BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL

UNDER ARTICLE 14B OF THE GAS (NORTHERN IRELAND) ORDER 1996

B E T W E E N : -

FIRMUS ENERGY (DISTRIBUTION) LIMITED

Appellant

and

THE NORTHERN IRELAND AUTHORITY FOR UTILITY REGULATION

Respondent

RESPONDENT'S REPRESENTATIONS AND OBSERVATIONS ON APPELLANT'S APPLICATION FOR PERMISSION TO APPEAL

GOWLING WLG

Introduction

1. These are the representations and observations of the Northern Ireland Authority for Utility Regulation (the **Respondent** or the **UR**) pursuant to paragraph 3(2) of Schedule 3A to the Gas (Northern Ireland) Order 1996 (the **Gas Order**). They relate to the application by Firmus Energy (Distribution) Ltd (the **Appellant** or **FE**) for permission to appeal certain aspects of the UR's GD17 price control licence modification (the **Decision**).

2. The UR's position is that each of the grounds (and sub-grounds, if they are intended to be freestanding) of FE's case is unmeritorious, and consequently that the appeal should fail in its entirety.

3. However, for the purposes of this document, the UR focuses solely on the permission-stage test to be applied by the CMA under the Gas Order, taking into account the limited time available to the CMA to make a permission decision and (as a result) the limited procedure that is followed for that purpose. Consequently – save for the general observations about materiality made below – the UR confines itself to drawing the CMA's attention at this stage to those grounds (or sub-grounds) which are clearly and demonstrably unarguable.

4. These representations and observations are made without prejudice to the fuller and more detailed submissions that will be made by the UR, under paragraph 3(4) of Schedule 3A to the Gas Order, should permission be granted on one or more grounds. In particular, where no representations or observations are made at this stage about any individual ground (or sub-ground), that is entirely without prejudice to the UR's intention to contest the appeal in respect of that matter.

Applicable test

5. The CMA is empowered to refuse permission to appeal on the grounds that:

    a. the appeal is brought for reasons that are trivial or vexatious; and/or

    b. the appeal has no reasonable prospect of success.[1]

[1] Gas Order, Article 14B(4)(d).

6. An appeal will have no reasonable prospect of success where there is no reasonable prospect of the CMA finding that the Decision was "*wrong*" in the sense used in Article 14D(4) of the Gas Order.

7. In its September 2015 determinations in the RIIO-ED1 appeals against GEMA[2], the CMA explored the legislative provisions in section 11E(4) of the Electricity Act 1989, which are for all relevant purposes equivalent to those applicable to this appeal.

8. In particular, the CMA considered when a decision can be characterised as "*wrong*" within the meaning of the statute. For these purposes, it endorsed and applied the Competition Commission's observations in *E.ON*[3] (another appeal against a decision by GEMA) that –

    a. "*it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator*"[4]; and

    b. the statutory test "*clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider to be inappropriate in the circumstances*"[5].

9. FE conspicuously omits to cite these conclusions in its summary of the standard of review to be applied by the CMA[6]. The UR says that this omission is highly revealing.

[2] Final determinations dated 29 September 2015 in *British Gas Trading Ltd. v. GEMA* (the **BGT Decision**) and *Northern Powergrid (Northeast) Ltd. & Northern Powergrid (Yorkshire) plc v. GEMA* (the **NPg Decision**).
[3] *E.ON UK plc v. GEMA: energy code modification appeal* (CC02/07, 10 July 2007).
[4] NPg Decision, para. 3.26.
[5] NPg Decision, para. 3.27.
[6] Notice of Appeal, Section 3D, paras. 3.27 – 3.34.

10. In addition, the CMA adopted the Competition Commission's reliance in *E.ON* on the judgment of the Court of Appeal in *Azzicurazioni Generali SpA v Arab Insurance Group*[7] that "*so far as the appeal raises issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge*'s *conclusion lay outside the bounds within which reasonable disagreement is possible*"[8].

11. The CMA further explained in the RIIO-ED1 appeals that it would only allow an appeal where an error was "*material*", concluding in particular that –

    a. It was "*obviously correct*" that the CMA "*should only interfere with the decision if we considered that the error identified was material*"[9];

    b. "*… an error will not be a material error where it has an insignificant or negligible impact on the overall level of price control …*"[10];

    c. "*Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle*"[11].

General observations

12. The conclusions of the CMA in the RIIO-ED1 appeals as to the standard of review give rise to a broad point of principle about the permission to appeal stage in energy licence modification appeals to the CMA.

[7] [2003] 1 WLR 577.
[8] NPg Decision, para. 3.29.
[9] BGT Decision, para. 3.58.
[10] BGT Decision, para. 3.60.
[11] BGT Decision, para. 3.61.

13. Assessment of allowed revenue in a price control is not a precise science. Moreover, no element of any price control is designed to stand entirely alone without reference to the other elements. Price controls consist of a number of separate parts, existing in (often complex) relationship to each other. A decision made by the UR, or any other regulator, to modify licence conditions for the purposes of implementing a new price control is a decision made in relation to the price control taken as a whole.

14. Consequently, within any price control decision, there is a balance. There will be some elements on which it is possible to argue that the licensee has been over-compensated, and some elements on which the licensee has been arguably under-compensated. What matters most is that the overall balance is correct, and that the price control viewed in the round reflects the different (and sometimes competing) aspects of the regulator's principal objectives and general duties[12].

15. Plainly, a licensee will only be incentivised to appeal those elements where it considers it arguable that there has been under-compensation. The other elements are unlikely to be brought before the CMA. Therefore, if the CMA were to accept every minor point taken on appeal, there would be a significant risk of upsetting the balance of the price control and over-compensating the licensee to the detriment of consumers.

16. In addition, unless grounds of appeal lacking materiality are stopped at the permission stage, there is a serious risk of the costs of the appeal to the parties (and the CMA and any interveners) outweighing the value of the appeal.

17. The UR respectfully suggests that it is incumbent on the CMA to exercise its judgment so as to avoid these outcomes.

18. In this case, excepting FE's ground 4 – which the UR accepts is material, but the principal element of which it says is unarguable for other reasons (see below) – this appeal consists of a series of points, each of which struggles for materiality in the sense described by the CMA in the RIIO-ED1 appeals (see paragraph 11 above). The appeal

[12] In the case of the UR's gas functions, these are to be found at Article 14 of the Energy (Northern Ireland) Order 2003.

appears to proceed on the basis that it is the aggregation of all of these points which crosses the materiality threshold in respect of FE[13].

19. The UR suggests that this is not the case, and that the materiality of each ground (and sub-ground) needs to be considered on its own terms, and within a framework in which it is understood that the overall balance of the price control requires to be protected. In the UR's submission, the costs of this appeal to all parties in relation to grounds 1 to 3 are likely to be disproportionate to the value of the issues in play.

Specific observations

Ground 1A – Benchmarking

20. The UR submits that permission to appeal should be refused in respect of ground 1A of the appeal, which criticises the use of top-down benchmarking.

21. The appeal on ground 1A has no reasonable prospect of success because it rests on a false premise. The false premise is that the Decision in respect of the FE price control was derived from top-down benchmarking of GB GDNs. In fact, the UR set the opex allowance by reference to a bottom-up assessment of FE's costs. It is true that the UR then used top-down benchmarking as a "*sense-check*". However, that sense-check did not ultimately affect the result of the bottom-up assessment.

22. On no occasion did the UR revise or adjust the bottom-up numbers for FE based on the top-down results. FE's bare assertion to the contrary[14] is supported by no evidence and is inconsistent with the clear description provided by the UR as to its own process.

23. In other words, the top-down benchmarking had no material effect on the outcome. As noted in paragraph 11 above, the CMA has previously stated that it will only allow an appeal in respect of a material error.

[13] Notice of Appeal, para. 1.19.
[14] The assertion is that top-down benchmarking was "*inappropriately taken into account in the UR's bottom-up cost line assessment of FE's GD17 Business Plan*" – Notice of Appeal, para. 4.36.

24. That the top-down benchmarking was not material to the result is clear in particular from the following passages from the UR's GD17 Final Determination which is annexed to the Notice of Appeal –

    a. "*These top-down model estimates have not been used for setting the GD17 final determination allowances, with the UR relying on the separate bottom-up approach instead. The top-down benchmarking analysis provides a valuable sense-check however.*"[15]

    b. "*As FE is a clear outlier in terms of scale compared to PNGL and the GB GDNs, the top-down benchmarking results for FE at GD17 final determination should be used for indicative purposes only.*"[16]

25. The Notice of Appeal does not even propose any specific remedy arising out of ground 1A.

26. If the CMA were to grant permission to appeal on ground 1A, it would open the door to an unfocused investigation of an immaterial matter having no reasonable prospect of success, which would entail a disproportionate use of resources.

Ground 1C – GIS

27. The UR submits that permission to appeal should be refused in respect of ground 1C of the appeal, which relates to an allowance for professional and legal fees associated with IT (notably, but not exclusively, GIS mapping software).

28. An appeal to the CMA is the incorrect process for resolving the issues raised under the heading of ground 1C. The proper remedy is one which FE is currently pursuing directly with the UR and which the UR is minded to grant. It is to seek an additional allowance pursuant to the "*uncertainty mechanism*" which is already provided for in the Decision, and as such it does not require any changes to the Decision.

29. The UR made its view on the appropriate process clear in the following passage in its consultation decision paper dated 28 October 2016 –

[15] GD17 Final Determination, Annex 5, footnote 46 **[NOA-1/Tab 7E/Page 2850]**.
[16] GD17 Final Determination, para. 6.46 **[NOA-1/Tab 7/Page 1841]**.

"*We note the FE comment in 'Additional Items of Note' that legal and professional fees have been inadvertently removed from the FD.*

These costs were correctly removed from maintenance costs and we do not regard this as an error. However our initial view is that an element of these costs, which largely relate to standard IT costs, may be included within the price control mechanisms.

We will continue to engage with FE on these costs for GD17 and will make a determination on what amount should be included within the Opex Uncertainty Mechanism. This will be detailed in future consultations as the Uncertainty Mechanism is applied and updated and does not require any changes to GD17 values."[17]

30. Subject to receipt of certain outstanding information which was initially requested on 19 October 2016[18], the UR would currently be minded to allow costs of £836,000 (post-efficiency) under this heading by means of the uncertainty mechanism.

31. For these reasons, it would be an inappropriate use of the appeal process for the CMA to devote time to considering this ground of appeal. The CMA having received the UR's assurance that it will address this matter through the uncertainty mechanism, permission to appeal should be refused.

Ground 2 – Connections incentive

32. The UR submits that permission to appeal should be refused in respect of ground 2 of the appeal, which relates to the targets set for the making of new gas connections by FE during the period covered by GD17.

[17] Decision paper dated 28 October 2016, paras. 2.16-2.18 **[NOA-1/Tab 9/Page 3146]**.
[18] The UR has received information on 2014 and 2015 costs, with the best available data for 2016. It is awaiting detail from FE on 2012 and 2013 costs, and clarification as to: how they were recorded under the annual cost reporting template; FE's approach to the capitalisation of IT expenditure; and how the costs were treated in the GD17 business plan template.

33. FE seeks to challenge the UR's choice of connection targets. It asks the CMA to substitute a new connection target and new non-additionality rate[19]. However, it does not seek to put before the CMA any other aspects of the Decision set with regard to the estimated number of future connections.

34. The connections targets provide a particularly stark example of the inter-connectedness of the different elements of the price control referred to above, and the requirement to consider them as a whole so as to maintain the internal consistency and overall balance of the control. Those targets cannot properly be modified in isolation, because they are closely related to, and indeed the driver for, a number of other cost allowances under the price control.

35. Specifically, the target number of connections has a direct impact on a range of issues across the Decision which FE does not seek to appeal. In particular, the assumption that FE will meet the connection targets underpins (among other things) –

    a. the UR's estimates of required capital investment (services and meters);

    b. the estimation of likely call centre contact and emergency call-outs. New connections are known to result in a higher probability of emergency call-out. Fewer new connections would therefore reduce emergency response opex;

    c. the economics of infill mains laying. With reduced connection targets, the UR would almost certainly have concluded that a reduced level of infill allowance was justified.

36. In addition, as FE itself recognises, connection targets must be considered together with the connection cost allowances that provide the basis on which they can be met[20]. The UR awarded FE sums greater than FE asked for in terms of the connection allowances, but FE insists that the true effect of this can only be understood in the context of the targets and the UR's conclusions on non-additionality[21]. Inconsistently, it nonetheless seeks to appeal only the targets and non-additionality, while retaining the connection allowances which it does not attempt to place before the CMA.

[19] Notice of Appeal, para. 5.78.
[20] Notice of Appeal, para. 5.18.
[21] Notice of Appeal, para. 5.17.

37. Accordingly, ground 2 is a blatant example of the use of the appeal process for the selective "*cherry picking*" of issues which suit the interests of FE but do not respect the overall balance of the price control or the relationship between its different component parts. If the CMA were to grant the relief sought by FE, it would drive a coach and horses through the Decision.

38. In the BGT Decision, the CMA recognised this risk, and specifically that –

> "*… it may in certain circumstances be necessary to take care that overturning one aspect of a complex regulatory decision does not have knock-on consequences for other, unappealed aspects of the Decision …*"[22]

39. The UR submits that there can be no reasonable prospect of the CMA allowing the appeal in respect of ground 2 because this would result in an internally inconsistent Decision, a windfall for FE, and an unfair outcome for consumers.

Ground 4A – Asset beta

40. The UR submits that permission to appeal should be refused in respect of ground 4A of the appeal, which relates to its choice of asset beta.

41. The UR set the asset beta at 0.40. The Notice of Appeal argues for 0.45 to 0.50 as a "*more reasonable range*"[23].

42. However, FE consistently submitted over a period of twelve months in advance of the Decision that 0.40 was within a reasonable range. Specifically –

    a. On 30 June 2015, Oxera (the expert economists instructed by FE) wrote a report stating:

    > "*An asset beta range of 0.40-0.50, at the top end of the sample for regulatory precedents, and higher than the current asset betas for GB comparators, appears reasonable to reflect the latest market evidence, and the risk of differentials between FE and its GB comparators.*"[24]

[22] BGT Decision, para. 3.50.
[23] Notice of Appeal, para. 7.27(d).
[24] Oxera report dated 30 June 2015, para. 3.3.9 **[NOA-1/Tab 17A/Page 4368]**.

b. In their further submission of September 2015, Oxera repeated their view as to the appropriate asset range (although they revised other figures).[25]

c. FE adopted the Oxera range in its September 2015 Business Plan[26].

d. Oxera continued to rely on this range (while arguing that the beta should be set towards the top end) in its submission of May 2016[27].

e. FE continued to rely on the range in its own submission of May 2016[28].

43. For the purposes of this appeal, FE produces another expert witness (PwC) in relation to the asset beta – even while continuing to rely on Oxera for other matters, and with no attempt to explain the change and contradiction in its own position – and says that the bottom end of the range should be 0.45.

44. This is an abuse of the appeal process. FE cannot be allowed to blow hot and cold by (on the one hand) telling the UR that 0.40 is reasonable while (on the other hand) telling the CMA that it is not.

45. Further, and in any event, ground 4A can have no reasonable prospect of success. FE cannot succeed in showing that the UR was "*wrong*" for the purposes of the legislative test in circumstances where the UR made a decision that was reasonable in the opinion of economists (Oxera) whom FE has itself held out as experts in the field.

46. It is fatal to FE's case on this issue that the UR determined an asset beta within the range for which FE itself had contended at all times prior to the Decision. That was plainly a reasonable position for the UR to adopt. Mere differences of opinion are insufficient to ground an appeal (see paragraph 8 above). In the UR's submission, they should not be entertained by the CMA in circumstances in which they are advanced only *post hoc* and self-evidently for the purpose of a change of position by FE.

[25] Oxera presentation dated September 2015 **[NOA-1/Tab 20H/Page 4729]**.
[26] FE Business Plan Template Commentary dated September 2015 **[NOA-1/Tab 19/Page 4604]**.
[27] Oxera Response to the Utility Regulator's Draft Decision: Rate of Return dated 31 May 2016 **[NOA-1/Tab 21D/Page 4938]**.
[28] FE Response to the GD17 Draft Determination dated May 2016 **[NOA-1/Tab 21/Page 4897]**.

Conclusion

47. The CMA is therefore respectfully requested to refuse permission to appeal on the basis that it has no reasonable prospect of success – generally, for the reasons given above in relation to materiality; and in particular, in relation to grounds 1A, 1C, 2 and 4A, for the additional reasons advanced in respect of each of those grounds.

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for the Respondent

12 December 2016