up the overpayment for two decades through the RAV adjustment. This is unfair to the consumers who have overpaid. As the AlixPartners Report states:

> '*It is extraordinary that Ofgem's solution to double charging by DNOs is not to seek immediate repayment (or even repayment over the next price control period), but instead to compel consumers to lend the money - which they should never have been made to pay - to DNOs over a period of 20 years*' (§1.3.4)

4.17 The Authority has also failed to require any interest to be paid for the period between the double-recovery and the RAV adjustment (AlixPartners Report at §4.2.7). Although the amount of such interest may be comparatively small, it nonetheless runs counter to the consumer interest; and leaves DNOs in a more favourable position than they would have been absent the double-recovery, an approach that risks giving rise to perverse incentives, particularly in circumstances where double-recovery will often be difficult to detect.[23]

4.18 The Authority appears to justify its approach by reference to (i) the interests of future consumers and (ii) financing considerations. The Final Determinations – Overview [**BG2/35-A**] at §5.47 contain the following brief and conclusory explanation in response to concerns raised

---

[22] Over or under recovery is an unavoidable and regular feature of *ex ante* cost-recovery based price controls, as charges will necessarily be based in part on estimates. Under the DPCR5 and ED1 Price Controls, as under many other price controls, over or under recovery is normalised by applying a correction factor, or 'k factor', to the following year's revenue allowance, or the year thereafter in the case of ED1, which operates a two year lag. See CRC 3 DPCR5 [**BG2/2**] and CRC 2A of ED1 [**BG1/3**].

[23] See AlixPartners Report [**BG1/HH1**] at §§4.1.7–4.1.8.

by BGT:

> '*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.*' (Emphasis added.)

4.19 The Authority's explanation does not withstand scrutiny:

a. The Authority does not explain *why* its approach strikes the appropriate balance between different generations of consumers, nor does it present any analysis on the relative impact of its approach on current and future consumers. In fact, the Authority's approach does not strike an appropriate inter-generational balance. As explained above, the cohort of consumers most likely to have suffered the original overcharge are current consumers. Far from promoting inter-generational equity, any delay in repayment serves to undermine it.

b. The Authority's position is not improved by considering the return of over-recovered revenues alongside other inter-generational issues, such as the change in the asset life policy, as the Authority seeks to suggest.[24] Both of these effects work in the same direction; and their combined impact is to exacerbate the transfer of value from current consumers to future cohorts.[25]

c. The Authority equally fails to explain how its approach would facilitate efficient financing or why it would be necessary or appropriate to support DNOs' short-term cash flows and financial metrics. The relevant DNOs by definition recovered revenues in excess of those required to finance their activities. The return of those revenues should have no detrimental impact on DNOs' financing. In so far as those revenues are no longer available to be returned to consumers, as they have already been distributed to

[24] See also the Authority's letter to BGT in response to the statutory consultation [**BG2/39**] at §40(3).

[25] See AlixPartners Report [**BG1/HH1**] at §§4.2.11–4.2.15.

shareholders, it would appear entirely inappropriate to remedy that situation by forcing current consumers to extend a line of credit to DNOs. In short, the Authority has failed to show that financeability is a relevant consideration when assessing the consumer interest in this context: see §2.22 above.

4.20 BGT first raised this issue with the Authority in May 2013 [**AM1/3**], and has raised it in various consultations since, including most recently during the December 2014 Statutory Consultation for the Decision (see 1st Manning, §82). In each case, BGT made it clear that it considered an immediate return of over-recovered revenues to be in consumer's interest. The Authority has notably failed to engage with BGT in relation to this topic. At the end of the process, its stated reasons still come down to a bare and unsupported assertion from the Final Determinations – Overview [**BG2/35-A**] at §5.47 that the proposed adjustment serves to '*keep an appropriate inter-generational balance and also facilitate efficient financing*'.

Statutory grounds and relief sought

4.21 For the reasons set out above, the Authority has erred in deciding not to return revenues double-recovered during the previous price control period to costumers immediately, and in failing to make an adjustment for interest to the amount to be returned by DNOs. In particular, the Authority has–

a. failed to have proper regard to the interest of consumers, thereby acting contrary to its principal objective;

b. failed to have proper regard to best regulatory practice;

c. given 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.

4.22 The decision is therefore wrong on the grounds set out in section 11E(4)(a), (b) and (e) EA89.

4.23 BGT invites the CMA to quash the relevant part of the Decision and substitute its own decision for that of the Authority by amending the proposed licence conditions in such a way that

double-recovered revenues including an adjustment for interest are returned as soon as possible via a rebate to RIIO-ED1 revenues.[26]

(2) Inappropriate incentive targets for IIS and BMCS

4.24 The RIIO-ED1 price controls contain a number of incentive mechanisms designed to encourage performance improvements, including:

a. the Interruption Incentives Scheme (IIS),[27] which aims to encourage improvements in the reliability of the service provided by DNOs to consumers; and

b. the Broad Measure of Customer Satisfaction (BMCS) scheme,[28] which aims to encourage improvements in DNOs' customer-facing performance.

4.25 The Authority's design of those schemes is flawed in a number of respects, and is likely to lead to significant rewards for DNOs, without these being justified by any substantive improvements in performance.

4.26 The manner in which the IIS is described in the Decision and its public consultation documents is opaque. BGT has sought clarification in correspondence following the Decision. The correspondence reveals that the methodology actually applied does not accord in all respects with that described by the Authority: see 1st Manning at §110(b). Moreover, some of the information is still not available to BGT because it is said to be commercially sensitive and therefore confidential. BGT therefore seeks a direction from the CMA for the Authority to disclose the disaggregated data used by the Authority in determining the initial targets and improvement rates applicable to CI and CML, within the confines of a confidentiality ring.[29]

---

[26] BGT notes that while this resolves the issue in relation to the Slow-track DNOs, it is entirely unclear whether and how fast-track DNOs were required to return any double-recovery in relation to excluded services. This issue des not fall within the scope of the current appeal and BGT is taking it up separately with the Authority.

[27] See RIIO-ED1 licence changes [**BG1/3**], *CRC2D: Adjustment of licensee's revenues to reflect interruptions-related quality of service performance*.

[28] See RIIO-ED1 licence changes [**BG1/3**], *CRC 2C: Broad Measure of Customer Service Adjustment*. Note that the Authority refers interchangeably to the 'Broad Measure of Customer Service' and the 'Broad Measure of Customer Satisfaction'.

[29] See the comments of the CC in its determination in the *Carphone Warehouse* LLU appeal, dated 31 August

(a) IIS

The Authority's approach

4.27 The IIS includes performance targets for unplanned customer interruptions ('**CI**') and customer minutes lost ('**CML**') as a result of such interruptions.

4.28 The targets consist of an initial target and a subsequent rate of improvement to apply for the remainder of the RIIO-ED1 period. The target applicable for each year of the Price Controls is then determined by adjusting the initial target by the rate of improvement for each year since the commencement of the Price Control. DNOs receive rewards in each year if their performance exceeds the relevant target for that year; and penalties if their performance falls below that target. An explanation of the manner in which the initial target and improvement rates have been set for each DNO in relation to CI and CML, insofar as this is apparent from the Authority's explanations, is set out in AlixPartners Report at §§5.1.5–5.1.23.

Errors in the Authority's approach

4.29 The CI and CML targets are calibrated 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.

4.30 Based on the most recent available data (the 2014/15 forecasts), 10 out of 14 DNOs already achieve performance levels which *exceed* the average target set by the Authority for RIIO-ED1; and would therefore be able to earn rewards under either or both of the CI or CML schemes without making *any* improvements over the next eight years.

4.31 Even excluding the 2014/15 forecasts and working only on the most recent year of actual data

---

2010 [**BG2/49**] at §§1.74-1.75. The CC recognised that a party '*challenging a regulatory decision in respect of a third party's pricing behaviour will suffer from the initial disadvantage of informational asymmetry in relation to the decision-making process*'. As one solution to this problem, It underlined the importance of '*any decision maker seeking to give the greatest possible degree of transparency to its decisions and decision-making process (consistent with duties of confidentiality) so as to obviate as far as possible the need for extensive disclosure applications in these time-sensitive appeals*'. Where necessary, however, it also observed that '*there are procedures before the Tribunal to enable a party to these proceedings to seek disclosure and/or obtain information where appropriate. We encourage parties to future appeals to invoke the case management powers of the Tribunal at an early stage in order to overcome any perceived lack of understanding of the basis for a contested decision*'.

(for 2013/14), 8 out of 14 DNOs already exceed the Authority's average targets. Over half of DNOs would therefore receive rewards without corresponding improvements in their performance.

4.32 The amounts in question are substantial: the total rewards that would accrue to the DNOs who already outperform their average targets for RIIO-ED1 amount to £424.2 million (£146.2 million attributable to Slow-track DNOs) (working from the 2014/15 forecasts); or £342 million (£126 million for Slow-track DNOs) (based on the 2013/14 actual data).

4.33 This excessive system of rewards represents obvious poor value to consumers. It is attributable to three more specific errors on the Authority's part, as follows.

4.34 First, the Authority's targets for CI and CML are based on outdated information and fail to take account of recent improvements in performance. Specifically, they fail to take account of actual performance data for 2013/14.

4.35 The impact of measuring average performance using the most recent actual data over the four years from 2010/11 to 2013/14, in place of the dataset from 2009/10 to 2012/13 relied on by the Authority, is significant: the average CI performance is 3.2% better than for the earlier period; and the CML performance is 6.1% better. These rates of improvement are much higher than the average annual improvement factor assumed by the Authority when deriving the initial CI and CML targets for 2015/16 (of only 0.3% over three years for CI; and 2.6% over three years for CML).

4.36 The position is even more stark when account is taken of the following matters:

a. DNOs' *forecast* data for 2014/15 anticipates a substantial improvement in IIS rewards (of around 8%) by comparison with 2013/14. This suggests that at an industry level, the DNOs can expect to outperform the Authority's target by an even greater margin than is suggested by the most recent actual data.

b. Adopting an initial target based on a four year average means that companies would in any event be expected to outperform the index, irrespective of the four years used. This is simply because performance has improved over the four year period, and the average will therefore be worse than the most recent performance achieved.

4.37 In its letter to BGT of 3 February 2015 [**BG2/39**] (at §35), the Authority contends that it would be inappropriate to use the most recent data available in setting targets. It asserts, without elaboration, that the data '*has not yet been finalised*'.[30] It also maintains that the targets needed to be set before the DNOs submitted their business plans, so that they could make investment decisions based on the targets. However:

a. the DNOs' investment decisions depend on the marginal incentive rate and not on the specific targets or improvement rates set by the Authority: see 1st Manning at §103 and AlixPartners Report §5.2.18;

b. in setting the DPCR5 price controls, the Authority was able to consider performance data across the four year period ending two years prior to those controls. The Authority should have been able to consider the equivalent dataset when setting the RIIO-ED1 price controls (i.e. 2010/11-2013/14) rather than allowing the time lag to increase to three years: see 1st Manning at §104;

c. in any event, the Authority's Strategy Decision did not contain the initial targets to be applied by the Authority, and the DNOs did not have the actual data for 2012/13 subsequently relied on by the Authority to fix those targets when they prepared their business plans: see 1st Manning at §103.

4.38 Secondly, the improvement factors applied by the Authority during the RIIO-ED1 price controls are well below historical average rates of improvement; and substantially below the rates achieved by upper quartile DNOs. They therefore fail to hold the sector to appropriate and achievable targets.

a. The annual rates of improvement required for CI (of 0.5% to 1.5% depending on each DNO's current performance, with an overall average of 0.8% are significantly below:

i. The actual average achieved since 2003/04 (of 3.2%);

[30] The Authority has provided no explanation as to why the data could not have been finalised in time to include in the setting of IIS targets for slow track DNOs (in the same manner that 2008/09 data was included in the setting of targets for DPCR5), or indeed why it remains in a provisional state. The Authority has previously indicated that the period required for auditing the data is at most 10 weeks. See Manning 1st [**BG1/AM1**] at §104.

ii. The four years from 2009/10 to 2012/13 considered by the Authority itself when setting its targets (of 3.9%); and

iii. The most recent four year period for which actual data is available, from 2010/11 to 2013/14 (of 3.1%).

b. Similarly the annual rates of improvement required for CML (averaging 1.8%) are significantly below:

i. The actual average achieved since 2003/04 (of 4.7%);

ii. The four years from 2009/10 to 2012/13 considered by the Authority itself when setting its targets (of 6.6%); and

iii. The most recent four year period for which actual data is available, from 2010/11 to 2013/14 (of 5.5%).

4.39 Further, when the Authority's targets for the RIIO-ED1 period are considered against the range of performance achieved by DNOs, it is apparent that those targets are much closer to the worst rate of historical performance that to the best rate; and are well below the upper quartile. As the AlixPartners Report records at §5.2.23:

'The fact that underperforming companies are set rates of improvement which are significantly below the sector average (let alone the average for leading performers) suggests that (as with previous price controls) the RIIO-ED1 regime provides scope for systematic outperformance and fails to penalise poor performance, to the detriment of consumers.'

4.40 <u>Thirdly</u>, the Authority's initial targets for CML are asymmetric:

a. companies that have performed above targets previously are allowed to benefit from that past performance since their target is set at an industry benchmark rate (which they already exceed);

b. by contrast, underperformers are not penalised for their poor performance to date, since their benchmark is fixed by reference to their own poor performance to date.

4.41 In practice, the effect is that outperforming DNOs are given targets for 2015/16 which they were already outperforming over three years ago (in the 2009/10 to 2012/13 period considered by the Authority); while lagging DNOs are judged against their own previous poor performance. As noted in the AlixPartners Report, '*taken together, this suggests that the industry will systematically outperform, since the expected rewards to the leading DNOs are not offset by any expected penalties for lagging operators*' (§5.2.29).

4.42 The perversity of this arrangement is particularly marked in circumstances where the outperforming DNOs have already been substantially rewarded over DPCR5 (in which £427m has been rewarded in the first four years, and a further £132m of rewards are forecast for 2014/15): AlixPartners Report at §5.2.30. In addition to those rewards, the Authority has now set benchmarks for the coming price control which effectively guarantee further rewards for those historic performance improvements, already achieved and rewarded in the last price control period.

(b) BMCS

The Authority's approach

4.43 The stated purpose of the BMCS is to '*encourage improvements in all aspects of DNOs' customer facing performance*' (Strategy Decision – Overview [**BG2/10-A**] at §2.30). It measures performance by means of:

a. a customer satisfaction survey, which seeks to gauge the views of three categories of customer, randomly sampled, who have (i) made a general enquiry, (ii) experienced an interruption or (iii) requested a new connection. DNOs' average score in each category of customer determines the level of the financial reward or penalty;

b. a complaints metric, measuring DNO performance by reference to four weighted measures: (i) the percentage of total complaints outstanding after one day; (ii) the percentage of total complaints outstanding after 31 days; (iii) the percentage of total complaints that are repeat complaints; and (iv) the proportion of energy Ombudsman decisions that find in favour of the complainant as a percentage of total complaints to the Ombudsman; and

c. a stakeholder engagement incentive, assessing how well the DNOs are engaging with stakeholders, through the grading of a report on stakeholder engagement which each DNO is required to submit to the Authority on an annual basis.

Errors in the Authority's approach

4.44 The BMCS is flawed in several respects. As a consequence of the flaws, the BMCS targets may be expected to lead to systematic unearned rewards at the sectoral level without any corresponding improvements in performance.

4.45 First, the targets set by the Authority under the BMCS have been relaxed by comparison with the targets applicable under the last price control; and/or set at a level that is too low, when assessed against DNOs' recent performance:

a. In the case of the customer satisfaction survey, the targets for the interruptions and general enquiries categories of customer have been set below the average level of performance of DNOs in 2013/14. Under the previous price control (which applied relative targets), only half of DNOs would have been rewarded for such performance. Under the absolute targets applicable in RIIO-ED1, 11 out of 14 DNOs will receive rewards each year simply by maintaining the performance levels already achieved in 2013/14. The underperforming DNOs in 2013/14 could see a further deterioration and still earn positive rewards under the Authority's new target.

b. In the case of the complaints metrics targets, the target has been set at a less demanding level than the 2012/13 and 2013/14 upper quartile performance (which DNOs needed to reach to avoid penalties under DPCR5).

c. In the case of stakeholder engagement, no change has been made to the method used to measure and reward DNO performance. DNOs are rewarded a mark out of ten, and may receive a reward if they reach a minimum threshold, with additional rewards available up to a maximum score, with both minimum and maximum scores set by the Authority. In 2013/14, the average score was almost 7 out of 10, and no DNO scored below 5.5.[31] The failure to tighten the existing incentive arrangements has the effect that substantial

[31] AlixPartners Report [**BG1/HH1**] at §6.1.34.

rewards are likely to be conferred on all DNOs, including the worst performing.

4.46 Secondly, the Authority has not incorporated any improvement factors in the absolute targets set under the BMCS. This is contrast to the stated objective of the BMCS of ensuring that DNOs are '*sufficiently incentivised to improve performance in customer-facing activities*' (Strategy Decision – Overview [**BG2/10-A**] at §2.30, emphasis added).

4.47 Thirdly, the incentive rates for the customer satisfaction survey rewards and penalties are not symmetric: the value of the rewards conferred for each unit of performance above the target is twice the value of the penalties imposed for each unit of performance below the target, without any obvious or stated justification.

Statutory grounds and relief sought

4.48 For the reasons set out above, in setting the IIS and BMCS targets for RIIO-ED1, the Authority has–

a. unreasonably refused to have regard to relevant information, available to it at the time of its Decision, giving rise to an error of law;

b. proceeded on the basis of erroneous forecasts in respect of a period for which actual figures were available by the time of the Decision, thereby committing an error of fact; and

c. failed to have proper regard to the interests of consumers, thereby acting contrary to its principal objective, in fixing targets which are too lenient.

4.49 The decision is therefore wrong on the grounds sets out in section 11E(4)(a), (c) and (e) EA89.

4.50 By way of relief, BGT requests the CMA to substitute its own decision for that of the Authority, and to adjust the IIS and BMCS in the manner proposed in the AlixPartners Report at §§5.4 and 6.4 respectively.

(3) Unwarranted ex-post change to information quality incentives

The Authority's approach

4.51 The IQI is a mechanism designed to incentivise DNOs to spend the time and resources necessary to produce high-quality and well-justified business plans; and to provide a financial deterrent against the submission of business plans containing inflated expenditure forecasts.[32] The business plans play an important role in deriving the Price Controls. In particular, they are used by the Authority to carry out benchmarking between DNOs, in order to inform its assessment of efficient costs.

4.52 The incentives under the IQI are therefore intended to influence the behaviour of DNOs while they are preparing their business plans for the forthcoming price control. Any adjustment to the IQI after business plans have been submitted can have no incentive effect for that price control.

4.53 Prior to the submission of DNOs' business plans, in March 2013, the Authority announced that the IQI would operate so that '*a DNO which submits an expenditure forecast for RIIO-ED1 that matches our assessment of that DNO's efficient expenditure can achieve a return equal to our estimate of its cost of capital, if it then spent the amount it had forecast over the control period*'.[33]

4.54 However, after the DNOs had submitted their business plans, the Authority decided to change the IQI so that '*a DNO group that forecasts 2.9 per cent above our efficient cost benchmark and achieve [sic] its forecast will earn its cost of capital...*'.[34]

Errors in the Authority's approach

4.55 The *ex-post* change applied by the Authority to the IQI is not well founded, and is harmful to the interests of consumers without any countervailing benefit.

4.56 The Authority's change to the IQI cannot advance the purpose of the IQI, which is to

[32] RIIO Handbook [**BG2/4**] at §8.46. The operation of the IQI is described in AlixPartners Report [**BG1/HH1**] at §7.2.

[33] See Strategy Decision: Outputs, Incentives and Innovation [**BG2/10**] at §9.14. This incentive structure was reflected in a matrix, recording the levels of reward or penalty applicable under the IQI, reproduced in the AlixPartners Report [BG1/HH1] at §7.2.16.

[34] See Draft Determinations: Overview [**BG2/30-A**] at §4.56; Final Determinations - Overview [**BG2/35-A**] at §4.86.

encourage DNOs to produce good business plans. By the time of the change, the DNOs had already submitted their business plans on the basis of the incentives resulting from the IQI as announced in the Strategy Decision. By that time, any incentive effect of the IQI in relation to the present price control period had already been achieved.

4.57 The overall effect of the change is to increase the allowable returns of the Slow-track DNOs, at the expense of consumers, by around £290 million over the course of the Price Controls (AlixPartners Report at §1.6.10).[35]

4.58 The reasons offered by the Authority do not provide a sound justification for the change.

4.59 First, the Authority contends that the £290 million cost to consumers should be set against '*cost savings of nearly £700m*',[36] which are said to have resulted from the slow track comparative cost benchmarking exercise during the course of the Price Controls.[37] However, those cost savings were the result of business plans which had already been submitted by the time of the change to the IQI. It is irrational to attribute such benefits to that change.

4.60 Secondly, the Authority contends that the change is needed to encourage '*the submission of better information … in future price controls*' (emphasis added).[38] This justification is equally unsustainable:

a. the effect of *ex-post* adjustments to the IQI is to weaken the incentives of DNOs in subsequent price controls to submit high-quality and well-justified business plans: the perception that the Authority 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; and

b. in any event, if the Authority considers that the IQI needs adjusting for the future, this

---

[35] The Authority itself estimates the cost at £290m: see the Authority's letter to BG of 3 February 2015 [**BG2/39**] at §26. The AlixPartners Report calculates the cost at between £290m-300m. See AlixPartners Report [**BG1/HH1**] at §7.4.7.

[36] The £700m figure cited by the Authority is largely capitalised, meaning reductions in revenue will be spread beyond the RIIO-ED1 period. The reduction in revenues in the RIIO-ED1 period is estimated by BGT as circa £264m: Manning 1st [**BG1/AM1**] at §129.

[37] The Authority's letter to BGT of 3 February 2015 [**BG2/39**] at §26.

[38] The Authority's letter to BGT of 3 February 2015 [**BG2/39**] at §25.

can be done by announcing a revised mechanism prior to the submission of business plans for the next price control period (RIIO-ED2). It does not require the Authority to increase DNOs' rewards after the event, at the expense of consumers, during the present price control.

4.61 Thirdly, the Authority contends that the change to the IQI is justified because:

a. the Authority's intention was always to confer rewards upon the four DNOs in the upper quartile of its efficiency benchmark; and

b. this would not have occurred under the IQI as originally formulated because of two adjustments made by the Authority to its efficiency analysis, after the upper quartile calculation, in order to account for (i) real price effects ('**RPEs**') and (ii) incremental efficiencies resulting from the deployment of smart grids by the DNOs.[39]

4.62 As to this:

a. The Authority is wrong to suppose that the overall effect of RIIO-ED1, following the change to the IQI, is to benefit only the four DNOs with the best business plans. On the contrary:

i. **four** DNOs (in the WPD group) have already been **rewarded** with substantial performance-related benefits by virtue of their business plans under the fast-track scheme, including an additional 2.5% allowance in revenues expressly in lieu of the IQI (AlixPartners Report at §7.3.8(b));

ii. **five** further DNOs (in the three least inefficient slow-track DNO groups, Electricity North West Limited (ENWL), Northern Power Grid (NPg) and Scottish and Southern Energy Power Distribution (SSEPD) all receive upfront **rewards** as a result of the change (Draft Determinations – Overview [**BG2/30-A**] §§4.59–4.60); and

[39] The Authority's letter to BGT of 3 February 2015 [**BG2/39**] at §25.

iii. the remaining five DNOs (in the SPEN Energy Networks (SPEN) and UK Power Networks (UKPN) groups) will receive a reduction in their penalties (and hence an increase in allowed prices) by virtue of the change (AlixPartners Report at §7.3.8(a)).

Overall, therefore, 9 out of 14 DNOs have received rewards in respect of their business plans, following the Authority's *ex-post* change.

b. Moreover, it is perverse to adjust the IQI mechanism simply in order to ensure that a certain number of DNOs benefit under the mechanism. The purpose of the mechanism is to reward high-quality and well-justified business plans, not to guarantee rewards to at least four DNOs.

c. The change cannot be justified either by reference to the Authority's efficiency adjustments by reason of expected smart grid benefits and real price effects.

d. The adjustment for smart grids reflects the collective inadequacy of DNOs' business plans in quantifying the efficiencies achievable by this new technology. The Authority's Strategy Decision [**BG2/10-A**] at §§3.17 and 3.20 put the DNOs on notice of the need to reflect the efficiencies resulting from the costly smart grid investments which consumers are funding. However, when the Authority considered the business plans, it found that the DNOs had collectively failed to pay sufficient regard to the efficiencies achievable from smart grids.[40] Its adjustment was made because of the deficiencies in the DNOs' business plans. If anything, the Authority considered the adjustment that it made to be conservative.[41] In assessing the efficiencies achievable from smart grids, the Authority drew on various publicly available sources, which were available to DNOs.[42] In the circumstances, there was no justification for adjusting the IQI to save DNOs from the consequences of their failure to prepare robust business plans in relation to smart grids. The adjustment runs contrary to the purpose of the IQI.

---

[40] Draft Determinations – Overview [**BG2/30-A**] at p 5.

[41] It decided not to count efficiency gains that may result from embedding innovation from smart grid solutions into standard business practices, which the Authority considered could be at least 1 per cent of total expenditure: Draft Determinations – Overview [**BG2/30-A**] at §4.39.

[42] Draft Determinations – Overview [**BG2/30-A**] at §§4.27–4.41.

e. As regards RPEs, the DNOs were similarly aware of their relevance to the consideration of expenditure, and specifically to the IQI.[43] The updates made by the Authority after submission of business plans were based on data for 2012/13 and 2013/14.[44] By the time that the DNOs submitted their business plans in March 2014, the DNOs should already have had a reasonable view of 2012/13 data and some sight of developments in 2013/14. They could have been expected to adjust their business plans accordingly, and should not be rewarded for poor forecasts.

f. In any event, even if it were appropriate to compensate for the smart grid and RPE adjustments, the change to the IQI is out of all proportion to the net impact that the adjustment would have on the DNOs' outturn costs under the proposed IQI *before* the Authority's change. As explained in the AlixPartners Report, this would amount to a loss of revenues of about -0.1%, taking account of the reduction in the DNO's outturn costs resulting from the adjustments. By contrast, the effect of the change to the IQI is to increase DNOs' revenues by 1.7%, **seventeen times** greater than would be needed to compensate for the net impact of the adjustments on the operation of the IQI.[45]

g. In any event, it is to be expected that circumstances might change between the submission of business plans and the final Decision. Those changes could affect performance in relation to the IQI index in either direction and therefore they could provide a benefit or a disbenefit to DNOs. This is an accepted part of RPI-X regulation, known as the 'fair bet' principle.[46] There is no justification for adjusting the index *ex post* simply because the fair bet turns out to disadvantage the DNOs. It is likely that other factors over the period of the control will operate to their benefit. In many cases those

[43] The Authority specifically stated that RPEs were included with IQI to give incentives for accurate forecasting of RPEs: see Strategy Decision - Outputs, Incentives and Innovation [**BG2/10-B**] at §9.8.

[44] Draft Determinations – Overview [**BG2/30-A**] at §4.21.

[45] AlixPartners Report [**BG1/HH1**] at §§7.3.31–7.3.33.

[46] The fair bet principle has been described as follows by Ofcom: '*An investment is a 'fair bet' if, at the time of investment, expected return is equal to the cost of capital. This means that, in order to ensure that an investment is a fair bet, the firm should be allowed to enjoy some of the upside risk when demand turns out to be high (i.e. allow returns higher than the cost of capital) to balance the fact that the firm will earn returns below the cost of capital if demand turns out to be low. This issue is particularly important where there is significant uncertainty around demand (or other factors that affect returns).*' Ofcom, Proposals for WBA Charge Control – Consultation, 20 January 2011, Annex 8, paragraph A8.27 available at: http://stakeholders.ofcom.org.uk/consultations/wba-charge-control/. See also AlixPartners Report [**BG1/HH1**] at §7.3.30.

factors may only be known to the DNOs and cannot reasonably be ascertained by the Authority.

Statutory grounds and relief sought

4.63 For the reasons set out above, the Authority erred in making *ex-post* changes to the IQI. In particular, its decision to do so is–

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

b. contrary to the Authority's principal objective to protect the interests of consumers;

c. contrary to the Authority'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 the Authority, namely to improve incentives to prepare well-justified business plans in the present and future price controls.

4.64 The decision is therefore wrong on the grounds set out in section 11E(4)(a), (d) and (e) EA89.

4.65 BGT requests the CMA to substitute its own decision for that of the Authority, and to reinstate the original IQI breakeven point which informed the DNOs' incentives when preparing their business plans.

(4) Unwarranted transitional arrangements for change in asset life policy

The Authority's approach

4.66 Since privatisation, DNO assets have been depreciated on the basis of a 20-year 'accelerated depreciation' policy. That policy is accelerated relative to actually expected technical or economic asset lives, which the Authority estimates are between 45 and 55 years.

4.67 The result of an accelerated depreciation policy is that current consumers overpay for the use of assets to the benefit of future consumers, who continue to benefit from the use of assets

even after the end of the 20-year depreciation period during which those assets are remunerated. DNOs also benefit by being repaid for their capital expenditure over 20 years, rather than over the full economic lives of assets as would be the case under standard accounting principles.[47]

4.68 In the course of developing the RIIO framework, the Authority concluded that there were clear disadvantages to accelerated depreciation, and that depreciation based on actual estimated asset lives would lead to better outcomes for both consumers and investors:

> *'... depreciation based on economic asset lives is appropriate and will provide for sustainable financeability over the longer-term, improved longer-term intergenerational equity and better longer-term pricing signals.'*[48]

4.69 BGT supports that conclusion.

4.70 In March 2011, the Authority decided to apply the change from accelerated to economic depreciation to <u>new assets only</u> from the beginning of the RIIO-ED1 price controls to assume a 45-year asset life. Existing assets would continue to depreciate over 20 years. The exclusion of existing assets was partly based on historical considerations, and partly in order to address concerns voiced by the DNOs about the impact on financeability if the change were to apply to all assets.[49]

4.71 The Authority acknowledged that the change of depreciation policy applicable to new assets could still have financeability implications for individual DNOs, and invited them:

> *'… to set out and justify in their RIIO-ED1 business plans the transitional arrangements that they believe are necessary to ensure financeability.'*[50]

4.72 The Authority commented further that it had a preference to manage any transition required over one price control period. In the event, all Slow-track DNOs proposed a straight-line 8-

---

[47] AlixPartners Report [**BG1/HH1**] at §8.1.4.

[48] Decision letter on the regulatory asset lives for electricity distribution assets, 31 March 2011 [**BG2/5**] p 3.

[49] Decision letter on the regulatory asset lives for electricity distribution assets, 31 March 2011 [**BG2/5**].

[50] Strategy Decision – Financial Issues [**BG2/10-F**] at §4.18.

year transition over the duration of the Price Controls, which the Authority decided to implement in the Final Determinations.[51]

Errors in the Authority's approach

4.73 In deciding to introduce transitional arrangements across all Slow-track DNOs, the Authority erred:

a. That approach is harmful to the interest of consumers, as it delays an economically efficient change and increases the cross-subsidy between current and future consumers.

b. By applying transitional arrangements across the sector rather than case-by-case on the basis of demonstrated need, the Decision also fails to have regard to the principle under which regulatory activities should be targeted only at cases in which action is needed.

4.74 Absent transitional arrangements, current and future consumers' contribution to investment costs for new assets would be equal to the cost associated with the use of these assets. As the AlixPartners Report explains at §8.2.3(a), this '*simply reflects the application of the appropriate level of economic depreciation*'.

4.75 Delaying the introduction of economic asset lives by the use of transitional arrangements means that current consumers continue to pay more than is economically appropriate for their use of DNO assets. It means that current consumers, who have historically overpaid for the use of assets under the accelerated depreciation which has applied until now, will continue to do so, thereby perpetuating the cross-subsidy of future consumers.[52]

4.76 A delay in the introduction of economic depreciation, which the Authority itself recognises to be the appropriate policy, is contrary to the interests of current consumers. Having identified economic depreciation as the correct policy the Authority should have implemented it as quickly as possible unless it could demonstrate a strong countervailing justification (which it has not done). The Competition Commission has recognised that regulators need to demonstrate 'good reasons' to delay the implementation of a policy which they have

[51] Final Determinations – Overview [**BG2/35-A**] at §5.1.

[52] AlixPartners Report [**BG1/HH1**] at §§8.2.1-8.2.4

otherwise identified as the correct one.[53]

4.77 The Authority introduced the transitional arrangements for its change in asset life policy in the Draft Determinations. It observed that each Slow-Track DNO had proposed a straight-line 8-year transition period and concluded, without further explanation:

> '*We consider their proposals are sensible.*'[54]

4.78 BGT raised the concerns articulated in this ground of appeal during the following consultation. The Final Determinations [**BG2/35**] did not acknowledge or address those submissions, or offered any further explanation.

4.79 In the statutory consultation prior to the Decision [**BG2/38**], BGT repeated its concerns. In its letter to BGT of 3 February 2015 **[BG2/39]** at §§28–30, the Authority identified for the first time three considerations which it considered to support the adoption of transitional arrangements:

a. first, the move to economic depreciation would result in '*[s]evere upward pressure on network charges*' after 2035/36 absent transitional arrangements;

b. secondly, transitional arrangements '*provided a better foundation for longer term financeability*'; and

c. thirdly, such arrangements were justified by '*[i]nter-generational considerations*', regarding '*which generation of consumers should bear the costs*'.

4.80 None of those reasons provides an adequate justification for the introduction of sector-wide transition arrangements.

---

[53] *British Telecommunications plc v Ofcom (Case 1180/3/3/11), Everything Everywhere Limited v Ofcm (Case 1181/3/3/11), Hutchison 3G UK Limited v Ofcom (Case 1182/3/3/11), Vodafone Limited v Ofcom (Case 1183/3/3/11) and Telefónica UK Limited* (9 February 2012) at §5.75: '*As Ofcom elected to adopt a LRIC cost standard and recognized in principle that it should align prices with LRIC as quickly as it reasonably could, we find there to be force in BT's arguments, supported by Three, that Ofcom needed good reasons to adopt the longer option. We agree with BT and Three that the reasons for preferring a four-year glide path are not convincing*.'

[54] Draft Determinations – Financial Issues [**BG2/30C**] at §3.52.

4.81 First, as the AlixPartners Report explains in more detail in §§8.2.5–8.2.15, the Authority's concern in relation to severe future upward price pressure is misplaced.

4.82 The Authority presents no analysis in support of that contention. Modelling undertaken by AlixPartners Partners on behalf of BGT indicates that the difference in any upward pricing trend with or without transitional arrangements would in fact be marginal (AlixPartners Report at §§8.2.5-8.2.15). As a result of the change from 20 to 45-year lives for new assets, allowable revenue will – all else equal – decline from 2015 until 2035/36 as existing assets subject to accelerated depreciation fall out of the regulated asset base. Revenues will thereafter increase again until reaching a new steady state in 2058/59. Assuming a modest rate of productivity improvement (leading to a downward pressure on prices of 1% per annum – broadly consistent with the assumptions for RIIO-ED1[55]), the AlixPartners Report estimates that the annual growth rate required from 2035/36 to 2058/59 to account for that effect would be 0.5% (with transitional arrangements) and 0.8% (without such arrangements).[56]

4.83 There is therefore no basis for assuming 'severe' upward pricing pressure absent the transition. Insofar as there are price increases in future price controls, those reflect a proper allocation of costs to those enjoying the use of the assets in question. In any event, the uncertain prospect of such increases, several decades in the future, is better addressed (if appropriate) in subsequent price controls. It does not provide a sufficient justification for imposing additional costs now on consumers who have already overpaid – and will continue to overpay – under the accelerated depreciation of existing assets.

4.84 Secondly, the decision has not been demonstrated to be necessary to secure financeability.

4.85 In the '*Handbook for implementing the RIIO model*', October 2010 [**BG2/4**] (at §12.37), the Authority makes it clear that transitional arrangements are a mechanism reserved for demonstrated need on an individual company basis:

> '*The onus will be on the network companies to demonstrate to us in their well justified business plans why transition arrangements are necessary and to propose a suitable*

[55] The impact of the transitional arrangements (i.e. a reduction in the upward pricing pressure of 0.3%) is not sensitive to the assumption of underlying efficiency of 1%: see AlixPartners Report [**BG1/HH1**] at §8.2.13.

[56] By way of context, the price increases over the last DPCR period were in the order of RPI+5.6%.

methodology. Where a company does demonstrate that application of the financeability principles in a single step would cause an efficient company financing difficulties, we will implement transition arrangements to ensure financeability.'

4.86 That is a sound policy position, as any transitional arrangement by its nature constitutes a delay to the achievement of an outcome that would otherwise be considered desirable in fulfilment of the Authority's statutory duties. Such a departure needs to be shown to serve the consumer interest in the round, having regard to other relevant considerations such as the ability of DNOs to finance their operations.

4.87 That justification has not been made out in the current case. The Authority has failed to offer any explanation or analysis – either at the consultation stage, or in support of the Decision – to show why transitional arrangements are necessary for any individual DNO or for the sector as a whole.

4.88 On the limited information that the Authority has provided, it appears unlikely that the arrangements could be justified as necessary:

a. The Authority's analysis of the overall impact of the RIIO-ED1 price control on financeability indicates that, for all but one metric – the post-maintenance interest cover ratio ('**PMICR**') – all DNOs, with the exception of one company for one year, meet or exceed targeted ratios for an investment grade credit rating.[57]

b. As the AlixPartners Report explains, that analysis assumes that transitional arrangements are in place, and a fuller analysis absent such arrangements, which the Authority does not present, would be needed. However, it is notable that the one ratio flagged as potentially critical, PMICR, is either not at all or only to a minimal extent supported by the proposed transitional arrangements.[58]

c. In any event, it is highly improbable that financeability issues would justify the introduction of transitional arrangements across the sector, rather than for individual

[57] Draft Determinations: Financial Issues [**BG2/30-C**] at §3.11.

[58] AlixPartners Report [**BG1/HH1**] at §§8.2.21–8.2.22.

DNOs, where merited by their specific circumstances.[59]

4.89 Moreover, the onus for ensuring an investment grade credit rating rests on DNOs in the first instance. Before concluding that financeability concerns justified a delay to the introduction of economic depreciation for a particular DNO, the Authority should therefore also have considered whether such concerns could be addressed by the DNO itself, e.g. by means of lower dividends or additional equity.[60] DNOs have benefited in the past from an accelerated depreciation policy as consumers have overpaid; and it is reasonable to expect them, rather than consumers, to finance the transition to a more efficient economic approach.[61]

4.90 Thirdly, the Authority is incorrect to contend that considerations of inter-generational equity support the introduction of transitional arrangements. On the contrary, the arrangements run counter to such considerations. While an effect of the move from accelerated to economic depreciation for new assets is that (all else equal) current consumers will pay lower charges and future consumers will pay higher charges, that does not represent a transfer of wealth from future to current consumers which requires to be mitigated by means of the transitional arrangements:

a. Lower charges for current consumers result from an unwinding of past over-payments as consumers continue to derive a benefit from the use of existing assets beyond their 20-year depreciation schedule.

b. Lower charges for current consumers do not represent a deferral of the appropriate cost of the use of assets for future generations to pay, as suggested by the Authority in its letter to BGT of 3 February 2015 [**BG2/39**] at §31. Absent transitional arrangements, both current and future consumers would at no point pay more than is appropriate for their use of new assets, while also enjoying a benefit from historical overpayments that

[59] AlixPartners Report [**BG1/HH1**] at §§8.2.24–8.2.26.

[60] The Competition Commission decided in relation to Bristol Water [**BG2/48-A**] at paragraph 10.8 that '*...the duty...to secure that companies can finance ...their functions is fulfilled by ensuring that opex and capex projections and the cost of debt and equity (and therefore WACC) are reasonable*'.

[61] This is particularly the case in circumstances where the proposed application of economic asset lives to new assets only is already a concession to financeability concerns. As the Authority observed in the Strategy Consultation – Financial Issues [**BG2/8F**] at §2.41: '*... if there is an impact on the cost of capital from the duration of cash flows, it is significantly mitigated by only applying 45-year asset lives to new assets.*'

diminishes over time: see AlixPartners Report at §8.2.3.

c. The interests of equity are not well-served in deferring such benefit further into the future, at the expense of current consumers, who are the ones who have overpaid for the existing stock of assets.[62]

Statutory grounds and relief sought

4.91 For the reasons set out above, the Authority's erred in introducing transitional arrangements in relation to its change in asset life policy. Its decision to do so –

a. is contrary to the Authority's duties to protect the interests of consumers, to promote efficiency, and to target its activities only at cases where action is needed;

b. gives inappropriate and unsupported weight to subsidiary considerations of financeability; and

c. is procedurally flawed, and therefore wrong in law, by reason of: (i) an inadequate consultation preceding the Decision, in which the Authority did not present any reasoning or analysis in support of its policy for consideration and comment by stakeholders; (ii) an inadequate statement of reasons in support of the Decision; and (iii) that Authority's failure at each stage to act in accordance with its duties of transparency and accountability.

4.92 The decision is therefore wrong on the grounds set out in section 11E(4)(a), (b) and (e) EA89.

4.93 BGT requests the CMA to substitute its own decision for that of the Authority, and to implement depreciation based on economic asset lives for new assets from the beginning of the RIIO-ED1 period without any transitional arrangements.

(5) Unwarranted change in cost of debt Indexation

The Authority's approach

[62] AlixPartners Report [**BG1/HH1**] at §8.3.10.

4.94 Allowed revenues under the Price Controls include an allowance to recover the DNOs' weighted average cost of capital (**'WACC'**), which in turn includes an allowance for the cost of debt. Under the RIIO framework, the cost of debt is estimated using an index derived from market evidence. This '*... helps ensure allowances are sensitive to changes in the interest rate environment that cannot be known at the time of a price review.*'[63]

4.95 In the Strategy Decision, the Authority stated that it would use a 10-year trailing index to estimate DNOs' cost of debt.[64] Such an index then formed the basis of the fast-track price control; it was also used in the other two RIIO price controls to date – for electricity transmission (RIIO-T1) and gas distribution (RIIO-GD1).

4.96 In the Draft Determinations, the Authority changed its approach and proposed a modified index, a 'trombone' index extending from a 10-year to a 20-year trailing average with a fixed start date of 1 November 2004.[65] That modified index was implemented in the Final Determinations[66] and the Decision.[67]

Errors in the Authority's approach

4.97 The Authority's change of approach creates significant additional costs for consumers (c. £120 million over the RIIO-ED1 period[68]) and is therefore not in the interest of consumers absent any strong countervailing justification. That justification has not been made out in the Decision or supporting documents and the Decision therefore does not provide a sufficient basis to justify the change in approach.

4.98 The 10-year trailing index was arrived at in the Strategy Decision following extensive consultation. At that point, the Authority concluded:

---

[63] Final Determinations – Overview [**BG2/35-A**] at §5.8.

[64] Strategy Decision – Financial Issues [**BG2/10-F**] at §1.4.

[65] Draft Determinations – Financial Issues [**BG2/30-C**] at §2.41.

[66] Final Determinations – Overview [**BG2/35-A**] at §5.6.

[67] See Price Control Financial Handbook [**BG1/4**] at §5.4.

[68] BGT submission in response to the Draft Determinations [**BG2/32-A**] p 4.

'*… we are not convinced by DNOs' arguments that they are different to the GDNs or transmission companies. We are therefore continuing with the index set out for RIIO-T1 and GD1. However, DNOs may, if they consider they have exceptional circumstances, suggest and justify modifications to the index in their business plans.*'[69]

4.99 The Final Determinations and the Decision fail to provide new evidence or reasoning that would be sufficient to justify departing from the position arrived at in the Strategy Decision. The analysis necessary to support the Authority's conclusions has not been presented, and what reasoning the Authority has offered is unsustainable in the light of the Authority's own policy position.

4.100 The Authority seeks to justify its change in approach with two considerations. It states that a modified 'trombone' index –

a. would have the benefit of better '*aligning forecast interest costs and cost of debt allowances*';[70] and

b. '*would better protect DNOs from exposure to market interest rate uncertainty*'.[71]

Aligning forecast interest costs and cost of debt allowances

4.101 Justifying the change in index construction by reference to actual forecast interest costs is not appropriate for two reasons.

4.102 First, a key principle of the RIIO framework is to allow an efficient network company to recover its costs. That principle extends to the cost of capital, and the Authority describes its policy position in relation to the cost of debt as:

a. a '*commitment to remunerating efficiently incurred debt costs*';[72] and in particular

---

[69] Strategy Decision – Overview [**BG2/10-A**] at §9.12.

[70] The Authority's letter to BGT dated 3 February 2015 [**BG2/39**] at §14(1).

[71] Final Determinations – Overview [**BG2/35-A**] at §5.9.

[72] RIIO Handbook [**BG2/4**] at §12.13.

b. to '*provide comfort that new debt, financed at efficient rates – even at levels higher than the allowed return – will be fully funded in the future*'.[73]

4.103 The policy position is <u>not</u> to allow a DNO to recover its actual costs from consumers irrespective of whether these were efficiently incurred.

4.104 It is therefore not sufficient to justify significant incremental costs by reference to the recovery of actual costs absent any analysis as to whether those costs were efficiently incurred.

4.105 BGT accepts that such an analysis is not straightforward in the context of cost of debt. However, the absence of any analysis at all – even the most basic benchmarking – is inappropriate given the magnitude of the financial impact of the change in index. As the AlixPartners Report states, the assumption that actual debt costs are efficiently incurred in their entirety simply '*is not a reasonable assumption to make without further investigation*' (at §9.2.4).

4.106 Furthermore, the change in index is not required to ensure '*that new debt, financed at efficient rates – even at levels higher than the allowed return - will be fully funded in the future*'.[74] A fixed-length trailing index fully achieves that goal. In fact, there is a risk that a 'trombone' index may not achieve the objective, as a feature of its construction is that lower weight is given to future years and higher weight to historical years which may or may not reflect future financing costs.[75]

4.107 <u>Secondly</u>, the Authority fails to present any analysis as to whether any shortfall in the recovery of actual interest costs may be attributable to other factors than indexation, most notably actual vs. notional levels of leverage for DNOs.[76]

4.108 As the AlixPartners Report explains, debt financing costs will be higher for more highly

---

[73] RIIO Handbook [**BG2/4**] at §12.15.

[74] RIIO Handbook [**BG2/4**] at §12.15.

[75] AlixPartners Report [**BG1/HH1**] at §§9.2.14–9.2.16.

[76] AlixPartners Report [**BG1/HH1**] at §9.2.6.

indebted companies and a substantial proportion of the high-cost embedded debt was issued by firms with highly indebted capital structures.[77]

4.109 However, as the AlixPartners Report further explains, the Authority does not need to take account of any gap in forecast vs. allowed costs of debt that results from higher gearing. The Price Controls allow DNOs to earn the allowed cost of debt and cost of equity on respective proportions of their RAV that are dictated by a notional level of gearing. Any debt in excess of that notional level of gearing will therefore be compensated at the (higher) cost of equity and not the cost of debt. All else equal, that effect should offset any higher costs of debt resulting from a higher level of indebtedness.[78]

4.110 The Authority also fails to take proper account of the so-called halo effect, by which market yields of DNOs' debt are significantly (around 50 basis points) below that of the benchmark underlying the cost of debt index.[79] The Authority fails to present any analysis on how that effect may impact DNOs' future financing costs. It simply acknowledges that '*our analysis is liable to overstate DNOs' cost of debt*'[80] without, however, acknowledging that it might therefore invalidate the Authority's finding that a simple 10-year trailing index is likely to under-recover forecast costs of debt.

Reduction of exposure to market interest rate uncertainty

4.111 Justifying the change in index construction by reference to a desire to reduce DNOs' exposure to interest rate risk is likewise unsustainable.

4.112 The reduction in interest rate risk is significant – the Authority estimates that its modified index represents '*nearly a ten-fold reduction in risk exposure*'[81] – and it is correct to conclude that '*[t]his kind of risk reduction would be of value to investors.*' (Draft Determinations §2.41).

---

[77] AlixPartners Report [**BG1/HH1**] at §9.2.5.

[78] AlixPartners Report [**BG1/HH1**] at §§9.2.5–9.2.6.

[79] AlixPartners Report [**BG1/HH1**] at §§9.2.8–9.2.11.

[80] Draft Determinations: Financial Issues [**BG2/30-C**] at §2.46.

[81] Draft Determinations: Financial Issues **[BG2/30-C]** at §2.44.

4.113 However, that reduction in risk for DNOs and their investors is not cost-free; it comes at the expense of consumers, who will see a reduction in the benefit associated with lower interest rates in the future.

4.114 An analysis of the impact of that risk transfer on consumers is notably absent from the Authority's reasoning. Equally absent is any assessment of whether the significant reduction in interest rate risk should result in consequential adjustments to other aspects of the Price Controls, for example a reduction in the allowed cost of equity which is likely to be improved by the lower interest rate risk exposure.

Statutory grounds and relief sought

4.115 For the reasons stated above, the Authority erred in changing its approach to the assessment of DNOs' cost of debt to using a 'trombone' index. In particular, the Authority has–

a. acted contrary to its principal objective of protecting the interests of consumers;

b. failed to have proper regard to its duty for transparency and accountability; and

c. failed to give adequate reasons to support its decision, and therefore erred in law.

4.116 The decision is therefore wrong on the grounds set out in section 11E(4)(a) and (e) EA89.

4.117 By way of relief, BGT invites the CMA to substitute its own decision for the of the Authority and to revert to an index based on a fixed 10-year trailing average, as proposed by the Authority in the Strategy Decision and adopted in the context of the fast-track price controls and the other RIIO price controls.

4.118 Alternatively, insofar as the CMA considers that further analysis is needed in relation to this issue that cannot be undertaken during the appeal process, BGT invites the CMA to remit this aspect of the Price Controls to the Authority for re-consideration following further investigation and analysis.

(6) Procedural flaws

The Authority's duties

4.119 The Authority is under a duty to act transparently; to consult before making a licence modification; and to give reasons explaining the purpose and effect of its proposed decisions at the consultation stage and addressing issues raised in consultation when adopting its final decision. See §§2.1–2.8 above.

4.120 Lord Woolf MR set out the requirements of an effective consultation in *R v North and East Devon Health Authority, Ex p Coughlan* [2001] QB 213 [**BG2/41**] at §108, as follows:

> '*… To be proper, consultation must be undertaken at a time when proposals are still at a formative stage; it must include sufficient reasons for particular proposals and allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and the product of consultation must be conscientiously taken into account when the ultimate decision is taken ...*'

4.121 Even an apparently extensive consultation process may be found to be flawed, insofar as, in substance, it has failed to enable effective participation. In *Vodafone v Ofcom* [2008] CAT 22 [**BG2/47**], the Competition Appeal Tribunal considered the adequacy of a consultation exercise by Ofcom that had involved '*a lengthy process, including two consultation documents*' and information requests under formal powers. As the Tribunal acknowledged, it therefore could not be said '*at least in form*' that *'the consultation process was inadequate*' (at §95). The Tribunal nonetheless found that the consultation was in substance deficient (at §§95-96):

> '*The purpose of consultation is to seek the informed views of, and best available information from, industry and, with the benefit of the expertise inherent in a specialised regulatory body, apply those views and information to the perceived industry failings …*
>
> *This Tribunal finds that, in the circumstances, the process undertaken by OFCOM did not allow stakeholders fully to provide intelligent and realistic responses to the questions asked of them. For example, as noted above, in the absence of a provisional technical specification on which consultees could provide useful data, OFCOM deprived themselves of the opportunity properly to inform their analysis of the potential costs of their proposals*.'

4.122 As regards the reasons to be given by a public authority, Lord Brown explained in *South Bucks District Council and another v Porter (No 2)* [2004] 1 WLR 1953 [**BG2/43**] at §36 that they:

> *' … must be intelligible and they must be adequate. They must enable the reader to understand why the matter was decided as it was and what conclusions were reached on the 'principal important controversial issues…'*

Defects in the Authority's procedures

4.123 The Authority's process has involved an extensive consultation exercise. The DNOs have necessarily played a central role in the process. They hold much of the information necessary in order to develop the Price Controls; and the proposals contained in their business plans are heavily relied upon by the Authority.[82]

4.124 However, it is also in the public interest that stakeholders on the purchasing side should also be able to engage effectively. The major suppliers like BGT are particularly well placed to represent and protect the consumer interest as they have the technical resources to understand and to challenge the DNOs' proposals.

4.125 BGT has therefore sought to contribute throughout the consultation process, but it has encountered difficulties in doing so, as set out in 1st Manning, §§56–64, and below. A particular source of difficulty has been the lack of detailed explanation of the Authority's reasons for rejecting BGT's proposals both at the consultation stage and in the Decision. In a number of cases, the reasoning given by the Authority:

a. is brief and conclusory, without supporting analysis;

b. makes general reference to considerations such as '*financeability*' or '*inter-generational equity*' which appear in the statute and could in principle serve as a countervailing justification for the lower prices which would otherwise serve current consumers' interests, but without any specific explanation of how the concerns arise in practice;

c. does not indicate what work has been undertaken by the Authority to assess the impact

[82] See the remarks of the CC in its determination in the *Carphone Warehouse* LLU appeal (31 August 2010) [**BG2/49**] at §§1.74-1.75, quoted in fn 29 above.

of its decisions, e.g. through a quantified assessment of inter-generational welfare effects, or by testing the impact of a given decision on DNOs' financial metrics;

d. introduces new considerations in the decision that were not identified at the consultation stage; and/or

e. is contained in side letters rather than in published documents (as in the case of the Authority's letter of 3 February 2015 to BGT [**BG2/39**]), thereby reducing the public visibility of the Authority's decisions and the basis upon which they have been reached.

4.126 As a consequence:

a. The multiple stages of the consultation have not enabled effective engagement by BGT. They have not provided the opportunity for an iterative process, in which BGT is able to understand and respond effectively to the Authority's reasoning.

b. Following the Decision itself, BGT remains uncertain as to what analysis, if any, underlies the Authority's very general statements in response to its concerns, leaving it with little choice but to pursue the present appeal in order to test the basis for the various adjustments made in the DNOs' favour during the preceding consultation.

4.127 Without effective engagement by stakeholders other than the DNOs, the construction of the Price Controls risks becoming a closed loop, in which the DNOs and the Authorities determine the shape of regulation to the exclusion of those who must pay the charges that are being set. In this connection, it is striking that apart from isolated examples of decisions affecting individual DNOs, every significant policy change made by the Authority since the Strategy Decision has been either neutral or to the advantage of the DNOs: see 1st Manning at §65 and accompanying table.

4.128 Instances of the Authority's lack of transparency can be seen from the substantive errors identified above. For example:

a. In the case of the double-recovered revenues from the previous price control period, the Authority offered no substantive reasons for its preference for a RAV adjustment in the Draft Determinations. In the Final Determinations, the Authority asserted that such an

adjustment struck '*an appropriate inter-generational balance*', particularly when considered with '*other factors that have inter-generational effects*', without explaining what this meant; and referred to the impacts of requiring restitution of the overpayments on DNOs' '*shorter term cashflows and financial metrics*', again without explaining the nature or significance of the impacts, or whether those had even been assessed.[83] The Authority's letter to BGT of 3 February 2015 [**BG2/39**] shed no further light on the Authority's reasoning, simply repeating (at §40) the assertion in the Final Determinations that the RAV adjustment '*would strike the right balance*' because of '*inter-generational issues*';

b. In the case of IIS / BMCS, the Authority's account of those schemes in the consultation documents is incomplete and in some respects inaccurate, as is now apparent from explanations provided by the Authority to BGT in correspondence: see 1st Manning, §110; moreover, the reasoning at the consultation stage and in the Decision is insufficient to enable a proper understanding of, or intelligent response to, the Authority's policy choices. In order to shed light on what the Authority has done, BGT has had to make a series of further enquiries in correspondence (see 1st Manning, §§106-110), and the picture remains incomplete;

c. In the case of IQI, the reasons given at the consultation stage and in the Decision are again not adequate to enable effective engagement. The Authority does not explain why cost savings in business plans submitted before the change to the IQI are attributable to that change; why the change may be expected to improve incentives during future price controls; or why collective deficiencies in the DNOs' business plans with regard to smart grids or RPEs serves to justify the change: see 1st Manning §§125–126. Nor does the Authority provide any supporting analysis to show the effects of the RPE/smart grids adjustments, or to support the level of the change made to the IQI.

d. In the case of the transitional arrangements for the change in asset lives, the Authority failed to provide any reasons for the introduction of transitional arrangements at the consultation stage beyond stating '*We consider [the DNOs'] proposals are sensible*' (see §4.77 above). Furthermore, in the Final Determinations, the Authority failed to acknowledge or address any of the concerns raised by BGT in relation to the transitional

[83] Final Determinations: Overview [**BG2/35-A**] at §5.47.

arrangements, or to provide any further explanation. The only reasoning provided by the Authority was contained in its side letter to BGT dated 3 February 2015 **[BG2/39]**, following the Decision. However, that reasoning fails to provide any proper explanation or analysis in support of the Authority's allegation that, without the transitional period, 'severe' future upward price pressure is to be expected. Nor does the Authority attempt to explain or analyse how transitional arrangement are necessitated by financeability concerns; or why transitional arrangements would promote inter-generational equity (when in fact they do not – see §4.90 above).

e. In the case of cost of debt indexing, the Authority failed to provide sufficient reasons for departing from its original approach, arrived at following consultation, and for apparently accepting arguments from DNOs it had explicitly dismissed previously (see §4.96 above). The Authority simply stated that it now considered that there were '*problems with using the 10-year index*' and indicated that the modified index would better match actual debt costs and provide significant interest rate risk protection to DNOs, without however explaining why it was appropriate to fund actual debt costs, whether it was appropriate to consider those costs to be efficiently incurred, or why it was appropriate for consumer to bear the cost of providing protection from interest rate risk to DNOs. Furthermore, in both the Final Determinations and in the Decision, the Authority failed to address any of the concerns raised by BGT in relation to the change in approach (beyond a one-line acknowledgment), and only provided a response in its side letter to BGT dated 3 February 2015 [**BG2/39**], following the Decision, without however addressing any of the above points.

f. The Authority's account of its reasons must be assessed in relation to each of the above topics having regard to the key importance of the Price Controls, which affect the prices to be paid for an essential commodity by all business and residential consumers in Great Britain. This underlies the legislature's emphasis on the need to maintain appropriate standards of transparency. BGT submits that the Authority has failed to act in accordance with those standards.

Statutory grounds and relief sought

4.129 By reason of the procedural defects identified above, the Authority has–

a. acted contrary to its duties of transparency and accountability; and

b. acted unlawfully, in breach of the requirements of fairness and its statutory obligations to consult and to give reasons.

4.130 The decision is therefore wrong on the grounds set out in section 11E(4)(a) and (d) EA89.

4.131 BGT recognises that the present appeal requires an intensive scrutiny of the underlying merits of the Authority's decision, and may therefore be sufficient cure the problems with the Authority's process.[84] However, BGT would invite the CMA to consider whether it would be appropriate to give general guidance to the Authority as to the importance of transparency for future licence modifications, as the CC did in the *E.ON v GEMA* appeal. See §2.27 above.

5. RELIEF AND PROPOSED DIRECTIONS

Summary of relief

5.1 For the reasons set out above, the CMA should:

a. set aside the Decision;

b. substitute a revised decision which corrects for the errors identified above; and/or

c. insofar as the CMA is unable to address any of the errors within the confines of the appeal process, remit the relevant matters to the Authority with directions to remedy the errors identified in the light of the CMA's findings; and

d. award BGT its costs of the appeal.

5.2 BGT proposes to make detailed submissions on the adjustments needed to remedy the Authority's errors, including as to the drafting amendments needed to the licences and associated documents, during the course of the appeal process.

[84] That is provided that the CMA is able to hear and consider fully BGT's substantive complaints in the accelerated timeframes in which the appeal must be determined.

Initial proposals for case management

5.3 As regards the management of the appeal, BGT requests that the CMA convene a case management conference at an early juncture so that the parties may make submissions as to the appropriate procedural directions and timetable for the appeal, pursuant to Rule 14 of the Competition Commission Energy Licence Modification Appeals Rules (which have been adopted by the CMA) ('**Rules**', individually a '**Rule**').

5.4 BGT notes the principle in Rule 4.1 that:

The overriding objective of these Rules is to enable the CC to dispose of appeals fairly and efficiently within the time periods prescribed by the Acts. The CC will apply these Rules so as to give effect to the overriding objective.

5.5 With this principle in mind, BGT submits that such directions should include:

a. provision for BGT to reply to the Authority's defence and any representations made by interested third parties;

b. establishment of a confidentiality ring, and disclosure of the disaggregated data used by the Authority in calculating its incentive targets for IIS and BMCS; and

c. directions to ensure that any representations on the part of the DNOs are tightly managed, including provision for a single statement of intervention and supporting evidence, in order to minimise complexity and cost; and to keep the appeal process within manageable bounds.

Towerhouse LLP

JOSH HOLMES

STEFAN KUPPEN

Monckton Chambers

2 March 2015

Statement of truth

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

Signed:

Raj Roy, Legal Director, Residential Energy

Dated: 2 MARCH 2015

Appendices

Appendix		**Page**
A	Extracts from legislative materials	64-73

Appendix A: Extracts from legislative materials

A1. *Electricity Act 1989*

A1.1 Section 11E(2) of the Electricity Act 1989 provides that the CMA must have regard, in determining this appeal, 'to the same extent as is required of the Authority, to the matters to which the Authority must have regard … in the carrying out of its principal objective under section 3A [and] in the performance of its duties under that section'.

A1.2 Section 3A (The principal objective and general duties of the Secretary of State and the Authority) provides that:

> *(1) The principal objective of the Secretary of State and the Gas and Electricity Markets Authority (in this Act referred to as 'the Authority') in carrying out their respective functions under this Part is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems.*
>
> *(1A) Those interests of existing and future consumers are their interests taken as a whole, including—*
>
> *(a) their interests in the reduction of electricity-supply emissions of targeted greenhouse gases;*
>
> *(b) their interests in the security of the supply of electricity to them; and*
>
> *(c) their interests in the fulfilment by the Authority, when carrying out its functions as designated regulatory authority for Great Britain, of the objectives set out in Article 36(a) to (h) of the Electricity Directive.*
>
> *(1B) The Secretary of State and the Authority shall carry out their respective functions under this Part in the manner which the Secretary of State or the Authority (as the case may be) 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.*
>
> *(1C) Before deciding to carry out functions under this Part in a particular manner with a view to promoting competition as mentioned in subsection (1B), the Secretary of State or the Authority shall consider—*
>
> *(a) to what extent the interests referred to in subsection (1) of consumers would be protected by that manner of carrying out those functions; and*
>
> *(b) whether there is any other manner (whether or not it would promote competition as mentioned in subsection (1B)) in which the Secretary of State or the Authority (as the case may be) could carry out those functions which would better protect those interests.*
>
> *(2) In performing the duties under subsections (1B) and (1C), the Secretary of State or the Authority shall have regard to –*
>
> *(a) the need to secure that all reasonable demands for electricity are met;*
>
> *(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part, the Utilities Act 2000, Part 2 or 3 of the Energy Act 2004, Part 2 or 5 of the Energy Act 2008 or section 4, Part 2, sections 26 to 29 of the Energy Act 2010 or Part 2 of the Energy Act 2013; and*
>
> *(c) the need to contribute to the achievement of sustainable development.*
>
> *(3) In performing the duties under subsections (1B), (1C) and (2), the Secretary of State or the Authority shall have regard to the interests of–*

(a) individuals who are disabled or chronically sick;

(b) individuals of pensionable age;

(c) individuals with low incomes; and

(d) individuals residing in rural areas;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(4) The Secretary of State and the Authority may, in carrying out any function under this Part, have regard to–

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

(b) any interests of consumers in relation to– (i) communications services and electronic communications apparatus, or (ii) water services or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

(5) Subject to subsections (1B) and (2), and to section 132(2) of the Energy Act 2013 (duty to carry out functions in manner best calculated to further delivery of policy outcomes) the Secretary of State and the Authority shall carry out their respective functions under this Part in the manner which he or it considers is best calculated–

(a) to promote efficiency and economy on the part of persons authorised by licences or exemptions to distribute, supply or participate in the transmission of electricity, to participate in the operation of electricity interconnectors or to provide a smart meter communication service and the efficient use of electricity conveyed by distribution systems or transmission systems;

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

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

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

(5A) In carrying out their respective functions under this Part in accordance with the preceding provisions of this section the Secretary of State and the Authority must each have regard to—

(a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and

(b) any other principles appearing to him or, as the case may be, it to represent the best regulatory practice.

(5B) In subsection (1A)—

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

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

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

(6) In subsections (1C), (3) and (4) references to consumers include both existing and future consumers.

(7) In this section and sections 3B and 3C, references to functions of the Secretary of State or the Authority under this Part include a reference to functions under the Utilities Act 2000 which relate to electricity conveyed by distribution systems or transmission

systems.
(8) In this Part, unless the context otherwise requires–
'exemption' means an exemption granted under section 5;
'licence' means a licence under section 6 and 'licence holder' shall be construed accordingly.

A1.3 Section 11E(2)(c) provides that, to the same extent as is required of the Authority, the CMA must have regard to the matters to which the Authority must have regard 'in the performance of its duties under sections 3B and 3C'. Section 3B (Guidance on social and environmental matters) requires the Authority to have regard to guidance issued by the Secretary of State 'about the making by the Authority of a contribution towards the attainment of any social or environmental policies set out or referred to in the guidance'. Section 3C (Health and safety) requires the Authority to take into account advice given by the Health and Safety Executive, the Office for Nuclear Regulation or the Secretary of State about any electricity safety issue. British Gas does not consider that sections 3B or 3C are relevant to its notice of appeal.

A2. Electricity Directive

A2.1 As noted above, section 3A(1A)(c) of the Electricity Act 1989 provides that the Authority's principal objective is 'to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems' and that the interests of existing and future consumers are 'their interests taken as a whole, including … their interests in the fulfilment by the Authority, when carrying out its functions as designated regulatory authority for Great Britain, of the objectives set out in Article 36(a) to (h) of the Electricity Directive'.

A2.2 The Electricity Directive (Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 Concerning Common Rules for the Internal Market in Electricity and Repealing Directive 2003/54/EC), article 36, provides as follows:

General objectives of the regulatory authority
In carrying out the regulatory tasks specified in this Directive, the regulatory authority shall take all reasonable measures in pursuit of the following objectives within the framework of their duties and powers as laid down in Article 37, in close consultation with other relevant national authorities including competition authorities, as appropriate, and without prejudice to their competencies:
(a) promoting, in close cooperation with the Agency, regulatory authorities of other Member States and the Commission, a competitive, secure and environmentally sustainable internal market in electricity within the Community, and effective market opening for all customers and suppliers in the Community and ensuring appropriate

> *conditions for the effective and reliable operation of electricity networks, taking into account long-term objectives;*
>
> *(b) developing competitive and properly functioning regional markets within the Community in view of the achievement of the objectives referred to in point (a);*
>
> *(c) eliminating restrictions on trade in electricity between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate electricity flows across the Community;*
>
> *(d) helping to achieve, in the most cost-effective way, the development of secure, reliable and efficient non-discriminatory systems that are consumer oriented, and promoting system adequacy and, in line with general energy policy objectives, energy efficiency as well as the integration of large and small scale production of electricity from renewable energy sources and distributed generation in both transmission and distribution networks;*
>
> *(e) facilitating access to the network for new generation capacity, in particular removing barriers that could prevent access for new market entrants and of electricity from renewable energy sources;*
>
> *(f) ensuring that system operators and system users are granted appropriate incentives, in both the short and the long term, to increase efficiencies in system performance and foster market integration;*
>
> *(g) ensuring that customers benefit through the efficient functioning of their national market, promoting effective competition and helping to ensure consumer protection;*
>
> *(h) helping to achieve high standards of universal and public service in electricity supply, contributing to the protection of vulnerable customers and contributing to the compatibility of necessary data exchange processes for customer switching.*

A2.3 As noted above, article 36 requires a regulatory authority to '*take all reasonable measures in pursuit of the following objectives within the framework of their duties and powers as laid down in Article 37*' in the course of '*carrying out the regulatory tasks specified in this Directive*'. Article 37(1) of the Electricity Directive provides that:

> *1. The regulatory authority shall have the following duties:*
>
> *(a) fixing or approving, in accordance with transparent criteria, transmission or distribution tariffs or their methodologies …*

A3. The Licensing Framework

A3.1 Section 4 of the Electricity Act 1989 (Prohibition on unlicensed supply etc.) provides that:

> *(1) A person who—*
>
> *(a) generates electricity for the purpose of giving a supply to any premises or enabling a supply to be so given;*
>
> *(b) participates in the transmission of electricity for that purpose;*
>
> *(bb) distributes electricity for that purpose;*
>
> *(c) supplies electricity to any premises;*
>
> *(d) participates in the operation of an electricity interconnector;*
>
> *(e) provides a smart meter communication service,*
>
> *shall be guilty of an offence unless he is authorised to do so by a licence.*

(2) A person guilty of an offence under this section shall be liable—

(a) on summary conviction, to a fine not exceeding the statutory maximum;

(b) on conviction on indictment, to a fine.

…

(3A) In subsection (1)(b) above, the reference to a person who participates in the transmission of electricity is to a person who—

(a) co-ordinates, and directs, the flow of electricity onto and over a transmission system by means of which the transmission of electricity takes place, or

(b) makes available for use for the purposes of such a transmission system anything which forms part of it.

…

(4) In this Part, unless the context otherwise requires—

'distribute', in relation to electricity, means distribute by means of a distribution system, that is to say, a system which consists (wholly or mainly) of low voltage lines and electrical plant and is used for conveying electricity to any premises or to any other distribution system;

…

'supply', in relation to electricity, means its supply to premises in cases where—

(a) it is conveyed to the premises wholly or partly by means of a distribution system, or

(b) (without being so conveyed) it is supplied to the premises from a substation to which it has been conveyed by means of a transmission system,

but does not include its supply to premises occupied by a licence holder for the purpose of carrying on activities which he is authorised by his licence to carry on;

…

A3.2 Section 6 (Licences authorising supply, etc.) provides that:

(1) The Authority may grant any of the following licences–

…

(c) a licence authorising a person to distribute electricity for that purpose ('a distribution licence');

(d) a licence authorising a person to supply electricity to premises ('a supply licence');

…

(3) A supply licence may authorise the holder to supply electricity–

(a) to any premises;

(b) only to premises specified in the licence, or to premises of a description so specified; or

(c) only to any premises situated in a specified area, or to premises of a specified description which are so situated.

(4) The Authority may, with the consent of the holder of a supply licence, modify terms included in the licence in pursuance of subsection (3) so as to extend or restrict the premises to which the licence holder may give a supply of electricity.

(5) A distribution licence may authorise the holder to distribute electricity in any area, or only in an area specified in the licence.

(6) The Authority may, with the consent of the holder of a distribution licence, modify terms included in the licence in pursuance of subsection (5) so as to extend or restrict the area within which the licence holder may distribute electricity.

…

(7) A licence, and any modification of a licence under subsection (4), (6) or (6B), shall be in writing.

(8) A licence shall, unless previously revoked in accordance with any term of the licence,

continue in force for such period as may be specified in or determined by or under the licence.

(9) In this Part–

'electricity distributor' means any person who is authorised by a distribution licence to distribute electricity except where he is acting otherwise than for purposes connected with the carrying on of activities authorised by the licence;

…

'electricity supplier' means any person who is authorised by a supply licence to supply electricity except where he is acting otherwise than for purposes connected with the carrying on of activities authorised by the licence.

A3.3 Section 7 (Conditions of licences: general.) provides:

(1) A licence may include—

(a) such conditions (whether or not relating to the activities authorised by the licence) as appear to the grantor to be requisite or expedient having regard to the duties imposed by sections 3A to 3C; and

(b) conditions requiring the rendering to the Authority of a payment on the grant of the licence, or payments during the currency of the licence, or both, of such amount or amounts as may be determined by or under the licence.

(2) Without prejudice to the generality of paragraph (a) of subsection (1) above, conditions included in a transmission licence or distribution licence by virtue of that paragraph—

(a) may require the licence holder to enter into agreements with other persons for the use of any electric lines and electrical plant of his (wherever situated and whether or not used for the purpose of carrying on the activities authorised by the licence) for such purposes as may be specified in the conditions; and

(b) may include provision for determining the terms on which such agreements are to be entered into.

(2A) Without prejudice to the generality of paragraph (a) of subsection (1), conditions included in a transmission licence by virtue of that paragraph may—

(a) require the licence holder not to carry on an activity which he would otherwise be authorised by the licence to carry on, or

(b) restrict where he may carry on an activity which he is authorised by the licence to carry on.

(3) Without prejudice to the generality of paragraph (a) of subsection (1), conditions included in a licence by virtue of that paragraph may require the licence holder—

(a) to comply with any direction given by the Authority or Secretary of State as to such matters as are specified in the licence or are of a description so specified;

(b) except in so far as the Authority or Secretary of State consents to his doing or not doing them, not to do or to do such things as are specified in the licence or are of a description so specified;

(c) to refer for determination by the Authority or Secretary of State such questions arising under the licence, or under any document referred to in the licence, as are specified in the licence or are of a description so specified; and

(d) to refer for approval by the Authority or Secretary of State such things falling to be done under the licence, and such contracts or agreements made before the grant of the licence, as are specified in the licence or are of a description so specified.

(3A) Conditions included in a transmission licence or a distribution licence by virtue of subsection (1)(a) may require the holder, in such circumstances as are specified in the licence–

(a) so to increase his charges for the transmission or distribution of electricity as to raise such amounts as may be determined by or under the conditions; and

(b) to pay the amounts so raised to such licence holders as may be so determined.

…

(4) Conditions included in a licence by virtue of subsection (1)(a) above may—

(a) instead of specifying or describing any contracts or agreements to which they apply, refer to contracts or agreements designated (whether before or after the imposition of the conditions) by the Secretary of State or the Authority; and

(b) instead of containing any provisions which fall to be made, refer to provisions set out in documents so designated and direct that those provisions shall have such effect as may be specified in the conditions.

(5) Conditions included in a licence may contain provision for the conditions–

(a) to have effect or cease to have effect at such times and in such circumstances as may be determined by or under the conditions; or

(b) to be modified in such manner as may be specified in the conditions at such times and in such circumstances as may be so determined.

(6) Any provision included by virtue of subsection (5) above in a licence shall have effect in addition to the provision made by this Part with respect to the modification of the conditions of a licence.

(6A) Conditions included in a licence may provide for references in the conditions to any document to operate as references to that document as revised or re-issued from time to time.

(7) Any sums received by the Authority in consequence of the provisions of any condition of a licence shall be paid into the Consolidated Fund.

A4. The Licence Modification and Appeal Process

A4.1 Provision to make modifications to electricity distribution licences is set out in section 11A of the Electricity Act 1989 (Modification of conditions of licences), which provides:

(1) The Authority may make modifications of—

(a) the conditions of a particular licence;

(b) the standard conditions of licences of any type mentioned in section 6(1).

…

(7) The Authority must—

(a) publish the decision and the modifications in such manner as it considers appropriate for the purpose of bringing them to the attention of persons likely to be affected by the making of the modifications,

(b) state the effect of the modifications,

(c) state how it has taken account of any representations duly made, and

(d) state the reason for any differences between the modifications and those set out in the notice by virtue of subsection (2)(b).

(8) Each modification has effect from the date specified by the Authority in relation to that modification (subject to the giving of a direction under paragraph 2 of Schedule 5A).

(9) The date specified by virtue of subsection (8) may not be less than 56 days from the publication of the decision to proceed with the making of modifications under this section.

(10) In this section 'relevant licence holder'—

(a) in relation to the modification of standard conditions of licences of any type, means the holder of a licence of that type—

(i) which is to be modified by the inclusion of any new standard condition, or

(ii) which includes any standard conditions to which the modifications relate which are in effect at the time specified by virtue of subsection (2)(d); or

(b) in relation to the modification of a condition of a particular licence (other than a standard condition), means the holder of that particular licence.

A4.2 Section 11C of the Electricity Act 1989 (Appeal to the CMA) provides for appeal of a decision by the Authority to modify a licence by specified classes of person and requires the CMA to grant permission for any appeal to be brought. Section 11C provides:

(1) An appeal lies to the CMA against a decision by the Authority to proceed with the modification of a condition of a licence under section 11A.

(2) An appeal may be brought under this section only by—

(a) a relevant licence holder (within the meaning of section 11A);

(b) any other person who holds a licence of any type under section 6(1)4 whose interests are materially affected by the decision;

(c) a qualifying body or association in the capacity of representing a person falling within paragraph (a) or (b);

(d) Citizens Advice or Citizens Advice Scotland or those bodies acting jointly in the capacity of representing consumers whose interests are materially affected by the decision.

(3) The permission of the CMA is required for the bringing of an appeal under this section.

(4) The CMA may refuse permission to bring an appeal only on one of the following grounds—

(a) in relation to an appeal brought by a person falling within subsection (2)(b), that the interests of the person are not materially affected by the decision;

(b) in relation to an appeal brought by a qualifying body or association, that the interests of the person represented are not materially affected by the decision;

(c) in relation to an appeal brought by Citizens Advice or Citizens Advice Scotland or those bodies acting jointly, that the interests of the consumers represented are not materially affected by the decision;

(d) in relation to any appeal— (i) that the appeal is brought for reasons that are trivial or vexatious; (ii) that the appeal has no reasonable prospect of success.

(5) References in this section to a qualifying body or association are to a body or association whose functions are or include representing persons in respect of interests of theirs which are materially affected by the decision in question.

A4.3 Section 11E (Determination by CMA of appeal) outlines the matters to which the CMA must have regard, and those to which it may have regard, in determining the appeal. It provides that:

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

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

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

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

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

(3) In determining the appeal the CMA—

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

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

(4) The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—

(a) that the Authority failed properly to have regard to any matter mentioned in subsection (2);

(b) that the Authority failed to give the appropriate weight to any matter mentioned in subsection (2);

(c) that the decision was based, wholly or partly, on an error of fact;

(d) that the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b);

(e) that the decision was wrong in law.

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

A4.4 Section 11F (CMA's powers on allowing appeal) sets out the CMA's powers if the appeal is allowed. It provides that:

(1) This section applies where the CMA allows an appeal to any extent.

(2) If the appeal is in relation to a price control decision, the CMA 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 the Authority for reconsideration and determination in accordance with any directions given by the CMA;

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

(3) If the appeal is in relation to any other decision, the CMA must do one or both of the following—

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

(b) remit the matter back to the Authority for reconsideration and determination in accordance with any directions given by the CMA.

(4) A direction under subsection (2) or (3) must not require a person to do anything that the person would not have power to do (apart from the direction).

(5) A person to whom a direction is given under that subsection must comply with it.

(6) A direction given under that subsection to a person other than the Authority is enforceable as if it were an order of the High Court or (in Scotland) an order of the Court of Session.

(7) For the purposes of this section 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.

(8) In determining for the purposes of subsection (7) what the purpose of a condition is the condition may be assessed on its own or in combination with any other conditions of the licence.

(9) In this section and sections 11G and 11H any reference to a party to an appeal is to be read in accordance with Schedule 5A.

A4.5 Section 11G (Time limits for CMA to determine an appeal) sets out the time limits for the CMA to determine an appeal. It provides that:

(1) The CMA must—

(a) determine an appeal against a price control decision within the period of 6 months beginning with the permission date;

(b) determine an appeal against any other decision within the period of 4 months

beginning with the permission date.

(2) Subsection (1)(a) or (b) does not apply if subsection (3) applies.

(3) This subsection applies where—

(a) the CMA has received representations on the timing of the determination from a party to the appeal; and

(b) it is satisfied that there are special reasons why the determination cannot be made within the period specified in subsection (1)(a) or (b).

(4) Where subsection (3) applies, the CMA must—

(a) determine an appeal against a price control decision within the period specified by it, not being longer than the period of 7 months beginning with the permission date;

(b) determine an appeal against any other decision within the period specified by it, not being longer than the period of 5 months beginning with the permission date.

(5) Where subsection (3) applies, the CMA must also—

(a) inform the parties to the appeal of the time limit for determining the appeal, and

(b) publish that time limit in such manner as it considers appropriate for the purpose of bringing it to the attention of any other persons likely to be affected by the determination.

(6) In this section 'price control decision' is to be read in accordance with section 11F.

(7) References in this section to the permission date are to the date on which the CMA gave permission to bring the appeal in accordance with section 11C(3).