In the Competition and Markets 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

REPLY SUBMISSIONS BY BGT

---

1. This is the Reply of British Gas Trading Limited ("**BGT**") to the Response to Notice of Appeal ("**the Response**") filed by the Authority. This Reply also deals with points raised by the Slow Track DNOs in their various joint and individual submissions, so far as they merit a response.[1] Abbreviations and terminology used in the Notice of Appeal ("**NoA**") are adopted unless the contrary is indicated.

2. The structure of the Reply is as follows:

   2.1. Section I replies to submissions on the legal framework, in particular the applicable standard of review; and

   2.2. Sections II to VII reply to submissions made in response to each of BGT's Grounds 1 to 6 respectively.

3. Some of the points raised in the DNOs' submissions are not properly responsive to BGT's appeal, and are instead countervailing complaints about the Authority's decision. Such points should have been raised (if at all) by means of an appeal by the DNOs in question, and cannot be raised in the context of the present appeal.

---

[1] Collectively the submissions made by the Authority and the Slow-track DNOs opposing the appeal amount to some 414 pages, together with 340 pages of supporting witness statements (some of which amount to submission) and thousands of pages of supporting material. In the circumstances, BGT does not attempt to address every point. Rather, it sets out below the key points in reply to the arguments now made against it. Insofar as a point is not addressed below, this does not mean that it is necessarily accepted.

4. The Reply is accompanied by, and incorporates:

   4.1. a supplemental report from AlixPartners **[BG3/HH2]**; and

   4.2. the second witness statement of Mr Andrew Martin Manning **[BG3/AM2]** ("**2nd Manning**"),

   which, in the interests of brevity, are not duplicated here but are to be treated as full parts of this submission.

I. <u>THE CMA'S APPELLATE JURISDICTION</u>

I(i) Standard of Review

5. Both the Authority and the DNOs have addressed lengthy submissions to the issue of the applicable standard of review. None of those submissions cast any doubt on the substance of what is said by BGT about the standard of review in its NOA. Indeed, many of them complement and support the BGT position.

6. The Authority seeks to present the errors identified in BGT's NoA as complex issues of regulatory discretion, and appears to consider that the CMA should only intervene to the extent that its approach is shown to be irrational. See for example the Response ¶31 and accompanying fn.10 (invoking '*the threshold test in the <u>Wednesbury</u> case*', under which '*a decision may be challenged as unreasonable if it is "so unreasonable that no reasonable authority could ever have come to it"*.') and the underlined citation at ¶59. This is incorrect.

7. <u>First</u>, BGT's appeal identifies a series of clear substantive errors, where the Authority has adopted an approach which is unsustainable having regard to its own stated policy goals and the statutory objectives enshrined in the EA89.

   7.1. Under ground 1 (double-recovery), the Authority has opted to defer repayment of sums it accepts as having been overcharged, at the expense of current consumers who are the group of consumers best approximating the DPCR5 consumers who were the victims of the overcharge, without any proper justification having been shown.

   7.2. Under ground 2 (IIS / BMCS), the Authority has adopted incentive arrangements with the professed intention of promoting improvements in supply and customer service, but has set

targets which ignore current performance levels, are already being exceeded by many DNOs, and which in some cases do not even incorporate improvement factors.

7.3. Under ground 3 (IQI), the Authority has adjusted an incentive mechanism, to benefit DNOs and at the expense of consumers, after the conduct which the mechanism was designed to incentivise has already taken place, in order to avoid DNOs suffering any penalties for their collective failure to prepare credible business plans in relation to SGBs and RPEs.

7.4. Under ground 4 (asset life transition), the Authority has deferred its own stated policy of moving to a realistic depreciation period for asset lives without any properly supported justification for doing so.

7.5. Under ground 5 (cost of debt), the Authority has departed from its policy approach in the Strategy Decision of using a fixed 10 year trailing average for determining DNO's cost of debt in favour of a 'trombone' index, thereby adding significant additional cost to consumers, without having conducted any proper investigation as to the efficiency of the DNOs' debt costs.

None of the above grounds turns on fine points of 'regulatory judgement': in each case, BGT submits that the Authority's approach to implementation of the Price Controls is clearly wrong, when judged by reference to the uncontroversial regulatory objectives given by the statute and the RIIO framework.

8. Second, the Authority is wrong to suggest that the CMA's role is confined to identifying and correcting instances of irrationality in the *Wednesbury* sense. That suggestion is inconsistent with the legislative history, the statutory grounds and the CMA's own expertise in regulatory matters, as the Authority appears to accept elsewhere in the Reply:

8.1. The Authority does not contest that the CMA's jurisdiction is broader than judicial review, and that the statutory grounds enable the CMA to '*consider the merits of the case*', as was clearly the intention underlying the EA89.[2]

8.2. The Authority recognises that, under the statutory grounds, the CMA may examine whether the Authority has had "*proper regard to*" and has given "*appropriate weight"* to the statutory objectives set out in s.3A EA 89.[3]

8.3. The Authority concedes that an error will arise, within the meaning of the statutory grounds, in the event that the Authority is shown to have adopted a '*clearly inferior*' approach.[4] The Authority's attempt to equate this standard with *Wednesbury* unreasonableness is incorrect: clear inferiority is not the same as irrationality.

8.4. The Authority also acknowledges that the CMA has been chosen by the legislature to hear the present appeal in view of its status as '*a specialist body with appropriate expertise in regulatory and price control appeals*'.[5]

8.5. Finally, the Authority cites with approval the approach taken in *E.ON v. GEMA*.[6] However, it fails to note that the CC panel hearing that case expressly rejected the view that '*every aspect of a code modification decision will be a matter for GEMA's discretion*'; observed that the Authority's decision may indeed be wrong if it '*has made an error of principle*'; and concluded

---

[2] See Response, ¶¶35(b), 37, 45, citing the Government's Response to the consultation on the Implementation of the EU Third Internal Energy Package **[BG2/1]**. The Authority seeks to distinguish appeal under the present framework, which enables the CMA '*to consider the merits of the case*', from appeals under the EU framework applicable in the field of communications, which requires that the merits of the case '*duly be taken into account*'. BGT accepts of course that the statutory grounds are not identical. However, it appears to be common ground that both require a consideration of the merits: see Response, ¶¶42, 45.

[3] See Response ¶67.

[4] See Response, ¶31; see to similar effect the case-law of the CC in communications price control appeals, reproduced at NoA, ¶2.20.

[5] See Response, ¶47.

[6] See Response, ¶53.

that the correct approach was therefore to '*consider on a case by case, and issue by issue, basis whether GEMA's decision is wrong on one or more of the statutory grounds*'.[7]

9. Third, the Authority takes issue with BGT's description of the appeal as being a '*merits*' appeal. As noted above, however, the Authority accepts that, unlike in judicial review proceedings, the CMA is able to '*take account of the merits*' in determining whether the Authority's decision is wrong. The Authority's objection appears to be simply that '*s.11E EA89 does not give the [CMA] jurisdiction to conduct a full rehearing*': see Response, fn.22. BGT has never suggested that this appeal requires a full rehearing. The CMA's task is to consider whether the Authority's decision is wrong, having regard to the statutory grounds of appeal, in any of the ways alleged by BGT in its NoA. In so doing, the CMA must consider whether the Authority had 'proper regard' to relevant statutory matters, and gave 'appropriate weight' to those matters. This requires an assessment of the merits, as the Authority appears to accept.

10. As regards the DNOs' submissions on standard of review:

    10.1. The Additional Submissions on the Statutory Framework filed jointly by eight of the Slow-Track DNOs similarly do not take issue with BGT's position of principle. Rather, they contend that the matters challenged by BGT are all within "*any margin of regulatory discretion*" which the Authority may enjoy (see ¶13). This is incorrect: BGT's appeal identifies clear errors in the Authority's implementation of its own stated price control methodology.

    10.2. The UKPN Submission[8] observes that the grounds of appeal under EA 89 s.11E(4) go well beyond grounds on which an appeal on point of law or an application for judicial review may be made (see ¶8) but that this does not amount to a *de novo* hearing (see ¶13). BGT agrees.

    10.3. SSE[9] makes a more ambitious argument that the CMA is not required to grant the Authority a margin of appreciation and that an appeal to the CMA amounts to a "merits rehearing". As noted above, BGT does not argue for that proposition; nor does it need to.

---

7 See *E.ON v. GEMA* **[BG2/46]**, §5.13.

8 The Individual Submission of Eastern Power Networks plc, South Eastern Power Networks plc and London Power Networks plc. ("**the UKPN submission**").

9 Scottish Hydro Electric Power Distribution plc and Southern Electric Power Distribution plc.

I(ii) An appeal does not re-open all aspects of the Decision

11. Both the Authority and certain of the DNOs accuse BGT of "cherry picking" points of the Decision with which it disagrees (see, eg, Response, ¶69). These complaints are hard to understand: whatever the standard of review that is to be applied, the nature of an appeal is that it requires the Appellant to identify where the decision-maker has erred; the Appellant cannot sensibly be asked to appeal against those aspects of the decision with which it does not take issue. The DNOs all had the opportunity to appeal against any aspect of the Decision with which they disagreed.

12. The Authority makes a limited argument that, when considering the grounds of appeal, the CMA is required to consider whether the specific errors alleged "*render the decision itself wrong*" and "*must do so by reference to the decision as a whole… mindful of the distortive effects that may arise from artificially cherry picking aspects of the decision for reconsideration*".[10] BGT accepts that it is necessary to show errors in the Authority's approach that affect the substance of the Decision. However, the Authority has not identified any specific respect in which it is said that allowing the appeal on specific grounds would give rise to any "distortive effects".[11] By way of comparison, in telecommunications price control appeals the CC has followed the practice of correcting discrete errors, rather than reconsidering the entire decision.[12]

13. The UKPN Submission contends that "*the CMA is required, when making any findings of its own on a part of the price control modifications that have been challenged on appeal, also to ensure that it has worked out fully the impact that any different conclusions of fact would have on all relevant*

[10] See Response, ¶69.

[11] As distinct from the Authority's general case that it was right on each of the points in question.

[12] For example, in the cases of *British Telecommunications Plc v Ofcom; British Sky Broadcasting Limited and TalkTalk Telecom Group Plc v Office of Communications* (Cases 1192 and 1193/3/3/12), the CC considered the nature of its appellate function and reiterated the approach it had taken in previous cases of "*determining whether Ofcom erred for any of the specific reasons put forward by the parties*" (see, CC Determination at ¶1.32, citing previous cases including in particular *Mobile Call Termination 1* (Cases 1083/3/3/07 and 1085/3/3/07), *Cable and Wireless* (Case 1112/3/3/09), *Carphone Warehouse (LLU)* (Case 1111/3/3/09), *Carphone Warehouse (WLR)* (Case 1149/3/3/09), *Mobile Call Termination 2* (Cases 1180–1183/3/3/11) and *WBA* (Case 1187/3/3/11)).

conclusions reached by the Authority".[13] BGT submits that this is a matter going to remedy rather than the scope of any appeal or the standard of review to be applied.

14. SSE goes further and argues that an appeal under s.11E requires the CMA to adopt a "global" approach to the price control and that "*it would not be appropriate for the CMA to review individual line items which form part of a price control decision without considering the price control packages as a whole*".[14] This argument is incorrect:

    14.1. S.11E provides for an appeal, and not a complete rehearing. If the CMA were required to reconsider every decision in the round on every appeal, the appeal process would become unmanageable. As Jacob LJ commented in respect of a telecommunications appeal under Article 4 of the Framework Directive in *T-Mobile v Ofcom* [2008] EWCA Civ 1373 **[BG4/1/A]** at [31]: "*it is inconceivable that article 4, in requiring an appeal which can duly take into account the merits, requires member states to have in effect a fully equipped duplicate regulatory body waiting in the wings just for appeals. What is called for is an appeal body and no more, a body which can look into whether the regulator had got something material wrong*".

    14.2. SSE seeks to support its contention by reference to the expert witness statement of Professor Littlechild. However, it is clear that Professor Littlechild can shed no light on BGT's appeal and its impact upon the wider price control. As he explains at paragraph 22 of his statement, "*BGT has claimed that Ofgem made errors in respect of five specific items…I have not examined and do not give a view on these particular items. But I note that they are just five of many individual parameters on which the price control proposal was based*".

    14.3. If, as SSE contends, the effect of a successful appeal were that the entire price control had to be reconsidered by the Authority the result would be chaotic and likely to produce complete uncertainty for DNOs, suppliers, investors and consumers as to the prices which would apply.

[13] See UKPN Submission at ¶17.

[14] See SSE submission at ¶¶21 and 23.

15. Indeed, in arguing that the CMA must examine (to some degree) the whole of the price control rather than just those grounds identified in the notice of appeal, the Authority and the DNOs ***all*** (to a greater or lesser extent) fall into the trap of conflating this appellate jurisdiction with the regulatory reference system[15] where an entire price control decision can be looked at afresh.

16. In fact the correct position is set out clearly and succinctly in the CC's own guidance (adopted by the CMA):

> *"The [CMA] must decide whether the appellant has demonstrated that GEMA's decision was wrong on one or more of the grounds set out in its notice of appeal".*[16]

II. GROUND 1: INAPPROPRIATE MECHANISMS TO RETURN DOUBLE-RECOVERED REVENUES FROM THE PREVIOUS PRICE CONTROL PERIOD

17. The starting point is that, as the Authority correctly acknowledges, "*if directly charged for, ES4 revenues represented a double recovery of costs*".[17] In other words, these are monies that have been paid by consumers, but which ought not to have been paid, under the DPCR5 charge control.

18. In those circumstances, the correct approach, in the interests of consumers, is to restore the overpayment as promptly as possible, with interest. Normally where a revenues have been over-recovered in breach of a licence, the Authority would exercise its powers to require prompt repayment.[18] The Authority instead chose to deal with the issue in the context of the RIIO-ED1 and BGT therefore addresses it in this context, but that cannot change the principle that over-recovered revenues should be returned promptly. As the Court of Appeal commented in *British Telecommunications plc v Ofcom* [2012] EWCA Civ 1051 **[BG4/1/D]** (in the context of overcharging in breach of a significant market power condition imposed under the Communications Act 2003)

---

15 Such as exists in the water and rail sectors, under the *Electricity (Northern Ireland) Order 1992* and as used to exist in other sectors (e.g. under the *Telecommunications Act 1984* and the old Section 12 of the *Electricity Act 1989*; this was the regime in force when Professor Littlechild referred the Scottish Hydro Electric price control to the MMC in November 1994).

16 *Energy Licence Modification Appeals: Competition Commission Guide* (September 2012) at paragraph 3.1

17 See Response ¶145.

18 In respect of consumers, the Authority may make a consumer redress order under ss.27G-H EA 89.

"The starting point must be, in a case of overcharging … to order repayment of the amount of the excess charge".

II(i) Returning double-recovered revenues through a RAV adjustment was not part of the DPCR5 price control

19. Both the Authority and the DNOs seek to argue that the use of a RAV adjustment to unwind the double-recovery of revenues was somehow foreshadowed in the DPCR5 charge control. The Authority suggests that the only change is that it has now decided that 100% of excess revenues (rather than 85%) should be returned in this manner.[19] The DNOs' Joint Submission contends that recovery through a RAV adjustment is "*in line with its policy decision taken in DPCR5*".[20]

20. This is incorrect.

21. First, as explained briefly below and in more detail in 2nd Manning,[21] the RAV Adjustment formed no part of the DPCR5 charge control. A RAV Adjustment was proposed in the DPCR5 Initial Proposals **[BG4/1/B]**, but for specific reasons that have nothing to do with the present issue. However, and in any event, the DPCR5 Final Proposals **[BG1/AM1/2]** did not in fact include such (unrelated) provision, nor did they make any other provision for a RAV Adjustment in order to deal with the risk of ES4 double-recovery.

    21.1. In the DPCR5 Initial Proposals, the Authority proposed that forecast ES4 revenues[22] be deducted from DPCR5 price control allowed expenditure. Given the difficulty in forecasting those revenues accurately, it was also proposed that actual revenues in excess of the forecast should be deducted from the RAV. The RAV adjustment in the Initial Proposals therefore was not intended as the primary means of preventing double recovery, nor as a means of returning double-recovered revenues to consumers. It was simply a way of allowing for forecasting error, as acknowledged by the Authority at Response ¶150(b).

---

19 See Response ¶¶144-147; Joint Submission

20 See Joint Submission at ¶11.

21 See 2nd Manning ¶¶9-35.

22 As a proxy for costs, which the revenues were intended to reflect.

21.2. By contrast, in its final price control decision, the Authority adopted a different approach. Under that decision, ES4 revenues were not to be deducted from the calculation of the DPCR5 main revenue allowance. Consequently, the final price control decision specifically and explicitly did not provide for the RAV adjustment foreshadowed in the Initial Proposal, since the issue of forecasting error which the RAV adjustment had been intended to address did not arise. This is clear from ¶3.9 of DPCR5 Final Proposals – Allowed Revenue and Financial Issues. That paragraph is only quoted in part in the Response and in full states:

"Excluded services under categories ES1 to ES4 are characterised by a broad assumption that the costs (and charges) arise when the customer requiring the service places his or her order. They mainly involve the provision of new infrastructure or modification of existing infrastructure to meet the customer's requirements. The DNO's capex programme should have catered for underlying infrastructure development and the costs driven by the provision of these services should largely be incremental. This means that there is only a limited risk that a DNO could profit by diverting resources which have separately been funded by use of system income. Consequently we do not consider it would be appropriate to make any RAV adjustment in respect of outturn levels of activity for these services. The corollary of this treatment is that the charges levied by DNOs for these services should be set on a cost recovery basis. Since Initial Proposals and after considering feedback we have decided that top-up, standby and enhanced system security (ES4) should be treated in this way." [Emphasis added]

21.3. The DPCR5 Financial Methodologies document **[BG3/1/C]** also makes clear that at the outset of the DPCR5 price control there was not intended to be any RAV adjustment for ES4 costs.[23] Rather, it was for DNOs to apply charges for ES4 only where these reflected costs which were incremental to the costs already included within the regulated price control.

21.4. The Authority and DNO submissions are therefore wrong to imply (if they seek to do so) that a RAV adjustment formed any part of the DPCR5 price control decision.

22. Secondly, the Authority and the DNOs gain no assistance from their reliance on the Electricity Distribution Price Control Cost and Revenue Reporting Regulatory Instructions and Guidance

[23] ¶¶1.15-1.16 of the DPCR Financial Methodologies document makes clear that the only excluded service costs which were to be deducted from the RAV in DPCR 5 were the costs of ES7 services. The costs of all other excluded services were not to be deducted from or added to the RAV but were to be excluded entirely from the calculation. The DNOs are therefore quite wrong to suggest that the costs of all excluded services other than ES7 were to be deducted from the RAV. See 2nd Manning at ¶¶16-21.

("**RIGs**"), which were issued by the Authority on several occasions during the DPCR5 charge control period.[24]

22.1. Although later versions of the RIG did include an instruction that the reported RAV should in some cases be adjusted in respect of ES4 services,[25] these provisions did not take any final decision as to how the overpayment should be returned to consumers. The RIGs were a no more than framework for the collection of cost and revenue information which the DNOs are required to provide under their licence. (They consist in (i) a series of Excel workbooks, together with (ii) instructions for completing those workbooks.) The information provided did not feed through into the DNOs' allowed revenues during the DPCR5 charge control.

22.2. Further, the RIGs relate only to the reporting of costs and revenues. They did not and could not amend the substance of price controls and were not capable of legitimising (whether prospectively or retrospectively) the DNOs' collection of additional ES4 revenues in breach of their licences.[26] Pursuant to Charge Restriction Conditions ("**CRCs**") 15.6 and 15.7 **[BG2/2]**, services were only to be treated as Excluded Services to the extent that the service was not remunerated under Use of System Charges. Since under DPCR5, ES4 costs were included in the calculation of allowed revenues, which drove the annual Use of System revenue cap, it follows that ES4 costs were already recovered by Use of System revenues.[27] It follows that the DNOs were not permitted to reclassify any use of system charges for these services under CRC15.9 (which permitted charging on a cost recovery basis for Excluded Services) and that, by purporting to do so, DNOs were not only obtaining double-recovery but were doing so in breach of their licence. The RIGs cannot legitimise that breach (whether it occurred before

---

24 Version 1 of the RIGs was issued in May 2010, version 2 in June 2011 and version 3 in April 2012. A version 3.1 was also issued in March 2014. See 2nd Manning at ¶32.

25 The Authority is simply wrong to state, at ¶146 of its Response, that it recognised the issue of double recovery <u>at the outset</u> of the DPCR5 period and required DNOs to report on the basis that 85% of these revenues should be deducted from DNOs' RAV. The Authority's 2010 RIGs do not contain any such instruction: see 2nd Manning at ¶¶28-32.

26 See 2nd Manning ¶¶24-27.

27 The Authority accepts this point: see Response ¶150(d) at footnote 49.

or after the relevant version of the RIGs entered into force), as they are explicitly subordinate to the licence conditions.[28]

22.3. Finally, even if the RIGs had included a RAV Adjustment which was comparable to that now proposed, that should not prevent the CMA from considering whether it is appropriate to include such a provision in the present charge control. In that connection it should be noted, first, that the Authority did not consult properly upon the RAV adjustment included in the later RIGs. In the 2011 version of the RIGs worksheet, C28 included a RAV adjustment for ES4 Revenue. The Authority stated only that this could be "*completed on a best endeavours basis*" and provided no explanation of why the adjustment had been included.[29] The 2012 version of the RIGs did expressly provide for a RAV adjustment.[30] However, it was not clearly stated to be connected to the recovery of ES4 revenues through Use of System charges.[31] Further at the time of the Authority's consultation on the 2012 version of the RIGs all other changes were "marked up" as a change in a tracked version of the document published by the Authority, but the change in respect of the RAV adjustment for ES4 revenues was not marked up. Nor was it flagged in any other way in its consultation. Nor did the Authority explain its reasoning for introducing the change. BGT submits that it is wholly inappropriate for the Authority, in the present appeal, to seek to argue that a prior decision which was reached without proper consultation (and which was not subject to an appeal in any event) should render its present decision immune from review on appeal.

II(ii) The interests of consumers and intergenerational equity

23. The Authority's first argument is that its decision does not harm existing and future consumers *taken together*, bearing in mind that immediate repayment and return by way of an adjustment to

---

[28] See 2nd Manning ¶26. This point is stated in each version of the RIGs.

[29] See 2nd Manning at table following ¶32.

[30] See 2012 RIGs **[BG4/AM2/C-5]** at ¶2.149, as set out in the table at 2nd Manning ¶32.

[31] Rather it was stated to apply if "*the DNO has been unable to separate ES4 costs from the cost figures included in its Costs Matrix reporting for inclusion on Worksheet C28*" which might occur "*if the DNO bases its ES4 charges to customers on a methodological assessment*": see 2nd Manning at table following ¶32. If the Authority had intended this to cover all cases of double recovery through Use of System charges it could and should have said so clearly.

the RAV are neutral in net present value ("NPV") terms; and all double-recovered costs will (eventually) be returned to consumers under either mechanism.

24. However, consumers twenty years in the future are much less likely to be the ones who have overpaid. Other things being equal, the interests of the relevant consumer cohort – those who have paid more than they should – clearly support immediate repayment and not deferral of repayment over several decades.[32]

25. Secondly, the Authority invokes the move to a 45 year depreciation policy tends to reduce the amounts payable by current consumers during the RIIO-ED1 period.[33] The Authority therefore "*avoided contributing*" to further savings for these consumers by requiring immediate repayment of the double-recovered ED4 revenues, and instead required that they be recovered through a RAV adjustment. However, that adjustment is unrelated to the double-recovery at issue under this ground; and cannot support depriving current consumers of the prompt repayment of monies that were wrongly charged during DCPR5.

II(iii) Financeability

26. The Authority's second argument is that a more immediate repayment to consumers would have had an adverse impact on key credit metrics of the DNOs and would have necessitated other adjustments in the financial package for at least one DNO (namely ENWL) to maintain its financial resilience at a standard considered appropriate by the Authority.

27. However, the Authority's financeability argument does not justify the RAV adjustment:

    27.1. For the avoidance of doubt, BGT accepts that financeability is, in principle, a relevant consideration as part of setting price controls more generally. The question is whether it is relevant <u>in this context</u>.[34]

---

[32] The first AlixPartners report **[BG1/HH1]** at paragraph 4.2.12 demonstrates that the asset life transition harms current consumers by requiring them to pay a higher proportion of the value of new assets compared with the economic lifetime.

[33] See Response ¶151(b).

[34] See NoA ¶4.19(c).

27.2. As a matter of principle, where DNOs have wrongly overcharged customers, financeability concerns cannot justify deferring the prompt repayment of the overcharge. On the contrary, the DNOs should be required to return the money immediately regardless of the financing implications. No DNO – far less an efficient DNO which is the benchmark for appraising financing considerations – has any entitlement to rely on overcharging to finance its business.

27.3. In any event, the Authority has failed to point to any concrete financeability concerns. In its reasoning in support of the Decision, the Authority referred to such concerns without any explanation or supporting analysis.

27.4. Similarly, in the Response, the Authority does not attempt to make out that there were concrete financeability concerns across DNOs in general. It now acknowledges that "*the adjustment to the RAV would not be expected to have a material impact on the financeability of the DNOs in general*".[35] It argues only that "*the impact was more significant for some DNOs*", of which only ENWL is identified in particular.

27.5. Even to the extent that valid financeability concerns were made out in respect of a specific DNO, the correct approach would have been to factor those in to the specific adjustment that was in any event being made in respect of the DNO in question, rather than by a general measure (the RAV adjustment), which ran counter to the direct and immediate interests of current consumers.

II(iv) Materiality

28. The Authority also argues that the double-recovered revenues (some £32 million) are immaterial in the context of the overall price control. As to this:

28.1. £32 million is in absolute terms plainly a material sum of money.

28.2. Moreover, this is £32 million which has wrongly been paid *by consumers*. Materiality needs to be assessed in context, and where a clear issue of principle is at stake, relating to a double-

35 See Response ¶154(d).

recovery of revenues at the expense of consumers, the error should be regarded as material and an adjustment made.

28.3. It is instructive to contrast the Authority's argument with its approach in November 2014 to requiring repayments by gas suppliers of overpayments which had arisen in connection with the use of out of date data as to the calorific value of gas supplied. In that case the Authority required immediate repayment the sums to consumers without any reference being made to the materiality of the sums.[36]

II(v) The effect of the Authority's decision on DNOs' incentives

29. The Authority denies that its decision gives rise to any inappropriate incentives for DNOs in future.

29.1. First, it claims that the double recovery was an isolated incident.[37] The specific point was structurally eliminated from RIIO-ED1 and the Authority remedied any lack of clarity in DPCR5 by modifying the DNOs' licences for RIIO-ED1. However, this does not meet BGT's argument: BGT does not claim that the DNOs will double recover in the same way in future; BGT's point is that should opportunities for double recovery arise in the future in relation to any costs, the DNOs will have an incentive to take advantage of those opportunities if they do not believe that they will be required to return the money promptly to consumers.

29.2. Secondly, the Authority argues that there are no incentives to double recover in future as both RAV adjustment and immediate return of monies are neutral in NPV terms.[38] The failure to require interest is said to be "trivial and insufficient".[39] However, again, the Authority fails to appreciate that the incentive effect to which BGT refers does not relate to the present double recovery but to double recoveries which may arise in the future and the ability of DNOs to fund their businesses on the basis of such overcharging.

---

[36] See letter dated 27 November 2014 **[BG4/AM2/K]** and 2nd Manning at ¶5253.

[37] Response ¶155(a).

[38] Response ¶155(b).

[39] Response ¶155(c).

29.3. Thirdly, the Authority argues that the RAV is indexed to RPI so this will exceed interest that would be payable if there were any immediate adjustment to allowed revenues.[40] This presumes that the right rate of interest to apply for overcharging will generally be less than inflation. This is self-evidently not an appropriate assumption, particularly where one is discussing inappropriate overcharging and where interest rates are at a historical low point. In general, the level of interest that should be applied to ensure that DNOs would not have an incentive to double recover would need to reflect both the real time value of money and the rate of inflation together. If the Authority is suggesting that it would be reasonable to apply a negative or zero real rate of interest to an over-recovery and that this would avoid any incentive to over-recovery in future, this cannot be right. Such an approach would not compensate for the time value of the money or any lending risk associated with this.

II(vi) Inappropriate procedure

30. The Authority denies that it adopted an inappropriate procedure in respect of this issue. It asserts (i) that it explained its reasoning in letter of 3 Feb 2015; and (ii) that the issues were discussed at a meeting between Ian Rowson and Andrew Manning on 28 May 2014.[41]

31. However, the letter of 3 February 2015 **[BG2/39]** does not adequately explain the Authority's reasoning: it refers to intergenerational factors and impacts on the '*shorter term cashflows and financial metrics*' of DNOs generally. Neither point was explained, and the latter appears to have been inaccurate insofar as the concern related only to ENWL and was not quantified even in its case.[42]

32. As regards the meeting on 28 May 2014:

32.1. It is inappropriate, in the context of a public consultation exercise, for the Authority to seek to rely on how issues were discussed in a meeting.

40 Response ¶155(d).

41 Response ¶156.

42 The Final Determination **[BG2-35A]** stated the financeability point only in the most general terms: "*We think our proposals … also facilitate efficient financing for the benefit of consumers in the long-run.*" (¶5.46).

32.2. In any event, the Authority says no more than that "the issues were discussed" at the meeting. This argument is unparticularised and is unsupported by evidence. Although the Authority has served two witness statements from Ian Rowson, neither statement deals with this point or responds to the account of the meeting set out in the First Witness Statement of Andrew Manning, which was served together with the Notice of Appeal.

32.3. Mr Manning's unchallenged evidence is that Mr Rowson did no more than refer to customers underpaying for the assets they used as a justification for the treatment of double-recovered services, but that it was not clear how the approach to asset life depreciation was connected with the need to return double-recovered revenues.[43]

II(vii) The DNOs' submissions

33. The DNOs' first argument is that the Authority carefully considered the options available as part of the DPCR5 review and "*decided that the costs associated with ES4 should not be added to the RAV…As a result, the costs associated with ES4 revenues are deducted from the costs which are used in calculation of RAV additions*."[44] This is incorrect for the reasons set out at ¶¶19-22 above.

34. At paragraph 12(2) of their joint submission, the DNOs also take issue with BGT's statement that the Authority deferred the issue of how to return the double recovery and argue that "*the decision was taken at DPCR5 Final Proposals and implemented during DPCR5*". Again, this is wrong for the reasons set out at ¶21 and ¶22 above.

35. Secondly, the DNOs argue that there has been no double-recovery.[45] It is asserted that CRC15.9 of the DCR5 licence always permitted recovery of the relevant costs and the DNOs' treatment of the associated revenues. Again, this is incorrect: the licence did not permit recovery of the relevant costs through additional charges for the reasons set out at ¶22.2 above. As the Authority points

43 See 1st Manning ¶78.

44 See DNOs' Joint Submission paragraph 11.

45 See DNOs' Joint Submission paragraph 12(1).

out,[46] "*ES4 costs were already recovered by Use of System revenues. Any ES4 revenues are therefore a double recovery*".

36. Thirdly, the DNOs argue that it is for the Authority to strike a balance between existing and future consumers and that this is a matter of judgement.[47] However, only current consumers were affected by the overcharge; and the Authority erred in giving inappropriate weight to the interests of future consumers.

37. Fourthly, the DNOs argue that the Authority's regard to financeability was "*consistent with its statutory duties in taking into consideration the potential impact on DNOs' finances when seeking to further the consumer interest*".[48] However, DNOs should not be permitted to finance their activities through overcharging consumers; and in any event, it now transpires that the Authority had not identified any financeability issue in respect of DNOs generally, or quantified the financial impact of requiring repayment of the overcharge on ENWL in particular: see ¶27 above.

38. Fifthly, the DNOs argue that the Authority's approach does provide for a form of interest in the form of the RPI uplift to the RAV calculation.[49] This argument is mistaken for the reasons set out at ¶29.3 above.

39. The DNOs' sixth argument is that there was no incentive for the DNOs to over-recover "*because the licence permitted levying of the charges and a mechanism was in place to avoid costs being funded twice*".[50] This argument is based on a factual premise that is mistaken: for the reasons set out at ¶22.2 above, the licence did not permit classification of the charges as excluded services and it is also clear that no mechanism was effective to prevent costs being funded twice.[51] In any event, BGT's point is not that the error in the DPCR5 price control created inappropriate incentives. Rather BGT's point is that by failing to require DNOs to return double-recovered revenues promptly, the

[46] See Response ¶150(d) at footnote 49.

[47] DNOs' Joint Submission ¶13(1).

[48] DNOs' Joint Submission ¶13(2).

[49] DNOs' Joint Submission ¶13(3).

[50] DNOs' Joint Submission ¶14.

[51] If there had been such a mechanism, there would be no need for the RAV adjustment that the Authority has now imposed.

Authority is setting a bad precedent and creating inappropriate incentives for the DNOs to take advantage of any other opportunities for double-recovery which may arise in the future.

40. Finally, the DNOs accuse BGT of having failed "*to engage with the Authority when the Authority consulted on its approach to ES4 costs and revenues and reached a final decision, much earlier, in DPCR5*".[52] For the reasons set out at ¶¶21 and 22 above, it is apparent that the Authority did not, in fact, consult on and implement the RAV adjustment which is now challenged in the DPCR5 process.

III. <u>GROUND 2: INAPPROPRIATE INCENTIVE TARGETS FOR IIS AND BMCS</u>

41. The arguments in respect of Ground 2 are largely technical and accordingly the Authority's responsive arguments are addressed in some detail in the 2nd AlixPartners Report. In the interests of concision, the substance of that report is not repeated in the body of this Reply. However, BGT relies upon sections 2 and 3 of the 2nd AlixPartners Report in full, which should be read as an integral part of this Reply. In summary, BGT's position is as follows.

III(i) IIS

42. The Authority has failed to address the main conclusion of the 1st AlixPartners Report, namely that the IIS is likely to lead to systematic outperformance and over-rewarding of the DNOs.[53] For example, the targets for CML start at 44 minutes and reduce to 39 minutes over the course of the charge control, but current performance is around 42 minutes.[54] Further as set out below the Authority's arguments in relation to the specific errors identified in the NoA add little to the justifications given in the Final Determinations, are unconvincing and do not undermine the conclusions in the 1st AlixPartners Report.

---

52 DNOs' Joint Submission ¶15.

53 See 2nd AlixPartners Report at ¶2.1.4.

54 See 2nd AlixPartners Report at ¶2.1.5.

Use of Outdated Data (NoA ¶¶4.34-4.37; Response ¶¶176-180)

43. The Authority advances four arguments against taking account of 2013/14 data, as proposed by BGT.

44. First, it contends that it had to set IIS targets prior to the formulation of the DNOs' business plans and 2013/14 data were not yet available then.[55] This point was addressed in the NoA at ¶4.37 and the 1st AlixPartners Report at ¶5.2.18. In short, for the purposes of formulating business plans DNOs did not need to know the final targets that would be set. It would have been sufficient to know indicative targets, together with an indication of how 2013/14 data would be used, and the marginal incentive rate.[56] The Authority accepts that investment decisions depend upon marginal incentive but simply asserts that DNOs "*desire…and benefit from*" clarity,[57] without explaining why this was required to enable stakeholder consultation or why any such need for clarity outweighs customers' interest for a well-calibrated incentive regime. In any event, such clarity was not in fact necessary for the DNOs to be incentivised to improve performance.[58] Companies in competitive markets do not need or expect to have exact clarity on the levels of service improvement which are required in order to obtain positive financial rewards.[59] The leniency of the targets that were fixed by the Authority is demonstrated by the fact, accepted by the Authority,[60] that several of the DNOs can earn rewards with no improvement in performance.[61] The Authority also notes that the 2013/14 data has still not been finalised due to the high number of storms in 2014.[62] However, this does not militate against having regard to the best available information for 2013/14, i.e. the

---

55 See Response ¶¶163(a), 176, 178(a) and 180.

56 See also 2nd AlixPartners Report at¶¶2.2.6–2.2.11; 2nd Manning ¶¶55-59.

57 See Response ¶180.

58 See 2nd AlixPartners Report at ¶2.2.10.

59 See 2nd AlixPartners Report at ¶2.2.11.

60 See Response ¶173(e).

61 See 2nd AlixPartners Report at ¶2.2.12.

62 See Response ¶180(b)(ii) and 1st Rossington ¶61.

indicative targets.[63] In any event, the Authority has not demonstrated that the 2013/14 data could not have been finalised in time.[64]

45. Secondly, the Authority raises a new argument that use of the 2013/14 data would lead to perverse incentives, encouraging the DNOs to worsen performance in the last year of one charge control so as to obtain a more lenient target in the next.[65] However this argument does not withstand scrutiny. Any such incentives would be diluted by the use of a four year average (which was BGT's proposal) and there are countervailing incentives arising from the fact that worsening performance in the last year of the DPCR5 charge control would have led to losses or reduced rewards under that charge control.[66] Any remaining risk of perverse incentives could easily be addressed through the use of benchmarks,[67] or by applying an industry rate of improvement which preserved strong incentives for performance improvements in later years.[68]

46. Thirdly, the Authority notes that it chose not to adopt rolling four year average targets for IIS during RIIO-ED1.[69] However this point does not answer BGT's complaint: BGT does not advocate the use of a rolling average as such; rather it argues that targets should so far as possible be set using the most up-to-date information.[70]

47. Fourthly, the Authority criticises AlixPartners' use of 2014/15 forecast data.[71] As set out at ¶58 below such criticisms are misplaced. In any event, the 2014/15 forecast data only renders the mismatch between the DNOs performance and the Authority's initial targets more stark. Even if

63 See 2nd AlixPartners Report ¶2.2.14; 2nd Manning ¶58-59.

64 See 2nd Manning ¶68.

65 See Response ¶¶167(b) and 177.

66 See 2nd AlixPartners Report at ¶2.2.14(a).

67 See 2nd AlixPartners Report at ¶2.2.14(b). The 1st AlixPartners Report did not adopt a benchmarking approach because of a lack of access to the relevant disaggregated data, but this would not have been an issue for the Authority.

68 See 2nd AlixPartners Report at ¶2.2.14(c).

69 See Response ¶178(c) and 1st Rossington ¶¶63-65.

70 See 2nd AlixPartners Report at ¶¶2.2.15–2.2.19.

71 Response ¶173.

that data were unreliable, it would not address the central point that targets should be based on up-to-date data, namely the 2013/14 actual performance data.

48. The DNOs advance a further argument that BGT has failed to recognise that the Authority specifically allowed for improvement factors in 2013/14 and 2014/15. This is incorrect: that point is addressed at ¶¶5.2.14-5.2.15 of the 1st AlixPartners Report. The 2nd AlixPartners Report reconsiders those improvement factors with the benefit of disaggregated data (which was not available to AlixPartners at the time of the 1st AlixPartners Report) and reaches the same conclusion, namely that the average annual improvement factors applied by the Authority were substantially below the actual improvement achieved taking account of 2013/14 data.[72]

Improvement Factors were too lenient (NoA ¶¶4.38-4.39; Response ¶¶181-186)

49. The second specific error identified by BGT (NoA ¶¶4.38 and 4.39) is that the improvement factors applied are too lenient, being below the average achieved since the inception of the IIS. The Authority makes four responsive arguments.

50. First, the Authority notes that improvement factors have been introduced for the first time in RIIO-ED1 and will contribute to the incentives for DNOs to drive improved performance.[73] However, the fact that improvement factors have not been applied in the past does not logically have any bearing on the correct level of the improvement factors.[74] Nor is it necessary, in order to drive performance, that the IIS is set in a manner which delivers generous rewards to DNOs: what is necessary is that the marginal rate of reward (or penalty) incentivises improvements.[75] On the contrary, setting over-generous rewards will fail to promote the interests of consumers, who have to pay for the rewards.[76]

---

[72] See 2nd AlixPartners Report at ¶2.2.20-2.2.22.

[73] Response ¶181.

[74] See 2nd AlixPartners Report at ¶2.3.6.

[75] See 2nd AlixPartners Report at ¶2.3.7.

[76] See 2nd AlixPartners Report at ¶2.3.8.

51. Secondly, the Authority argues that applying conservative improvement factors to CI was reasonable because improvements to CI require greater investment than improvements to CMLs.[77] However, this is a *non sequitur*: the issue does not concern the level of CI improvement factors relative to CML improvement factors, but the level of CI improvement factors compared with CI performance. In any event, BGT does not advocate setting improvement factors for CI at the same level as CML.[78]

52. Thirdly, the Authority argues that recent performance is not a reliable guide to future performance.[79] However, the Authority fails to recognise that the improvement factors proposed by BGT are based upon a *long term* average, and are only proposed to be applied to under-performing DNOs.[80] Further:

52.1. The Authority is wrong to suggest that BGT's argument is undermined by the volatility of historic performance data.[81] BGT's use of a long-term industry-wide average smooths out such variations.[82]

52.2. The Authority points out that historic improvements had themselves been incentivised by the IIS.[83] However, the Authority does not satisfactorily explain why improvements incentivised by the IIS should be ignored. The IIS merely replicates the incentives to improve performance that any business in a competitive market would face. Further the source of

---

77 Response ¶¶182-183. The Authority accepts that the CI target is conservative, closer to the worst rate of historical improvement than the best rate and below recent four-year averages.

78 See 2nd AlixPartners Report at ¶¶2.3.32-2.3.33.

79 See Response ¶¶184-185 and 1st Rossington ¶¶62-71.

80 See 1st AlixPartners Report at ¶5.3.2; 2nd AlixPartners Report at ¶2.3.13-2.3.18. Underperforming DNOs are those identified as failing to meet their benchmarks at the outset of RIIO-ED1. Underperforming DNOs are likely to have greater scope for improvement and can take advantage of any industry-wide factors which have improved performance over time.

81 Response ¶183; 1st Rossington ¶65. Ms Rossington also notes at 1st Rossington ¶69 that operating conditions (such as weather) may vary from year to year. This does not add anything to the general point on volatility.

82 See 2nd AlixPartners Report at ¶¶2.3.13-2.3.18.

83 Response ¶181; 1st Rossington ¶72.

past incentives is not relevant: what matters is the level of performance improvement which is demonstrated to have been attainable.[84]

52.3. The Authority contends that changes in ownership may have driven one-off performance improvements.[85] However, such improvements have been given no additional or artificial weight in AlixPartners' analysis. Further, BGT does not advocate raising the improvement rate applicable to DNOs who are presently out-performing their benchmark. The Authority has not shown that DNOs which have changed ownership and restructured could not find other cost savings, nor that other DNOs could not restructure and hence find similar cost savings without changing ownership.[86]

52.4. Finally the Authority asserts that recent rates of improvement probably cannot be maintained.[87] However, the Authority provides no evidence that further improvements cannot be achieved through operational means, nor that the historic rate of improvement has slowed in recent years.[88] In fact, recent improvements for CML and CI have exceeded the long-term average.[89] Further the Authority itself has considered that smart-metering may drive significant reliability improvements, which have not been taken into account in IIS targets.[90]

53. Fourthly the Authority notes that it set improvement factors based on disaggregated data for each voltage level, whereas the 1st AlixPartners Report did not adopt this approach.[91] That is correct – the disaggregated data was not available to BGT at the time of preparing its NoA and supporting evidence. In fact, taking account of the disaggregated data would not change the overall conclusions set out in the 1st AlixPartners Report, namely that the IIS has not been properly

84 See 2nd AlixPartners Report at ¶¶2.3.19-2.3.22.

85 Response ¶173(f); 1st Rossington ¶68.

86 See 2nd AlixPartners Report at ¶2.3.23-2.3.26.

87 Response ¶184.

88 See 2nd AlixPartners Report at ¶¶2.3.27-2.3.31.

89 See 1st AlixPartners Report at Table 5.5.

90 See 2nd AlixPartners Report at ¶¶2.3.30-2.3.31.

91 Response ¶171(d).

calibrated and will lead to very significant rewards to DNOs even for modest improvements in performance.[92]

Asymmetries in Target Setting (NoA ¶¶4.40-4.42; Response ¶¶187-188)

54. The Authority disputes BGT's argument that initial targets for CML are asymmetric by reason of the targets for overperforming DNOs being based on benchmarks but the targets for underperforming DNOs being based on their own performance.

55. First the Authority argues that CML targets for underperforming DNOs are based partially on benchmarking.[93] However, the inclusion of an element of benchmarking (with 25% weight against 75% weight for their own performance) does not change the fact that there is an asymmetry, with overperforming DNOs' targets being based entirely on benchmarking and underperforming DNOs targets being based substantially on their own performance.[94] Further, it is clear from the Authority's own evidence that the CML targets for the HV and LV networks exhibit asymmetries in favour of the DNOs. These networks together represent around 96% of customer minutes lost and the effect of the asymmetrical targets for these networks is likely to swamp the asymmetry in favour of consumers in the targets for the EHV and 132kV networks, which together represent a mere 2% of CML.[95]

56. Secondly, the Authority argues that its approach preserved the incentives for DNOs to continue to improve in the last years of the DPCR5 charge control rather than creating perverse incentives to delay improvements, which it claims would have arisen had targets been based solely on the DNOs' own performance.[96] However, even if it were true that such incentives might have arisen from using

---

92 See 2nd AlixPartners Report at ¶2.3.43.

93 Response ¶187(b)

94 See 2nd AlixPartners Report at ¶¶2.4.3-2.4.4.

95 See 2nd AlixPartners Report at ¶¶2.4.6-2.4.7.

96 Response ¶187(a).

only the DNOs' own performance,[97] that is an argument in favour of using benchmarking rather than an argument in favour of setting asymmetric targets.[98]

57. Thirdly, the Authority asserts that its approach will not lead to systematic outperformance.[99] However, the 2nd AlixPartners report explains that the calculation which underlies this assertion appears to be based on the implausible assumption that DNOs would make no improvements over the period from 2013/14 to 2015/16.[100]

Alleged Flaws in AlixPartners' modelling

58. The remedies proposed by BGT are based upon modelling carried out by AlixPartners.[101] The Authority claims that the modelling and the use of data by AlixPartners are flawed in various respects.[102] Those criticisms are addressed in the 2nd AlixPartners Report at ¶¶2.5.1—2.5.29 and 2nd Manning ¶¶62–68. In summary, those criticisms are either unfounded or require only minor adjustments to the modelling which do not substantially affect the conclusions reached.

III(ii) BMCS

Target Starting Levels / Relevance of 2013/14 performance (NoA 4.45; Response ¶¶198-203)

59. In its NoA, BGT submitted that the Authority's approach to calibrating the incentive scheme would fail to incentivise DNOs to improve performance and be unlikely to deliver value for money for consumers because it set BMCS targets at a level which many of the DNOs are already outperforming.[103] BGT had understood it to be common ground that the objective of the BMCS had been to incentivise <u>improvements</u> in DNOs' customer facing performance, and not to give rewards DNOs where current performance was only maintained.

---

97 It is not clear that this is the case, as the DNOs would then have been subject to losses or reduced rewards under DPCR5.

98 See 2nd AlixPartners Report at ¶¶2.3.9-2.4.12.

99 Response ¶187(c).

100 See 2nd AlixPartners Report at ¶¶2.4.13-2.4.16.

101 See 1st AlixPartners Report at ¶¶5.4.1-5.4.4.

102 1st Rossington ¶¶93-96.

103 NoA ¶4.45.

60. In response, the Authority argues that the aim of the BMCS is not solely to incentivise improvements, but also to encourage the maintenance of existing good levels of customer service.[104] However, even in respect of this weaker objective the Authority has not explained how targets that are in many cases below current performance are justified. [105]

61. In any event, the Authority has offered no satisfactory explanation as to why, over and above funding DNOs' efficient operating and capital expenditure, consumers should also be required to pay an additional amount to incentivise the maintenance of present levels of performance.

62. The Authority advances five reasons as to why targets are not set at too low a level compared to recent performance. These arguments are addressed in turn below.

63. The Authority's first argument is that historical data is not a good guide, in particular because rising customer expectations mean that improvement (in absolute terms) will be required to maintain current performance levels.[106] According to the Authority, DNOs may be required to make ongoing investments in order to achieve the same level of customer satisfaction on the basis that customer expectations increase over time.[107] However, the Authority offers no direct evidence for the factual premises of this argument,[108] stating only that "*It was acknowledged during the course of the consultation that consumers' expectations are becoming more demanding. It is therefore unnecessary to set further improvement factors.*" Further, even if such rising expectations were shown to be a relevant factor which must be taken into account, the Authority has not advanced

---

[104] Response ¶193(e) and ¶198. BGT acknowledges that the Authority's Strategy Decision [BG2/10A] did refer to one of the objectives of RIIO-ED1 as being "*maintaining high-levels of customer satisfaction and improving service where required*". However, that does not equate to a decision that the BMCS should reward mere maintenance.

[105] See Strategy Decision at ¶2.30.

[106] Response ¶193(a)

[107] Response ¶193(a)(i) and ¶204.

[108] Such evidence would have to consist in evidence (i) that the expectations of DNOs' customers will materially rise over the course of RIIO-ED1; and (ii) that such expectations will rise in such a way as to cause a deterioration in the DNOs' scores under the BMCS. The only evidence proffered by the Authority is a report from the Institute of Customer Service in respect of UK consumers more generally. See further 2nd AlixPartners Report ¶3.2.8.

any argument or evidence as to why it necessitates relaxing starting standards below prevailing performance in respect of a number of BMCS elements.

64. Secondly, the Authority also contends that it was correct not to take account of 2013/14 performance when setting BMCS targets.[109]

64.1. The Authority asserts that (i) those data were not available at the time of setting targets prior to DNOs' preparation of business plans and (ii) if it had indicated its intention to do so at that time, that would have incentivised DNOs to perform poorly in 2013/14.[110] For similar reasons to those set out above in respect of IIS, the incentive effect of the BMCS depends upon the marginal incentive rate for improving performance, which could clearly have been signalled to DNOs without knowledge of 2013/14 performance and DNOs did not require certainty as to the precise level of rewards in order to plan appropriately.[111] Further, any risk of a perverse incentive was substantially mitigated by the fact the BMCS was already in place in 2013/14 (such that a deterioration in performance would have attracted reduced rewards / increased penalties) and could easily have been counteracted, for instance by the use of an industry wide benchmark.[112]

64.2. The Authority also claims BGT's complaint "*implies that the Authority should have focussed solely or primarily on data relating to DNOs' historical performance*".[113] This is incorrect: BGT's case is simply that the Authority should have taken historical performance data into account, including 2013/14 data, and that had it properly done so it would have set BMCS targets at a higher level.[114]

65. Thirdly, the Authority argues that the 1st AlixPartners Report, on which BGT relies, disregards the fact that the BMCS includes a new measure of unanswered calls which could reduce the rewards

109 Response ¶199(b)

110 Response ¶193(d).

111 See ¶45 above; 2nd AlixPartners Report ¶¶3.2.16-3.2.18

112 See 2nd AlixPartners Report ¶3.2.19.

113 Response ¶193(b).

114 See further 2nd AlixPartners Report ¶¶3.2.21-3.2.22.

that DNOs receive by increasing penalties.[115] This is incorrect: that report includes an estimate of the unanswered calls penalty based upon the most recent data which the Authority had made available.[116] Further, it appears that the Authority is basing its estimate of the impact of including the unanswered calls measure on 2013/14 data which shows a sharp decline in performance (and which was not previously made available). However, the Authority has not provided any justification for why this particular year's data should be treated as a reliable metric and there are good reasons to believe that 2013/14 may be distorted due to one-off factors.[117] Further, the wide range in performance between DNOs, as well as the deterioration in performance between 2012/13 and 2013/14, suggests that there is considerable scope for improvement. Further, the wide range in performance between DNOs suggests that there is considerable scope for improvement.[118]

66. Fourthly, as regards the complaints metric, the Authority accepts that the target has been set at a less demanding level than was required under DPCR5.[119] The Authority does contend that DNOs that perform the same or worse than the performance of the worst-performing DNO in 2012/13 will attract the maximum applicable penalty. However, that is incorrect for the reasons set out at 2nd AlixPartners Report ¶3.2.22 and is in any case a distinct point from whether or not the targets are set at too high or too low a level.[120]

67. Fifthly, the Authority contests BGT's complains regarding the customer satisfaction survey and stakeholder engagement incentive.[121] It argues that the customer satisfaction survey in RIIO-ED1 will include interviews with "*customers to whom the DNOs have not previously been incentivised to provide a good service*", namely those who have been pro-actively contacted about power cuts and those who contact DNOs through email or social media in respect of the customer satisfaction, survey.[122] In addition, the Authority notes that the stakeholder engagement incentive will also

---

[115] Response ¶¶193(a)(ii) and 200.

[116] 1st AlixPartners Report, footnote 133 on page 65; 2nd AlixPartners Report ¶3.2.9.

[117] See 2nd AlixPartners Report ¶3.2.13.

[118] 2nd AlixPartners Report ¶3.2.14.

[119] Response ¶201.

~~1.~~

[121] Response ¶202.

[122] Response ¶¶193(a)(iii) and 202.

include an assessment of how well the DNOs address customer vulnerability.[123] However, neither the Authority nor the DNOs have offered any reason or evidence to expect that the inclusion of these customer groups is likely, all else equal, to reduce slow-track DNOs' performance.[124] Further in relation to the stakeholder engagement incentive, the Authority also argues that targets have not yet been finalised so there is no reason to expect current levels of rewards to be maintained.[125] However the Authority has provided no explanation of what the revised targets/evaluation criteria are likely to be or how it expects these to affect DNOs' performance, nor, therefore, has it given any reason to doubt that recent performance is likely to provide a reliable indicator of future performance.[126] Moreover, the delay in finalising this aspect of the BMCS clearly hinders, as it has done in this context, the ability of stakeholders to engage.

Improvement Factors (NoA ¶4.46; Response ¶204-205)

68. BGT's case is that the Authority erred by failing to include explicit improvement factors into the BMCS.[127] In response, the Authority claims that it has "in effect" included improvement factors.[128]

69. First it claims that a requirement for improvement is "effectively built-in" to the absolute targets for the customer satisfaction survey insofar as customers' expectations change over time.[129] Secondly, it claims that the same will be true in respect of the stakeholder engagement incentive once finalised.[130] These points are unsubstantiated for the reasons set out at ¶63 above, and in the 2nd AlixPartners Report at ¶¶3.3.4-3.3.5.

[123] Response ¶193(a)(iv).

[124] 2nd AlixPartners Report ¶3.2.14.

[125] Response ¶193(f).

[126] See 2nd AlixPartners Report 3.2.25.

[127] See NoA ¶4.46.

[128] See Response ¶204. The Authority also claims in passing that the aim of BMCS is maintenance of standards as well as improvements. It is not clear from Response ¶¶204-205 what reliance the Authority places on this contention. Insofar as it is relevant it is addressed at ¶60 above.

[129] Response ¶204(a).

[130] Response ¶204(b).

70. Thirdly, in respect of the complaints metric the Authority claims that its policy was specifically to maintain the best performing DNOs' level of performance and to penalise the worst performing DNOs to incentivise improvement.[131] However, the Authority's policy only applies to the level of performance at which DNOs will receive the maximum penalty and therefore does not incentivise poorly performing DNOs in general to improve, only the very worst performers. Moreover, this maximum penalty score is fixed throughout RIIO-ED1 and cannot therefore credibly be characterised as an improvement factor.[132]

Asymmetry in the BMCS scheme (NoA ¶4.47; Response ¶206)

71. The Authority accepts that the incentive rates in the BMCS are asymmetrical in the sense that if the DNO exceeds the target by a given amount it will earn a reward which is twice as large as the penalty that it would receive for falling short by this amount.[133] However, the Authority makes two points.

    71.1. First, it makes the negative argument that there was no reason to adopt a symmetrical approach.[134] However, in the absence of any evidence that levels of outperformance by above-average DNOs are systematically less than the levels of underperformance of below-average DNOs, or that customers value outperformance at twice the rate that they dislike deteriorations in performance, there is no clear need for an asymmetrical incentive rate which rewards out-performers at double the rate of the penalty to under-performers.[135] Further such an asymmetrical system has an obvious cost to consumers, who must pay for the rewards in question.

    71.2. Secondly, the Authority argues that one element of the reward scheme was symmetrical, namely that it set the maximum reward and penalty scores at 1.75 above and below the mean so that "*any company that scored significantly higher or lower than an average*

131 Response ¶204(c).

132 See 2nd AlixPartners Report ¶¶3.3.22 and 3.3.6.

133 See Response ¶206(a).

134 Response ¶206(b).

135 See 2nd AlixPartners Report at ¶3.4.2.

performing company will incur the maximum reward or penalty".[136] Further, the Authority notes that if the maximum rates were set symmetrically around the target, the score required to achieve the maximum reward could have been unrealistically high.[137] However, this argument focuses unduly on the maximum reward point; it is the marginal rates or reward and penalty that matter for DNOs' incentives, not the maximum rewards or penalties, while no evidence has been provided to demonstrate the risk of targets being set unrealistically high.

Other points

72. The Authority notes that the BMCS has in the past had a positive impact on bringing the DNOs up to acceptable levels of service.[138] However, this is irrelevant to BGT's appeal which concerns the design of the BMCS over the next charge control period.

73. The Authority also contends that BGT did not raise in detail the points it now makes during the consultation on the design of the BMCS.[139] The difficulties experienced by stakeholders other than DNOs in engaging with the Authority's consultation process are addressed by Mr Manning in his second witness statement.[140]

IV. GROUND 3: UNWARRANTED EX-POST CHANGE TO INFORMATION QUALITY INCENTIVES

74. The Information Quality Incentive ("**IQI**") is an incentive intended to influence the DNOs to produce high-quality business plans that accurately reflect forecast costs; and to provide a financial deterrent against the submission of business plans containing inflated expenditure forecasts. In its NoA, BGT complained of the Authority's decision to relax the IQI baseline or break-even point (at which a DNO can achieve a return equal to the Authority's estimate of its cost of capital, if it spends the amount it had forecast over the control period) from 100% (i.e., where the DNO's costs forecast in its business plan equals the Authority's view of efficient costs) to 102.9% ("**the IQI**

---

136 Response ¶206(b).

137 Response ¶205(c).

138 Response ¶194.

139 Response ¶195.

140 See 2nd Manning ¶¶88-101.

adjustment").[141] The effect of the adjustment was to improve upfront rewards or reduce upfront penalties for all Slow-track DNOs in relation to any given level of forecast costs. This change was made after the DNOs' business plans had been submitted. BGT considers that such an *ex post* change undermines the integrity of the IQI scheme.

75. Much of the Authority's Response (and that of the DNOs) is concerned with justifying the IQI approach in general.[142] This is not an answer to BGT's case. BGT supports the use of the IQI; its complaint is with the changes to the IQI baseline made after business plans had been submitted. For this reason, BGT does not reply to each assertion by the Authority and the DNOs that the IQI in general was positive for consumers.

IV(i) Arguments raised by the Authority

76. In relation to the IQI adjustment, the Authority contends that:

76.1. it was intended to preserve the supposedly necessary component of the IQI to reward some DNOs;[143]

76.2. it had to be seen in light of the Authority's approach to smart grid benefits (SGBs) and real price effects (RPEs), and that overall the Authority's related changes (including the IQI adjustment) led to a reduction of £372 million in allowed revenues, not an increase of £290 million as BGT contends;[144] and

76.3. it was required to preserve the credibility of the incentive for future price controls.[145]

141 NoA ¶4.63.

142 See, for example, the Authority's Response at ¶222(a)(ii): "the IQI encouraged the submission of more efficient costs in the DNOs" business plans…".

143 Response ¶216(d).

144 Response ¶221(a).

145 Response ¶221(b).

77. None of these arguments is new.[146] They simply restate the reasons provided for the change in the IQI in the Draft Determinations and Final Determinations. BGT therefore reiterates its arguments advanced in the NoA (¶4(3)) and supported by the 1st AlixPartners Report (§7) and does not address each of the Authority's points in detail in this Reply.

78. However, it is useful here to address two key erroneous assertions that underlie much of the Authority's reasoning, namely:

78.1. that it was clear from the Strategy Decision that the Authority would "*set its benchmark view [of efficient expenditure] at the upper quartile of DNOs' submissions*",[147] leading to the consequential assertions that:

78.1.1. it was an "*inherent element of the Authority's IQI design … that some DNOs would earn rewards*";[148] and that

78.1.2. the treatment of SGBs and RPEs "moved the goalposts"[149] and the IQI adjustment was therefore necessary to preserve credibility and incentive properties.

78.2. that costs of the IQI adjustment need or indeed can logically be offset against savings achieved variably by the Authority's approach to SGBs and RPEs, or the comparative cost assessment process more widely.

79. BGT also addresses briefly (i) the Authority's disagreement with BGT's assessment that the IQI adjustment in any event overcompensates DNOs relative to the impact of any cost adjustments made by the Authority; and (ii) the Authority's comments in its Response which dispute that the "fair bet" principle militates against allowing DNOs to benefit from their poor business plans.[150]

---

146 The Authority's argument that the costs of the IQI change had to be seen in light of RPE and SGB related savings is a different nuance to the argument previously advanced that they had to be offset against the benefit derived from the IQI generally; however, both versions of the argument fail for the same reasons as discussed below.

147 Response ¶214.

148 Response ¶213.

149 Response ¶221c.

150 Response ¶224.

80. Finally, section 4 of the 2nd AlixPartners Report should be read as an integral part of this section, as it addresses further points not explicitly covered here in the interest of concision, including in particular arguments advanced by the Authority, in the DNOs' Joint Submissions and in the expert report of Oxera on behalf of the Slow-track DNOs.

IV(ii) The correct IQI benchmark is efficient costs and not upper quartile DNO performance

81. The Authority's justification of the IQI adjustment can be summarised as follows:

81.1. The Authority contends that when it communicated the IQI in the Strategy Decision it had been clear that it would set the efficient cost benchmark on the basis of upper quartile performance relative to the DNOs' business plans.[151]

81.2. As a result, it contends that "*it necessarily followed that those DNOs whose cost efficiency was better than the upper quartile of efficiency would earn rewards*",[152] and it was therefore an *inherent* element of the IQI that some DNOs, namely the upper quartile, would earn rewards.[153]

81.3. Further, when the Authority then concluded that none of the DNO business plans appropriately reflected SGBs or RPEs, and decided to make its own adjustments to its assessment of efficient costs, it "moved the goal posts".[154]

81.4. In order to be "fair" and preserve the incentive qualities of the IQI for the future, the Authority therefore had to make the IQI adjustment and ensure that some DNOs got rewarded.

82. This reasoning is in error, as explained below.

---

151 Response ¶214.

152 Response ¶214.

153 Response ¶213.

154 Response ¶221c.

The Authority did not move the goal posts

83. First, the "goal posts" for the IQI were never set at upper quartile performance. As the Authority correctly states in the Response,[155] the IQI's design was such that:

> *"DNOs would earn rewards for the submission of business plans which were more efficient than* *the Authority's view of efficient costs" (Emphasis added.)*

84. The Authority's argument relies on the assertion that "*the Authority's view of efficient costs*" can be equated to upper quartile performance. However, this was never the position, nor would it be an appropriate position for the Authority to take.

85. While it is correct that upper quartile benchmarking was to be the Authority's starting point in assessing efficient costs, it had been clear throughout the RIIO process that the Authority would depart from that starting point where necessary – as it eventually did with the SGB and RPE adjustments. For example:

    85.1. In the RIIO Handbook, the Authority stated that where benchmarking is used, it is "*neither being used mechanistically nor exclusively of other evidence*"[156]. It expressly stated that "*where a company's business plan is not well-justified, we will be able to put aside the company's forecasts and make our own assessment of the company's expenditure requirements drawing on other sources of data*"[157]; and

    85.2. In its Strategy Consultation, the Authority stated that the assessment of business plans would draw on "*any available comparative evidence both our own and additional information provided by the DNOs - including benchmarking data*" (emphasis added)[158].

86. The second witness statement of Anna Rossington cites the Strategy Decision as stating that the Authority would "*avoid picking elements out of the cost assessment and therefore its upper quartile*

155 Response ¶213.

156 RIIO Handbook **[BG2/4]** ¶8.44.

157 RIIO Handbook **[BG2/4]** page 67.

158 Strategy Consultation **[BG2/8]** ¶1.26.

view".[159] However, this reflects only part of what the Authority stated in the Strategy Decision. The Authority could not have been clearer that it would depart from the upper quartile benchmark where appropriate, including specifically in circumstances where there were concerns with regard to data quality:[160]

> *"2.13 We are minded to set the benchmark for efficient costs at the upper quartile (UQ) level of performance, allowing for other factors that may influence our results. However, <u>we may vary this if there are particular concerns with regards to data quality</u>.*
> *…*
>
> *…*
>
> *2.30 Our intention is that we will make as few normalising adjustments as possible prior to benchmarking. <u>However, our decision will ultimately be guided by the quality of the data submitted by the DNOs and we will carry out normalisation adjustments where necessary</u>." (Emphasis added.)*

87. It was precisely these types of concerns about the quality of the data submitted in the DNOs' business plans that led the Authority to make the SGB and RPE adjustment, in line with its stated intention that it would do so where necessary.

    87.1. In relation to SGBs, the Authority found that:

    > *"we don't believe that the DNOs have sufficiently considered the potential savings they can make to the cost of running their networks by adopting smart grid solutions. It is important that consumers receive adequate returns on their investment in innovation trials and the roll-out of smart meters. Evidence suggests that the DNOs can save around £400m more than they have forecast"[161]; and*

    87.2. in relation to RPEs, the Authority found that using actual data required it to depart from the DNOs' forecasts:

    > *"We have updated our RPE assumptions from those at fast-track. This results in an RPE forecast that is significantly less than that of the DNOs. This difference equates to*

159 Second witness statement of Anna Rossington, ¶22.

160 Strategy Decision – Tools for Cost Assessment (Supplementary Annex) **[BG2/10-D]**.

161 Draft Determinations – Overview [**BG2/30-A]** page 5.

> *£850m (4.5 per cent) of their requested totex. This is mainly driven by using actual data as a measure of growth for 2012-13 and 2013-14."*[162]

88. It is clear therefore (i) that there could not have been a legitimate expectation on behalf of the DNOs that the IQI would be based mechanistically on an upper quartile benchmark, and (ii) that the possibility of adjustments motivated by issues with the data quality of the DNOs' business plans, such as the SGB and RPE adjustments, had been well flagged.

89. Moreover, an approach to benchmarking which reserves the right to make adjustments to the benchmark based on independent information is the only appropriate approach for the Authority to adopt. Without the possibility of such adjustments, the Authority removes an important safeguard of consumer interests, and risks creating an incentive for DNOs to collectively bid unchallenging business plans.

Rewarding some DNOs is not an inherent and necessary feature of the IQI

90. For the reasons just explained, it could never have been the legitimate expectation of DNOs to be rewarded for top quartile performance irrespective of whether that performance reflected efficient costs. It is therefore <u>not</u> an inherent feature of the IQI that some DNOs, namely the upper quartile performers, are rewarded. The IQI is designed to reward the provision of high quality business plans, and it is entirely consistent with that purpose if no rewards are being paid in a situation where *all* the DNOs' business plans were found to reflect inefficient levels of cost.

91. Furthermore, even assuming that DNOs erroneously expected that a quarter of DNOs would be rewarded irrespective the overall quality of business plans, it still does not follow that some *Slow-track* DNOs would be rewarded.

92. The Authority contends that "*any rewards accruing to WPD as a result of being fast-tracked are entirely irrelevant to the current issue*".[163] However, that is not correct. Fast-track rewards are in fact highly relevant. The original structure of the IQI, as communicated prior to the DNOs' submissions of their business plans, was that upper quartile benchmarking would be applied on the

---

162 Draft Determinations – Overview [**BG2/30-A]** ¶4.21.

163 Response ¶222(e).

basis of all 14 DNOs (including ultimately fast-tracked WPD).[164] It is entirely feasible in that set-up that the fast-tracked companies (which accounted for about a quarter of DNOs) could have been identical to the top performing, i.e. upper quartile, companies. In fact, such a scenario would be entirely consistent with the related aims of fast-tracking and the IQI of rewarding high quality business plans. A scenario in which *no* slow-track DNOs received an IQI award and the only IQI related upfront reward was the fast-track payment in lieu of IQI is therefore entirely compatible with the design of the IQI.

93. Finally, it also cannot be argued that some DNOs have to be rewarded for the incentive to work. In a situation where no DNO receives an upfront IQI award, as all DNO business plans were found to be deficient, the IQI's incentive properties nevertheless apply, as it is more favourable for those DNOs that have submitted relatively less bad information.

The IQI adjustment is not necessary to preserve credibility or incentive properties

94. As discussed in the NoA and in the previous paragraph, it is clear that the IQI adjustment was neither able nor necessary to preserve the IQI's incentive properties in relation to RIIO-ED1. The IQI adjustment is equally not required "*to maintain the Authority's credibility for future price controls and therefore the ability to get good information from companies*".[165]

95. The Authority alleges that incentives to provide good information in the future will be undermined if it is perceived that the Authority "*may change its assessment of costs and 'move the goalposts' in such a way as to eliminate any rewards for provision of good information*".[166]

96. That is not the case. Without the IQI adjustment, the IQI would have been true to its objective of rewarding the provision of high quality information, and be a deterrent against providing inflated cost forecasts. DNOs would have earned rewards if the information they provided in their business plans had reflected an efficient level of spending; and DNOs that provided relatively less bad information fared relatively better in any event.

---

164 Strategy Decision – Outputs, incentives and innovation **[BG/10-B]** ¶9.13: "*We will set the IQI matrix based on the final submissions from all 14 DNOs*".

165 Response ¶216(d).

166 Response ¶221(c).

97. Not paying a reward given the provision of poor information across all DNOs strengthens the incentive to provide good information in the future and does not undermine it. On the contrary, making the IQI adjustment and paying rewards nevertheless risks undermining the future efficacy of the IQI.

98. The Authority further makes reference that "*incentives under the IQI are not only intended to incentivise the DNOs while they are preparing their business plans for the forthcoming price control; they also provide an efficiency incentive throughout the price control period to incentivise efficient delivery*"[167].

99. That reference is simply irrelevant in the context of the current ground of appeal. BGT's complaint concerns solely the *ex post* adjustment made to the upfront component of the IQI. The upfront component is a fixed reward and has no impact on DNOs' incentives to deliver efficiently during the price control period. It is the efficiency incentive sharing rate provides that provides an incentive to deliver efficiently, which is preserved irrespective of whether the IQI adjustment is made or not.

IV(iii) The changes cannot be set against cost reductions for SGBs and RPEs

100. The Authority alleges that:

100.1. The IQI adjustment "*must be seen in light of the £750mn or so of costs savings to consumers achieved through the Authority's approach to RPEs and SGBs. Overall (including the IQI adjustment) the changes have led to a reduction in allowed revenue of £372m over the RIIO-ED1 period to the benefit of consumers";*[168] and

100.2. it was justified to "*offset the additional £290mn of costs to consumers resulting from the change in the break-even point against the £700mn of costs savings which were achieved through the comparative cost assessment process*".[169]

101. Neither of these arguments can logically be sustained. It is unsound to seek to offset costs against benefits where there is no causal link between the two; or in other words, it is illogical to treat an

[167] Response ¶219(b).

[168] Response ¶221a.

[169] Response ¶222a(ii).

expense as the cost of a benefit where in the counterfactual of not incurring that expense, the benefit would still accrue. That is not good value for consumers.

102. As explained above, making the adjustments in relation to RPEs and SGBs and thereby achieving the related cost savings for consumers did not “move the goal posts”. As a result, neither some notion of fairness versus expectations, nor any considerations as to preserving the efficacy of the IQI for the future, required the IQI adjustment to be made. The RPE and SGB related savings did not depend on the IQI adjustment and cannot logically be offset against its costs.

103. Similarly, it is not justifiable to offset the wider benefit of the IQI and the comparative benchmarking process against the costs of the IQI adjustment. As is self-evident, those benefits were achieved on the basis of business plans submitted *before* the IQI adjustment was made. It is at the core of BGT’s complaint that those benefits cannot logically be attributed to such an *ex post* adjustment, as explained above and in the NoA.

IV(iv) IQI adjustment in any event over-compensates

104. In the NoA, BGT raised the further concern that, even if it was recognised that new information had arisen that DNOs could not have taken into account in their business plans (such as evidence suggesting that RPEs would be lower than they expected), the adjustment made by the Authority was out of all proportion to the net impact that this would have had given the structure of the IQI rewards.[170] The 1st AlixPartners Report estimated that the IQI adjustment overcompensated DNOs by 17 times the required amount. As AlixPartners explained: “*This is fundamentally a consequence of the fact that the IQI matrix only imposes relatively small disincentives for inaccurate forecasting, but much greater incentives for actually delivering lower costs.*”[171]

105. The Authority disagrees with that assessment, partly on the basis of the same argument addressed above that it believes the costs of the IQI adjustment are more than offset by the cost savings in relation to RPEs and SGBs.[172] In addition, Ms Rossington claims that AlixPartners analysis was

170 NoA ¶4.62f.

171 1st AlixPartners Report ¶7.3.31.

172 Response ¶223b.

"*manifestly incorrect*".[173] That is not the case for reasons explained in more detail in the 2nd AlixPartners report.[174]

IV(v) The fair bet principle

106. In its NoA, BGT argued that the IQI breakeven point should not be amended simply because subsequent changes in circumstances have turned out to disadvantage the DNOs, pointing to the "fair bet" principle that it is unfair to advantage DNOs when the Authority discovers new information that advantages them, given the information asymmetry between the DNOs and the Authority.[175]

107. The Authority rejects the view that the "fair bet" principle applies:

107.1. First, the Authority argues that the IQI change was a result of its own decision rather than changing circumstances. As to this, in relation to RPEs, the Authority itself states that the change to RPEs was 'mainly' a result of new information becoming available (see ¶87.2 above), not a change in regulatory approach. In relation to SGBs, the Authority's treatment was compelled by the collective inadequacy of the DNOs' business plans and subsequent further investigation of SGBs and it is illogical to allow the DNOs to gain an advantage under the IQI from their own poor forecasting.

107.2. Secondly, the Authority asserts that it is unlikely that other factors will benefit the DNOs to a similar extent. The Authority puts forward no reasoning in support of this assertion. Since there will be information that only the DNOs know and have no incentive to disclose – or indeed, that no stakeholders are aware of – it is not possible to estimate the likely extent of countervailing factors. Further, it would defeat the purpose of the "fair bet" principle to apply it only where the countervailing factors are already "expected" to balance. The very purpose of the principle is to manage the risk of unknown factors.

107.3. Thirdly, the Authority considers that the "fair bet" point should be the cost of capital. But this could only be a logical starting point <u>before</u> the submission of business plans. If the Authority

[173] See Second Witness Statement of Anna Rossington at ¶43.

[174] See 2nd AlixPartners Report at ¶1.1.8ff.

[175] NoA ¶4.62(g).

seriously contends that the "fair bet" should be recalibrated after the submission of business plans (regardless of the particular baseline to which the calibration occurs), the very purpose of the IQI to incentivise the provision of higher quality business plans would be undermined.

V. GROUND 4: UNWARRANTED TRANSITIONAL ARRANGEMENTS FOR CHANGE IN ASSET LIFE POLICY

108. The change in the Authority's depreciation policy for new assets to move from an assumption of an asset life of 20 years to one of 45 years represents a change from an accelerated depreciation period to one that more realistically reflects economic asset lives. Depreciation allowances will as a result more closely match the true long run incremental cost of the use of assets, in line with sound regulatory principles.

109. BGT submitted in its NoA that the Authority should not have delayed the introduction of that change in policy by an eight-year transitional period; that the transitional arrangements were contrary to the interest of consumers; and that their necessity in the light of financeability considerations had not been demonstrated, in particular not as a measure to be applied across all DNOs. BGT further complained about a lack of engagement on the proposed transitional arrangements at the consultation stage, and a lack of reasons in the Decision to justify them.

110. The Authority in its Response defends its decision to apply an eight-year transitional period and to apply it across all Slow-track DNOs on the basis of considerations of intergenerational equity and financeability. For the reasons set out in BGT's NoA and for the further reasons discussed below neither of those considerations is capable of justifying the Authority's decision.

V(i) Intergenerational equity

111. Central to the Authority's defence of its use of an eight-year transition period as an additional transitional measure[176] and of applying that period across all Slow-track DNOs are considerations of intergenerational equity. However, the arguments advanced by the Authority fail to justify its decision for two reasons:

---

[176] The change in assets life applies to new assets only thereby providing a natural 20-year transition period before applying to the whole asset base. As the Authority explains in the Response (¶238ff), this form the first of various transitions options with a transitional period listed as a second option.

111.1. First, arguments about a detrimental impact on intergenerational equity of a change in asset lives are most notable for their absence from any of the relevant Decision documents. From the available evidence they do not appear to have formed the basis of the Authority's decision to introduce a transitional period or have been of concern in the context of the change in the asset life policy.

111.2. Secondly, the Authority's arguments rely on a mischaracterisation of the effect of the transitional period and are flawed as a result.

The available evidence suggests that intergenerational equity did not form the basis of the Authority's decision to introduce a transitional period

112. Following consultation, the Authority set out its decision to change the regulatory asset life assumption in a March 2011 *Decision letter on the regulatory asset lives for electricity distribution assets* **[BG2/5]**.

113. On page 1 of that letter, the Authority raises the possibility of transitional measures in the context of financeability by stating: "*We are committed to ensuring that efficient networks are able to raise the finance they require, both equity and debt, in a timely manner. We recognise that, even with the policy of applying the change in asset lives to new assets only, transitional arrangements may be required …*".

114. The only finding in relation to intergenerational equity in that decision letter is "*that depreciation based on economic asset lives is appropriate and will provide for … improved longer-term intergenerational equity …*" (page 3). The Authority further stated that in deciding to apply the change in asset lives to new assets only, it had "*listened to the arguments … about the impact on intergenerational equity that has already arisen from the valuation of assets at vesting*" (page 4), i.e. that the 'privatisation discount' made it potentially inappropriate to apply the new asset lives policy to existing assets. However, even that decision appears ultimately to have been based on financeability considerations: "… *we have had regard to our financing duty and the RIIO principles of not creating shocks or instability. These persuade us that in this case we should not apply the new asset lives to existing assets*" (page 4).

115. At no point does the decision letter contemplate that considerations of intergenerational equity might necessity transitional arrangements, or that the move to economic asset lives had a detrimental impact on intergenerational equity as far as new assets are concerned.

116. The Authority introduced the eight-year transitional arrangements in the Draft Determinations **[BG2/30C]**. In that document, the Authority notes in general terms that "*Asset life assumptions … have intergenerational effects …*" (¶3.49). However, the entirety of its treatment of the transition period is at ¶3.52: "*The DNOs have all proposed transition arrangements for asset lives from 20 to 45 years in equal steps over the eight years of RIIO-ED1 to assist financeability. We consider their proposals are sensible*".

117. Considerations of intergenerational equity were for the first time raised as an alleged driver behind the Authority's consideration in a letter to BGT of 3 February 2015 **[BG2/39]** (at ¶¶28–30) sent at the same time that the Decision was adopted.

118. On the available evidence, it does not therefore appear to BGT that the Authority's decision to implement an eight-year transitional period for the change in asset lives, or to apply that transition period across all DNOs was motivated by considerations of intergenerational equity. Considerations of intergenerational equity, which do not depend on input from DNO business plans, were open for consideration at the stage of the original decision to introduce a change in asset lives, in March 2011, and appear to have at least in part informed the decision at that stage to apply the change to new assets only. Reasons communicated for the first time 4 years later and solely by private side-letter are not sufficient to justify the Authority's decision – even when leaving aside their substantive flaws (see below).

The Authority's argument mischaracterises the effect of a transitional period

119. The argument on intergenerational equity advanced by the Authority relies on a mischaracterisation of the effect of a transitional period and is therefore flawed and cannot support the Authority's decision; nor, for this reason among others, can the question fall within the realm of permissible regulatory discretion. Contrary to the Authority's assertion, a transitional period runs counter to rather than aids intergenerational equity.

120. The Authority's position is probably best summarised by reference to its statement (at ¶243b) that "*Absent transitional arrangements, over £1.1bn in allowed revenues would be deferred from RIIO-ED1 consumers to future generations of consumers. … Taken at its simplest, BGT therefore advocates a position where future consumers pay more so that existing consumers pay less. … with [transitional arrangements] in place, only £600 million in allowed revenue is deferred from RIIO-ED1 consumers to future generations of consumers.*" (Emphasis added.)

121. This statement mischaracterises the nature of the transitional period and BGT's case. BGT does not ask that current allowed revenue be *deferred*; instead it asks that future revenue not be *brought forward*.

122. The Authority's statement at ¶243 should more correctly read that transitional arrangements *bring forward* £0.5bn in allowed revenues from future generations of consumers to RIIO ED-1 consumers, and BGT advocates a position where *current consumers do not pay more so that future consumers pay less*.

123. It is common ground that moving to a longer depreciation period has the effect of reducing costs to consumers in the short term followed by a subsequent rise in costs. However, the Authority's analysis of that fall and rise is flawed when it asserts (at ¶230) that: "*The fall and subsequent rise in costs unfairly distributes the burden of moving to a 45-year asset depreciation period between generations*" (Emphasis added).

124. The simple fact that prices first fall and then rise is not generationally unfair. It would be unfair only if, as a result, future consumers had to bear costs which properly they should not have to bear because they should be borne by current consumers. That is not the case here.

125. The change in depreciation policy for new assets represents a move from an economically artificial depreciation period to a depreciation period that appropriately reflects economic reality and therefore more closely matches the true economic cost of the use of those assets. As a result, payments by future consumers – whether higher than current payments or not – simply reflect their appropriate share of the costs of the relevant assets. At no point in the future will future consumers be required to pay more than the costs associated with their use of the network. Those payments cannot therefore be described as either (i) causing harm to those consumers and therefore being *unfair*, or (ii) containing a component of costs *deferred* to them by prior generations.

126. The effect of the change in the asset life assumption therefore is not generationally unfair. Instead, it is the transition period that introduces generational unfairness, as it has the effect that future consumers will pay less than their appropriate share of the cost of their use of the relevant assets, at the expense of RIIO-ED1 customers.[177]

127. At ¶245b, the Authority repeats the point that lower costs for current consumers represent a 'deferral' and that "*future generations will experience that additional cost as the cost of financing a higher RAV value (than the value that would exist without the change in policy)*". For the same reasons as above, that is not correct. The higher RAV value in the future results from the fact that due to the change in policy the RAV will no longer be artificially depressed. As a result of an accelerated depreciation period, assets currently are fully depreciated less than halfway through their true economic life and are therefore carried at zero value in the regulatory accounts for the remainder of their period of use. The higher cost of financing the then higher RAV is therefore a cost appropriately reflective of the future asset base and not a deferral from current consumers.

128. <u>In summary</u>, intergenerational considerations cannot justify the transition period or its application across DNOs. Future higher payments are not unfair to consumers and do not need to be mitigated at the expense of current consumers.

129. While there may be an intergenerational argument that consumers, current and future seen as a whole, would prefer a smoother transition in the level of payments, or as put by the DNOs that consumers' interests extend beyond the interest of existing consumers in low prices and include the stability of network charges (JS ¶214), that is (i) not the basis of the Authority's argument, and (ii) as a justification of transitional arrangements should have been consulted on and in any case been supported by appropriate evidence on consumer preferences – as also highlighted in the submissions by Citizens Advice.

---

177 Equally, the argument that it is justified for current consumers to have to pay more, as they are no longer paying for other assets they may be using (¶233a) is illogical. As the 2nd AlixPartners report explains that implies that consumers should in principle continue to pay for assets for which the full amounts due have already been recovered by the DNOs (¶5.2.3).

Uncertainty

130. BGT in its NoA further submitted that the upward pricing pressure identified by the Authority was too far in the future and therefore uncertain (see ¶4.83). As a result, even if intergenerational considerations were able to justify some mitigation of future price rises, any intervention by the Authority should more appropriately take place closer to the time.

131. The Authority contends in its Response that contrary to BGT's view the future price increases are not uncertain (at ¶244c), and that it is therefore appropriate to address them now.

132. On BGT's analysis, which the Authority states "*broadly conforms to that of the Authority*" (¶244a), the upward pressure in prices resulting from the change in depreciation policy will occur in the time period from 2035/36 to 2058/59, and will be of the magnitude of approx. 0.8% per annum (NoA, ¶4.83), assuming all else is equal. The Authority estimates a slightly higher rate of approach 1.5% p.a. (1st Witness Statement of Ian Michael Rowson; Table 2 below ¶26) due to the absence of any assumption of a productivity improvement; however, calculates a similar impact of the transition period of 0.4% (vs. BGT's 0.3%).

133. In BGT's view, it is implausible to describe as 'not uncertain' price movements of around 1% p.a. that are based on the very broad assumption that all else remains equal, including for example the level of investment, that are to occur between 20 and 33 years in the future, and estimates of which fluctuate significantly more than the projected impact of the transition period on the basis of a modest productivity assumption. BGT continues to be of the view that any such upward price pressure should be assessed and (if necessary) addressed nearer to the time only.

NPV neutrality

134. The Authority repeatedly (see ¶230a and ¶243a) refers to the fact that the transitional arrangements are NPV neutral and therefore cannot harm consumers. However, as discussed above the concept of NPV neutrality lends itself more readily to the perspective of the DNOs rather than consumers, as it specifically fails to take into account intergenerational equity.

135. A lack of NPV neutrality would make a measure objectionable for that reason alone, but the fact that a measure is NPV neutral in itself does little to show that the measure does not harm consumer interests. A multi-year payment holiday for one generation of consumers financed by NPV neutral

higher payments of another generation would for example require a strong countervailing justification to not appear harmful to consumer interests even with future and current consumers seen as a whole.

136. As discussed above (¶129**Error! Reference source not found.**), while there may be an argument that consumers might have a preference for the NPV neutral smoothing of price transitions that is not the Authority's argument, and in any event no evidence in support of such an argument has been presented.

V(ii) Financeability

137. In relation to financeability, the Authority in its Response reiterates that (i) the change in depreciation policy would have an impact on financing metrics, and (ii) that it was alert to the fact that transitional arrangements might therefore be necessary. Neither of those points is contested, nor are they particularly informative in the context of the current appeal.

138. What BGT says the Authority has failed to do is to provide sufficient evidence and reasoning to support its conclusion that transitional measures were in fact necessary – and not just potentially necessary – in the light of financeability considerations, and were appropriately applied across all DNOs.

139. The Authority's bare assertion in the Draft Determinations that proposals by the DNOs for a transition period were 'sensible' (see ¶116 above) is not sufficient to justify delaying the implementation of a desirable policy change, effectively compelling consumers to provide cash flow support to the DNOs.

140. The Authority's arguments in support of the transition period now presented in the Response continue to fail to provide credible evidence in its support, and portray an inappropriately broad interpretation of the Authority's duty to secure financeabilty which seemingly equates investors' interests with those of consumer.

141. BGT agrees that it is in the interest of consumers to ensure that DNOs are able to finance their activities at appropriate costs. However, it does not agree that this requires investors to be shielded from the effects of regulatory change as a matter of principle, as the Authority appears to contend. For example:

141.1. The Authority states that the "*issue of financeability was not one which it was appropriate for the DNOs to attempt to address themselves*", as it arose out of a change in the regulatory framework (¶246h);

141.2. It considers that credit metrics would deteriorate "*assuming no change in gearing ratios*" (¶246e), i.e. assuming that DNOs did not themselves take measures to support credit metrics, for example by retaining more equity for a transitional period; and

141.3. It states as one reason for the transition period that even though "*there remained headroom in most of the affected credit metrics*", "*potential investor concerns*" would have been "*unnecessarily heightened*" by an immediate transition to 45-year asset lives (¶246d).

142. The correct standard for transitional measures to support financeability has to be whether a change "*would cause an efficient company financing difficulties*" as the Authority itself stated in the *Handbook for implementing the RIIO model* **[BG2/4]** (at ¶12.37). The question is not whether absent transitional arrangements the company would have to make adjustment to its financing arrangements, by for example introducing its own transitional arrangements in the return of equity to shareholders as dividends.

143. In its 2010 Report on Bristol Water **[BG2/48-A]**, the Competition Commission defined a parallel statutory duty (at ¶10.8): "*… the duty … to secure that companies can finance … their functions is fulfilled by ensuring that the opex and capex projections and the cost of debt and equity (and therefore the WACC) are reasonable. If these are reasonable (and [the company] has reasonable options which enable it to raise finance while complying with its licence conditions), then [the company] should be able to finance its functions.*"

144. BGT recognises that maintaining attractive financing conditions can be in consumers' interests in light of the potential negative effects on financing costs. However, the Authority's duty cannot extend to having to alleviate *potential* investor concerns, or absolving DNOs from *their* duty to maintain appropriate capitalisation and an investment-grade credit rating. If a new policy leads to actual costs being more appropriately reflected in allowances then it should be implemented without delay and the onus should be on the DNOs in the first place to finance themselves appropriately unless they can demonstrate that they cannot do so at appropriate costs.

145. In the current context, the need for a transitional period simply has not been made out to any appropriate standard. This is illustrated by the following points:

146. First, the specific evidence presented by the Authority about individual DNOs' need for transitional arrangements is extremely weak. Far from presenting a compelling picture supporting the industry-wide application of a transitional period, the Authority continues to refer to only one company (ENWL) for which a further adjustment would have been required absent a transitional period (¶246d). Other evidence cited from DNOs' slow-track submissions refers variably to 'signs of financial stress', 'the minimum acceptable level of forecast credit ratios' and support for transitional arrangements (all ¶242).

147. Secondly, this weak evidence is consistent with the Authority's own statement that the "*the effects from transition on credit metrics within the control period … were limited*" (¶246c) and that "*there remained headroom in most of the affected credit metrics*" (¶246d).

148. Thirdly, the Authority presents no evidence to support that the relatively minor identified impacts on credit metrics would have any practical impact on financing costs. In this context it is interesting to note what Moody's Investors Service, one of the three major credit rating agencies, explains in relation to this ground of appeal in a note on the impact of the current appeals[178] (at page 6): "*… regulatory decisions regarding timing of cash flows affect liquidity but not underlying credit quality. As a result, a change in these areas is unlikely to affect our fundamental view. Notably, the Adjusted Interest Coverage Ratio, one of our two preferred metrics for GB regulated networks, adjusts funds from operations to exclude regulatory depreciation.*" (Emphasis added.)

149. Fourthly, the proposed change to regulatory asset lives had been well flagged for a long time, allowing DNOs to take appropriate preparatory steps in terms of their financing arrangements and making investor surprise unlikely. The move to a 45-year asset life was decided four years ago in early 2011 and had been mooted since well before then. As the Authority points out in its March 2011 decision letter (see above, **[BG2/5]**): "*As long ago as Nov 2004 in the DPCR4 final proposals we stated that in the longer term, electricity distribution asset lives should more closely reflect the useful or economic asset life.*" (page 3). In the decision letter, the Authority itself considered this

[178] Moody's Investors Service (11 March 2015): *GB Electricity Distribution Networks: Final Determination appeals create uncertainty but major changes unlikely* **[BG4/1/E]**.

fact to lend some weight to the possibility of applying the change in asset lives to *all* assets despite the much more severe effect that would have had on cash flows. As it explained then: "*… we think there are reasonable grounds for applying the change in asset life to existing assets, including the fact that we have long signalled our intention to consider this aspect of the regulatory framework*" (page 4).

V(iii) Summary

150. The Authority's argument on intergenerational equity is flawed and fails to justify the use of transitional arrangements. It therefore also cannot, as the Authority argued, lend support to the application of transitional measures across all DNOs.

151. Equally, the arguments and evidence put forward by the Authority in relation to financeability remain unconvincing and fail to demonstrate either the need or the appropriateness for consumers to provide cash flow support to either some or all of the DNOs.

152. Therefore, neither of "*considerations of intergenerational equity and financeability … were more than sufficient to delay implementation of the policy*" as claimed at ¶243g, and the change to economic depreciation should be implemented without delay.

V(iv) Procedural deficiencies

153. In the Response, the Authority separately addresses BGT's criticism that the decision to implement a transition period was procedurally flawed due to a lack of engagement at the consultation stage and insufficient reasons.

154. The Authority refers to the various consultations in relation to the change in asset lives, to submissions made by the DNOs in their slow-track business plans, and to the Authority's February 2015 letter to BGT (see above, **[BGT2/39]**).

155. Neither of these points addresses BGT's criticism. As explained in the NoA and above, the criticism of a lack of engagement at the consultation stage relates to the transition mechanism which was only introduced in the Draft Determinations, where it was justified by means of a terse one-line statement. In the subsequent consultation, the Authority did not address or even acknowledge the concerns about the transition mechanism raised by BGT. Furthermore, relying by (implied)

incorporation on reasoning in the DNOs' business plans, which contain several hundred pages of material each, cannot constitute sufficient reasoning, in particular in the light of RIIO's stated aim of stakeholder engagement. The same is true of a private side-letter sent to BGT on the eve of the final decision.

VI. GROUND 5: UNWARRANTED CHANGE IN COST OF DEBT INDEXATION

156. The arguments in respect of Ground 5 (as with Ground 2) are largely technical and accordingly the Authority's responsive arguments are addressed in some detail in the 2nd AlixPartners Report. In the interests of concision, the substance of that report is not repeated in the body of this Reply. However, BGT relies upon section 6 and confidential annex 2 of the 2nd AlixPartners Report in full and it should be read as an integral part of this Reply. The following serves merely as a summary of BGT's reply in relation to Ground 5.

157. In the Final Determinations, the Authority changed its approach to determining the DNOs' cost of debt by adopting a 'trombone' index extending from a 10-year to a 20-year trailing average with a fixed start date of 1 November 2004. That modified index represented a departure from the fixed 10-year trailing average adopted in the Strategy Decision and used in the fast-track settlement and the other two RIIO price controls to date (T1 and GD1).

158. As BGT noted in the NoA (¶4.97), the effect of that change in index construction is a significant additional cost to consumers over the period of RIIO-ED1 due to the greater weight given by the modified index to the higher interest rate environment prevailing prior to the 2008 financial crisis.[179] BGT argued that those costs and therefore the change to a trombone index could not be justified on the basis of the reasoning offered by the Authority.

159. The Authority's main motivator for the change in index appeared to have been a desire to make DNOs' cost of debt allowances match more closely their actual incurred cost of debt. It was BGT's view that absent *any* analysis as to efficiency of the DNOs' debt such a move was not justified.

---

179 See also 1st AlixPartners Report, §1.8.8.

160. The arguments advanced by the Authority in the Response do not change that view. In the Response, the Authority in summary contends that:

160.1. A 10-year trailing index would underfund actual debt costs under a variety of interest rate scenarios (¶261a);

160.2. The new index still underfunds actual debt costs and therefore cannot be considered too generous (¶261b); and

160.3. The additional costs to consumers of the change in index do not mean that the change is not in the interest of consumers given the potential detrimental impact of any underfunding on the future perceived credit quality of the energy network sector and therefore its cost of financing (¶261c and ¶264f).

161. None of these points is new, nor do they address BGT's central criticism. The Authority states that "*a cost of debt index that materially underfunds <u>efficiently incurred</u> debt would have longer term adverse consequences for consumers*" (¶264; emphasis added). BGT does not argue with that statement. BGT's complaint is (i) that the Authority's actual approach to cost of debt recovery is that "*the best basis available to which to calibrate the cost of debt index … is the sector wide <u>actual</u> debt costs*" (at ¶275c; emphasis added), and (ii) that this assertion is not supported by sufficient analysis as to the efficiency of those actual costs incurred, which is contrary to the Authority's own stated policy that its "*long term strategy to this end, consistent with other regulators and recent decisions by the CC, has been to set allowances for financing costs that relate to the costs of debt that have been reasonably incurred by the regulated companies (embedded debt) <u>subject to appropriate consideration of whether those costs had been incurred prudently and efficiently</u>*"(emphasis added).[180].

162. Apart from an apparently light touch periodic analysis "*of the rates at which regulated companies issue debt against market benchmarks*" (¶258), which "*found no evidence of systematic inefficiency across the sectors*" (¶275c(i)), the Authority relies in support of its assumption that actual debt costs are the best proxy for efficient debt costs on the assertion that the DNOs "*have always been*

[180] Response ¶251, by reference to Competition Commission, *Final Determination: Northern Ireland Electricity Limited* **[BG2/52-A]**.

incentivised to issue efficiently" and that "*since the introduction of the index mechanism this incentive has become stronger, because, issuing debt below the allowances means that the DNOs may keep the difference*" (¶275c(iii)).

163. The DNOs advance a similar argument by contending that the 'iBoxx' cross-industry index underlying the Authority's cost of debt index in itself was a sufficient safeguard against the recovery of inefficient debt costs, as "*it represents a sensible proxy for the rates at which the DNOs could be expected to raise debt efficiently*" making it "*unnecessary to consider the efficiency of DNOs' actual debt issuance*", continuing in line with the Authority that "*DNOs always had a strong financial incentive to minimise the cost of individual debt instruments*" as "*DNOs have borne the full cost of any 'inefficiency' in debt issuance*" (DNO Joint Submissions, §233(2)).

164. However, even leaving aside concerns about suitability of the iBoxx index as a measure of efficient DNOs debt costs[181], the change in the specification of the index is expressly motivated by a desire to achieve higher cost of debt allowances that better match *actual* costs. In short, the Authority has created a direct link between DNOs' actual debt costs and the specification of the index. The outcome is that DNOs no longer bear "*the full cost of any 'inefficiency' in debt issuance*" (above) as they are gaining the benefit of the consequential increase in the overall cost of debt index, thereby undermining the supposed incentive effect relied upon by the Authority and the DNOs.

165. The actual incentive mechanism appears to be a biased one in that (on the Authority's own account) DNOs may retain the benefit of any debt issued below the index, while costs incurred above the index will mostly still be recoverable via a suitably timed modification of the index.

166. For the same reasons, and contrary to the Authority's assertion, the change in index also does not contribute to regulatory certainty. First, the Authority has changed the specification of its index, arrived at following extensive consultation, from its previous RIIO price controls. Moreover, it creates the expectation that next time the current index departs from actual debt costs at a price control review, for example in a scenario where interest rates rose rapidly contrary to expectations,

[181] Given that DNOs have historically consistently outperformed that index which as an economy-wide index fails to reflect the benefits of the regulatory regime enjoyed by DNOs. While BGT acknowledges that there may be debate about the exact size of that so-called "halo effect", the Authority is clear that this effect has been historically important and it should have considered its likely future impact; see 2nd AlixPartners Report ¶6.3.9 and section 6.5.

the index would be amended again. That is undoubtedly attractive for investors in DNO debt, but it cannot be in the interest of consumers as long as the Authority's effective motivation remains to match actual cost of debt without a meaningful analysis of efficiency – contrary to the Authority's own stated policy position to allow only recovery of efficiently incurred costs.

167. Finally, the Authority also considered that the modified index would better protect DNOs from exposure to interest rate risk.[182] In the Response, it argues that contrary to BGT's view such protection was also in the interest of consumers who will, for example, benefit from "*today's exceptionally low interest rate environment for an additional ten years*" (¶263). While such future benefits (beyond RIIO-ED1) may exist, the Authority has provided no analysis on their magnitude, on the degree to which they would offset the more immediate higher costs, or on what the effect on intergenerational equity would be of any such offset.[183] Furthermore, the Authority's apparent willingness to change its approach to cost of debt indexation in light of actual debt costs presents a risk that such potential benefits to future consumers would never materialise.[184]

168. <u>In summary</u>, the Authority should have conducted an appropriate analysis of whether DNOs higher actual costs of debt are reflective of efficient debt issuance, and would have had to justify any change in index intended to better match actual costs on the basis of that analysis.

169. The Authority (see e.g. 2nd Witness Statement of Ian Michael Rowson, ¶18) and the DNOs (DNOs Joint Submissions, ¶245) place great weight on the fact that, as BGT accepts, such an analysis is not straightforward. However, that could be said about much of the price control process and as the Authority rightly observes: "*The cost of financing the capital intensive electricity distribution networks is a significant part of the overall cost to consumers.*" (¶251) In combination with the Authority's principal objective, it is therefore clear that significant and extensive investigation in this area would have been justified.[185]

170. From the available evidence, it is apparent that the Authority's reliance on an economy-wide index and on the absence of evidence of systematic inefficiency to justify not investigating the efficiency

---

182 Final Determinations – Overview **[BG2/35-A]** at ¶5.9.

183 2nd AlixPartners Report §x.6.3.

184 2nd AlixPartners Report §x.6.6.

185 Also see 2nd AlixPartners Report §x.4.14.

of DNO debt further is unsatisfactory, and proportionate further steps of investigation were available to the Authority. This is explored in more detail in the 2nd AlixPartners report in sections 6.3 and 6.4 and confidential annex 2, which should be read as an integral part of this section.

VII. GROUND 6: PROCEDURAL FLAWS

171. BGT's central concern is that deficiencies in the consultation process had led directly to the Authority making a poorly –reasoned and, ultimately, erroneous decision as set out in the other grounds of appeal.

172. The Authority's general response is to point out that it has conducted an extensive consultation process.[186] However, that misses the point.[187] BGT's criticism is not addressed to the overall quantity of consultation, in terms of its length or the number of documents issued, but to the quality of consultation on specific points.[188] Its case is that the consultation process did not enable effective engagement by BGT on these important issues. It is particularly noteworthy in this regard that the first time the Authority considered it appropriate to respond to some of BGT's most important points was at the very end of the process, and at BT's instigation in a letter dated 3 February 2015 – the very day of the Decision **[BG2/39]**.[189] Indeed, even following the Decision, BGT remains uncertain what analysis (if any) underlies the Authority's very general statements,[190] and as set out further below, the Authority's justifications for certain of its decisions appear to have changed between the Decision and the Response.[191]

---

186 See Response ¶¶286-287.

187 BGT acknowledged this at NoA ¶4.123.

188 As set out at NoA ¶4.121. In *Vodafone v Ofcom* [2008] CAT 22 **[BG2/47]**, the CAT held that what mattered was not the form of the consultation but whether, it substance, it was deficient.

189 It is not clear why the Authority took the unusual course of dealing with these points in a letter rather than transparently in the explanatory section of the actual decision; this does, however, rather undermine the Authority's suggestion elsewhere that BGT was insufficiently engaged in the process. See further ¶189.1 below.

190 See NoA ¶4.126.

191 See in particular ¶¶176, 180 and 183 below.

173. The CMA has confirmed that submissions are only required on procedural flaws which relate to the matters covered by the five substantive grounds of appeal. This reply addresses the Authority's response under those five headings below.

174. This reply addresses the Authority's response under the rubric of the five substantive grounds of appeal.[192] However, it is necessary briefly to address certain preliminary legal issues.

174.1. First, the Authority contends that it is not under a duty to act transparently, rather only under a duty to have regard to the principles under which regulatory activities should be transparent. BGT submits that this distinction is, at best, so fine as to be irrelevant. At worst it is liable to lead to the Authority's activities being screened from appropriate scrutiny by interested parties, to the detriment of good decision-making and the public interest. Such scrutiny of the regulator is all the more important in markets that are closed to competition.[193] In any case, the Authority has not explained how it makes any difference on the facts of this case. The Authority does not appear to dispute BGT's central submission on the law that the consultation should enable effective engagement by BGT and permit stakeholders to provide an intelligent response.[194]

174.2. Secondly, BGT accepts that, as the Authority points out,[195] reasons can be briefly stated, with the degree of particularity required depending on the nature of the issues falling for decision. However, that does not assist the Authority. As set out in the NoA and further below, BGT's complaints are in respect of matters where the Authority has wholly failed to set out its reasons in a manner which would enable BGT to engage intelligently with the consultation and/or to test the basis for the various adjustments made in the DNOs' favour and in consequence the Authority has proceeded to make flawed decisions.

---

192 The NoA set out procedural errors by reference to the five substantive grounds (see NoA ¶4.128), and the CMA has confirmed that submissions are only required on procedural flaws which relate to the matters covered by the five substantive grounds of appeal.

193 See the views expressed by the Energy and Climate Change Committee as set out at 1st Manning ¶64.

194 See Response ¶¶283 and 285(a).

195 Response ¶286(b).

174.3. Thirdly, the Authority states that it "*does not accept that the present appeal requires an intensive scrutiny of the underlying merits of its decision*" but "*does consider that the appeal process is sufficient remedy for any of BGT's complaints*".[196] BGT submits that there is an evident tension between these two propositions: if the appeal does not enable the merits to be scrutinised, it cannot provide an effective remedy for flaws in a consultation which prevent a party from engaging effectively with the merits of the issues at that stage.

174.4. Fourthly, the Authority argues that it is not under a duty "*to respond in forensic detail to every point raised by every consultee*" or to provide "*detailed supporting analysis*".[197] However, this fails to engage with the facts of the case. BGT's submission of law is simply that interested parties are entitled to be given comprehensible and specific reasons for the particular decision that the Authority has taken. That may or may not require detailed supporting analysis, depending on the particular context. The central problem is the Authority's reasons on the issues set out below were either incomprehensible or unspecific or in some instances entirely absent.

174.5. Finally, the deficiencies in the consultation process must be understood in the context of the process of which they form part. As the Competition Appeal Tribunal has held, the prospective analysis required for an *ex ante* price control requires rigorous analysis.[198] BGT submits that transparency in the consultation process is essential to securing such rigour. Further, as the CC commented in *E.ON v GEMA*:[199]

> *'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).*

196 Response ¶308.

197 Response ¶289(d) and ¶302. See also ¶305 in relation to cost of debt.

198 See *Hutchison 3G (UK) Limited v Ofcom* [2005] CAT 39 [**BG2/45]** at ¶33.

199 **[BG2/46]** at ¶6.196.

VII(i) Double-recovery in respect of directly remunerated services

175. The NoA alleged that the Authority offered no substantive reasons in its Final Determination or the 3 February 2015 letter for its preference for a RAV adjustment, as its assertions in those documents are limited to generalities.[200] In the Response the Authority relies again on the Final Determination and its letter of 3 February 2015, but also asserts that "*the issues were also discussed at a meeting between Ian Rowson of Ofgem and Andrew Manning*" (of BGT) on 28 May 2014. To the extent that the Authority relies upon the Final Determination and the letter of 3 February 2015, BGT maintains its submissions in the NoA. To the extent that the Authority relies upon the meeting of 28 May 2014, as set out at ¶32 above, BGT submits that the Authority has submitted no evidence as to the extent of what was said at that meeting[201] and in any case the discussion of issues at a meeting is neither an appropriate nor a sufficient means of consultation.

176. In addition, the Authority's own arguments in this appeal point up the inadequacy of the consultation process:

176.1. BGT notes that in the argument on financeability in the Response, the Authority relies for the first time on more specific allegations in respect of ENWL, but acknowledges that there are no financeability issues in respect of DNOs "*in general*". This precisely demonstrates the problem arising from the fact that the Authority has previously only made vague assertions that restitution would have effects on "*shorter term cashflows and financial metrics*". It is impossible for interested third parties, without access to the relevant data, to test such vague and general assertions. Further, those assertions have disguised the fact that, as it now appears, there are no financeability issues in respect of all but one of the DNOs.

176.2. Further, the Authority seeks to rely upon the RIGs issued under the DPCR5 charge control to argue that a policy decision has already been taken to recover the relevant costs via a RAV adjustment. However, as set out at ¶22 above, the Authority did not properly consult upon the inclusion of a RAV adjustment in the RIGs, failing even to make clear that a change was

[200] NoA ¶4.128(a).

[201] In particular, it is entirely unclear what the Authority means by "the issues were discussed". This is not an assertion that it was stated that the meeting that the double recovered revenue would be returned by way of a RAV adjustment.

being made, let alone calling it to stakeholders' attention or provide reasons for it. This illustrates the difficulties for parties other than the DNOs to engage meaningfully with the Authority if consultation is not carried out properly.

VII(ii) IIS and BMCS

177. BGT's complaint was that the Authority's account of those schemes in the consultation documents is incomplete and in some respects inaccurate and that the reasoning at the consultation stage and in the Decision is insufficient to enable a proper understanding of and intelligent response to the Authority's policy choices.[202]

178. In respect of IIS:

178.1. The Authority acknowledges that it gave incomplete information about the way in which CML improvement factors and targets were set,[203] but asserts that the omission was "*not significant overall*". Further the Authority seeks to rely upon a presentation to the Reliability and Safety Working Group on 17 May 2012. The Authority appears to complain that BGT did not attend Reliability and Safety Working Group meetings, and relies upon the fact that the slides for the presentation were made available on the Authority's website.

178.2. BGT submits that it is not appropriate for the Authority, instead of setting out a complete and accurate account of its methodology and decision in the formal consultation documents, to rely upon presentations given at meetings. BGT had already raised with the Authority, at the outset of the process, its concern that the number of working groups undermined the consultation process as it was not reasonable to expect, or feasible for, parties other than the DNOs to attend all the meetings of all groups.[204] Nor should the Authority expect interested third parties to trawl its website for documents on the basis that they might or might not contain information as to some important part of the Authority's proposed decision which was not correctly and fully set out in its formal consultation documents.

[202] See NoA ¶4.128.b. and 1st Manning ¶¶106-110.

[203] See Response ¶296.

[204] See 2nd Manning ¶¶88-101.

Stakeholder engagement and attendance at meetings should complement, rather than substitute for, proper consultation.

178.3. The Authority also notes that BGT did not appeal against the Authority's decision to modify WPD's licence, although the same IIS was applied to that modification. However, as set out in 1st Manning at ¶¶60-61, as a result of the lack of scrutiny to which WPD was subjected, details of its price control were not transparent and BGT was therefore not in a position to appeal. Indeed it is only after considerable additional investigation and bilateral correspondence with the Authority that BGT has been able to understand and identify the errors in the IIS scheme in relation to the Slow-track DNOs.

179. In respect of BMCS:

179.1. The Authority does not contend that its formal consultation documents were sufficient. Rather it complains that BGT failed to take opportunities to engage with the Authority, namely through (i) the Customer and Social Issues Working Group; (ii) its response to the consultation on WPD; (iii) its response to the Draft Determinations; (iv) its response to the consultation of 16 December 2014; and (v) its response to the final statutory consultation.

179.2. So far as the Authority complains about BGT's response to its consultations, it has missed the point. BGT's complaint under this heading is precisely that the Authority's account of the scheme in the consultation documents was inadequate and insufficient to enable intelligent engagement. It is therefore not a good response to that argument to say that BGT did not raise its *substantive* complaint in its response to consultation.

179.3. So far as the Authority relies upon the fact that BGT did not attend the Customer and Social Issues Working Group, BGT relies upon the points made and evidence cited at paragraph 178.2 above.

180. Further, it should be noted that the Authority's response in respect of IIS and BMCS contains certain new points which did not feature in the consultation or in the Final Determination. These further demonstrate that the consultation and final decision did not transparently set out the Authority's reasoning so as to enable effective engagement by BGT:

180.1. The Authority has suggested for the first time that the objective of the BMCS is to maintain, rather than improve, customer service levels.[205]

180.2. In respect of both IIS and BMCS, the Authority makes the new contention that using data for 2013/14 would have led to perverse incentives, encouraging the DNOs to worsen performance in the last year of one charge control so as to obtain a more lenient target in the next.[206]

180.3. The Authority objects to AlixPartners' analysis of IIS improvement factors on the basis that it does not take account of disaggregated data which was not previously made available.[207]

VII(iii) Information Quality Incentives

181. BGT's case is that the reasons given at the consultation stage and in the Decision are not adequate to enable effective engagement in respect of IQI.[208]

182. In the Response:

182.1. The Authority first asserts that its reasons were sufficient to enable an intelligent response and, essentially, repeats those substantive reasons. As set out in the NoA at ¶¶4.58-4.61 and ¶4.128c. and above at section IV, BGT submits that those reasons are not sufficient to enable intelligent engagement with the substantive question of whether the *adjustment* to the IQI was justified. The Authority's assertions appear to be focussed on whether or not the IQI in general is good for consumers, and not on the specific question of whether an adjustment after submission of business plans was warranted.[209] The Authority simply does not explain why cost savings in business plans submitted before the change to the IQI are attributable to

---

205 See Response ¶193(e) and ¶¶60, 63 and 70 above.

206 See Response ¶167(b) and ¶193(d).

207 See ¶53 above.

208 See NoA ¶4.128.c and 1st Manning ¶¶125-126.

209 The Authority states that the cost of the IQI should be set off against savings made through the comparative cost assessment. This is simply irrelevant to the question of whether an adjustment was warranted: the fact that a cost may in some sense be set off against a saving does not mean that costs should be needlessly incurred; consumers would be still better off if they can benefit from the saving without incurring unnecessary cost.

that change; nor why the change may be expected to improve incentives during future price controls; nor why collective deficiencies in the DNOs' business plans with regard to SGBs or RPEs serve to justify the change.

182.2. The Authority also states that it does not understand what further information BGT could have required as regards to why the change to the IQI would be expected to improve incentives for future price controls or why the underestimation of savings as regards SGBs and RPEs justified an adjustment to the IQI. Further it makes the surprising assertion that it has "*no duty…to provide detailed supporting analysis*".[210]

182.3. BGT's submission is that interested parties are entitled to be given comprehensible and specific reasons for the particular decision that the Authority has taken. That may or may not require detailed supporting analysis, depending on the particular context. However, the Authority's reasons on this issue are neither comprehensible nor specific; they are a no more than a justification of the IQI scheme in general rather than a justification for the particular decision to adjust the IQI after submission of business plans. Indeed the Authority appears to concede that the IQI change was not necessary to achieve the cost savings for SGBs and RPEs.[211] It therefore is wholly unclear how the Authority can rely on those cost savings to justify the IQI adjustment.

183. Further, the Authority's response introduces an entirely new justification for the IQI, suggesting it provides 'an efficiency incentive throughout the price control period to incentivise efficient delivery'[212]. This did not feature in the consultation or in the Final Determination and further demonstrates that the consultation and final decision did not transparently set out the Authority's reasoning so as to enable effective engagement by BGT.

---

210 Response ¶302.

211 See Response ¶222(a)(ii).

212 Response ¶2.19(b).

VII(iv) Transitional arrangements for the change in asset depreciation policy

184. BGT's case is that, in respect of transitional arrangements for asset lives, the Authority failed to provide any substantive reasons at consultation stage,[213] and in the Final Determination it failed to provide any further explanation or address any of the concerns expressed by BGT. Further, the Authority's side letter to BGT failed to provide any proper explanation or analysis to support the Authority's vague and general contentions regarding future upward price pressure, financeability concerns, and inter-generational equity.

185. In its response the Authority relies again upon the same documents[214] which are the focus of BGT's criticism. In respect of these, BGT maintains its submission that the consultation was inadequate.

186. The Authority also relies upon the business plan submissions of the Slow-track DNOs, which it is said "*contained detailed reasoning on the impact of transitional arrangements on the financeability of the DNOs – which the Authority accepted*".[215] However, it must be a matter for the Authority, as the statutory decision-maker, to set out its own reasoning and assessment of such issues. Third parties are not in a position to carry out a detailed analysis of DNOs' business plans and should not be required to speculate about, for example, whether the Authority accepts all or only some of the DNOs' assertions and analysis. Further, and in any case, the Authority cannot rely on the DNOs' business plans to amplify its reasoning in respect of any issue other than financeability.

VII(v) Cost of Debt Indexing

187. In respect of this issue, BGT's case is that 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.[216] The Authority failed to explain why it was appropriate to fund actual debt costs, whether it was appropriate to consider those costs to

---

213 It merely stated that the DNOs' "*proposals are sensible*": see Draft Determination – Financial Issues **[BG2/30-C]** at ¶3.52.

214 i.e. the Draft **[BG2/30-C]** and Final Determinations **[BG2/35-A]** and the 3 February 2015 letter **[BG2/39]**.

215 Response ¶303(d).

216 NoA ¶4.128(e).

be efficiently incurred, or why it was appropriate for consumer to bear the cost of providing protection from interest rate risk to DNOs. Nor did it address any of the concerns that BGT raised.

188. The Authority relies on the same documents as are criticised by BGT. Accordingly, BGT maintains its submissions and invites the CMA to consider the terms of the Authority's reasoning.

189. Further:

189.1. The Authority also contends that the letter of 3 February 2015 was "part of" its Decision. It is profoundly unsatisfactory for the Authority to rely, in support of its Decision, on reasoning in a letter which was provided only when the Decision had been taken and then was only sent privately to a single stakeholder. Self-evidently, in circumstances where a decision changed from the Final Determination, stakeholders would not have had the opportunity to comment on the Authority's reasons prior to the Decision, and it is all the more important that the decision should set out those reasons clearly for all to see. BGT as recipient of the letter should not be required to piece together an understanding of the Authority's reasons from multiple different documents; those reasons should be clearly set out in the Final Determinations and/or the reasons accompanying the Decision. Further, if reasoning is not in the Final Determination but only in a letter to one stakeholder, it is not being properly communicated to all interested parties.

189.2. The Authority states that it was "*not under a duty to address all of BGT's concerns in the Draft or Final Determinations*".[217] For the avoidance of doubt, BGT does not need to contend, nor does it contend, that the Authority was obliged to deal individually with each concern expressed by BGT. However, BGT does submit that the Authority was under an obligation to provide comprehensible and specific reasons for its particular decision, and that, where the Authority is changing its view on a particular point, this includes an obligation to explain clearly why reasonable arguments against that course are not being accepted.

[217] Response ¶305.

VIII. CONCLUSION

190. For the reasons set out above, it is respectfully submitted that neither the Response nor the submission of the DNOs provide a good answer to the grounds of appeal set out the NoA, and in the premises the appeal should be allowed.

TOWERHOUSE LLP

JOSH HOLMES
PHILIP WOOLFE
STEFAN KUPPEN
Monckton Chambers

8 May 2015

Statement of truth

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

Signed:

Raj Roy, Legal Director, Residential Energy

Dated: 8 May 2015