BEFORE THE COMPETITION AND MARKETS AUTHORITY

B E T W E E N : -

SP TRANSMISSION PLC

Appellant

and

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

NOTICE OF APPEAL
(ENERGY LICENCE MODIFICATION)

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A. THE APPELLANT'S DETAILS

1. The Appellant (**SPT**), company number SC189126, holds an electricity transmission licence (**the Licence**) under section 6(1)(b) of the Electricity Act 1989 (**EA 1989**) to transmit electricity in Central and Southern Scotland.

2. SPT's registered address is 320 St. Vincent Street, Glasgow G2 5AD.

3. SPT's solicitors are:

Allen & Overy LLP	and	Shepherd & Wedderburn LLP
One Bishops Square		1 West Regent Street
London E1 6AD		Glasgow G2 1RW
(Ref.: Mark Friend / Dominic Long)		(Ref.: John Grady)

4. Documents relating to this appeal should be sent to Allen & Overy LLP at the above London postal address and by email to [✂] and [✂].

B. STATEMENT PURSUANT TO RULE 5.2

5. On 3 February 2021, the Respondent (**GEMA**) published the decision under section 11A(7) EA 1989 to modify the special conditions of SPT's Licence with effect from 1 April 2021 which is reproduced at [NOA1(10)] (**the Decision**).

6. Accordingly, SPT is a relevant licence holder within the meaning of section 11A(10)(b) EA 1989 insofar as it is the holder of the particular licence that has been modified by the Decision.

7. In that capacity, SPT requests permission to appeal the Decision pursuant to section 11C EA 1989 on the following grounds, which are elaborated later in this Notice.

B1. Ground 1: Cost of equity

8. GEMA has under-assessed the cost of equity, as a result of (i) an overall error of approach which reflects a failure to take into account, or to give sufficient weight to, the

Sustainability Objectives[1] to which it was obliged to have regard and/or (ii) a series of specific errors. In particular:

(1) Ground 1A (aiming up): GEMA has failed to have regard, or to have sufficient regard, to the principle of 'aiming up' in order to ensure that the cost of capital allowed to SPT (and other transmission companies) is sufficient to incentivise those that provide it with equity capital so as to enable it to undertake and plan for the considerable further and/or faster investments that are likely to be required in the course of RIIO-T2 and in subsequent price control periods to attain the Sustainability Objectives and, more specifically, to attain the objective of Net Zero[2].

(2) Ground 1B (CAPM evidence): At step 1 of its cost of equity calculation, when considering Capital Asset Pricing Model (**CAPM**) evidence, GEMA failed to have adequate regard to the Sustainability Objectives and/or made a series of errors of assessment, in particular by:

   (a) relying solely on real gilt yields to estimate the risk-free rate (**RFR**);

   (b) when estimating Total Market Return (**TMR**):

      (i) relying on an unreliable historical purported CPI series;

      (ii) ignoring established estimators of expected returns which produce substantially higher TMR estimates; and

   (c) placing undue reliance on 10-year averages when considering the beta of National Grid plc (**National Grid**) and on the betas of water companies to calculate the appropriate beta.

(3) Ground 1C (cross-checks): At step 2 of its cost of equity calculation, GEMA used inappropriate and/or flawed cross-checks.

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1 In this Notice of Appeal, for convenience we refer to the following matters as "*the Sustainability Objectives*": (a) protecting the interests of existing and future consumers in the "*reduction of electricity-supply emissions of targeted greenhouse gases*" (s. 3A(1A)(a) EA 1989); (b) the duty to have regard to "*the need to contribute to the achievement of sustainable development*" (s. 3A(2)(c) EA 1989); and (c) the duty to have regard to the "*effect on the environment*" (s. 3A(5) EA 1989). EA 1989 is at [NOA1(24)].

2 i.e. the balancing of CO_2 emissions and CO_2 removed from the atmosphere by 2050.

9. As a result, SPT has been allowed an insufficient sum to incentivise the necessary investments that will be required during RIIO-T2 and in future price control periods. GEMA has paid insufficient regard to the need to secure SPT's ability to finance its licensed activities through reasonable returns on capital. The Decision risks hampering the fulfilment of SPT's statutory and licence obligations during RIIO-T2 (in particular to develop and maintain an efficient, co-ordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity pursuant to sections 9(2)(a) and (b) EA 1989). The costs to future consumers will consequently be increased.

10. In the premises, the Decision was wrong in that:

(1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

(i) the reduction of electricity-supply emissions of targeted greenhouse gases,

(ii) the security of the supply of electricity to them;

(b) the need to secure that all reasonable demands for electricity are met;

(c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

(d) the need to contribute to the achievement of sustainable development;

(e) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

(f) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) It is irrational and accordingly wrong in law (section 11E(4)(e) EA 1989).

11. GEMA ought instead to have adjusted its cost of equity calculation in order to take into account the factors set out in paragraph 8 above.

B2. Ground 2: Outperformance wedge (expected v. allowed return on equity)

12. Having already under-assessed the cost of equity (see Ground 1 above), GEMA then applies a 25 bps reduction known as the "*outperformance wedge*" in order to convert the cost of equity into the "*allowed return on equity*". This "*outperformance wedge*" is labelled "*expected outperformance at 60% gearing*" in the Price Control Financial Model.[3]

13. The outperformance wedge undermines the rigour of the process undertaken to assess costs and set incentives. It is arbitrary and unprecedented. It fails to recognise the existing regulatory mechanisms and tools available to GEMA that are sufficient and appropriate to target and remedy any undeserved potential outperformance.

14. As a result, SPT has been allowed an insufficient return to incentivise the necessary investments that will be required during RIIO-T2 and in future price control periods. GEMA has paid insufficient regard to the need to secure SPT's ability to finance its licensed activities through reasonable returns on capital. The Decision risks hampering the fulfilment of SPT's statutory and licence obligations during RIIO-T2 (in particular to develop and maintain an efficient, co-ordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity pursuant to sections 9(2)(a) and (b) EA 1989). The costs to future consumers will consequently be increased.

15. In the premises, the Decision was wrong in that:

[3] RIIO-ET2 Price Control Financial Model; Ofgem; 3 February 2021, "*Input*" tab, lines 192-194. (Available here) [NOA1(15)].

(1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

(i) the reduction of electricity-supply emissions of targeted greenhouse gases,

(ii) the security of the supply of electricity to them;

(b) the need to secure that all reasonable demands for electricity are met;

(c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

(d) the need to contribute to the achievement of sustainable development;

(e) the promotion of efficiency and economy on the part of transmission licensees;

(f) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

(g) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) It is irrational (and accordingly wrong in law: see section 11E(4)(e) EA 1989).

B3. <u>Ground 3: Ongoing efficiencies</u>

16. GEMA has made a series of errors in its analysis of the ongoing efficiencies which SPT is capable of achieving. In particular:

(1) GEMA's efficiency challenge incorrectly includes a 0.2% uplift for efficiencies supposedly to be derived from innovation funding allowances in RIIO-T1.

(2) GEMA's calculation of ongoing efficiency challenge relies solely on the Value Added (**VA**) productivity measure, failing to take into account in its calculations the established Gross Output (**GO**) measure.

(3) GEMA's efficiency challenge is based upon the incorrect assumption that regulated network companies should be able to outperform the economy at large.

(4) GEMA's efficiency challenge calculation ignores the marked downturn in productivity growth since 2008 and instead erroneously bases its productivity growth estimates solely on historic long-term productivity data.

17. As a result, SPT's totex allowance has been reduced arbitrarily, with the consequence that SPT has been given insufficient funds for the necessary investments that will be required during RIIO-T2. If in practice SPT is unable to reduce its totex, then this will affect the return to SPT's investors. The Decision risks hampering the fulfilment of SPT's statutory and licence obligations during RIIO-T2 (in particular to develop and maintain an efficient, co-ordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity pursuant to sections 9(2)(a) and (b) EA 1989). The costs to future consumers will consequently be increased.

18. In the premises, the Decision was wrong in that:

(1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

(i) the reduction of electricity-supply emissions of targeted greenhouse gases,

(ii) the security of the supply of electricity to them;

(b) the need to secure that all reasonable demands for electricity are met;

(c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

(d) the need to contribute to the achievement of sustainable development;

(e) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

(f) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) GEMA's analysis was irrational (and accordingly wrong in law: see section 11E(4)(e) EA 1989).

19. GEMA ought instead to have reduced its assumed scope for ongoing efficiencies in order to take into account the factors set out in paragraph 16 above.

B4. <u>Ground 4: Circumvention of licence modification process</u>

20. By the Decision, GEMA has improperly sought to retain for itself the ability to amend significant elements of the RIIO-T2 price control by way of future direction, rather than through the statutory licence modification process under section 11A EA 1989. The circumstances in which GEMA will make such directions are not properly specified. As a result, the effect of the Decision is materially uncertain, and SPT (and others) are denied the procedural protections which the legislator intended to confer. This applies in particular in respect of:

(1) The Network Asset Risk Metric regime under Special Condition 3.1.

(2) Net Zero Re-opener under Special Condition 3.6.

(3) Large Onshore Transmission Investments under Special Condition 3.13.

(4) Medium Sized Investment Projects under Special Condition 3.14.

(5) Access Reform Changes under Special Condition 3.16.

(6) Uncertain Non-Load Related Projects Re-opener under Special Condition 3.29.

(7) Evaluative Price Control Deliverables under Special Conditions 3.9, 3.14, 3.18 and 3.29.

21. In purporting so to do, GEMA has acted outside its powers in section 7 EA 1989. Further or alternatively, GEMA has used its powers contrary to the policy and purposes of EA 1989. By denying procedural protections, GEMA has cut across the intention and scheme of the EA 1989.

22. In the premises, the Decision was wrong:

(1) in law (section 11E(4)(e) EA 1989); and/or

(2) for failing properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the principles under which regulatory activities should be transparent and accountable; and

(b) best regulatory practice.

23. GEMA ought instead to have provided for these matters to be dealt with by way of licence modification.

B5. <u>Relief</u>

24. The relief sought by SPT is modification of the Decision such as would result from the following:

(1) Correction of the cost of equity values in the Price Control Financial Model[4] including the individual CAPM parameters (with consequent adjustment to the

[4] RIIO-ET2 Price Control Financial Model; Ofgem; 3 February 2021, "*Input*" tab, lines 188-192 & 200. (Available <u>here</u>) [NOA1(15)].

values based on them) and associated references and impacts in the Price Control Financial Handbook[5], so as to remedy the deficiencies identified in Ground 1.

(2) Deletion of the "*expected outperformance*" values in the Price Control Financial Model[6] (with consequent adjustment to any values based on them, in particular such that "*allowed return on equity*" replicates "*cost of equity*"[7]) and associated references in Special Condition 2.3[8] and in the Price Control Financial Handbook[9], so as to remedy the deficiencies identified in Ground 2.

(3) Correction of the totex values in the Decision (with consequent adjustments to the Price Control Financial Model and licence conditions) so as to remedy the deficiencies identified in Ground 3.

(4) Substitution of the provisions identified in Ground 4 which permit GEMA to make changes by direction with a requirement that any such changes are instead made by licence modification.

C. SPT'S EVIDENCE

25. SPT relies by way of evidence supporting its appeal on:

(1) Witness statements of fact from:

(a) Frank Mitchell (Chief Executive Officer of SP Energy Networks) dated 3 March 2021 (including, in the Appendix thereto, the Note prepared by Juan Luis Ríos Sánchez, Global Planning and Regulation Director for Iberdrola Group's Networks Business, and Daniel Alcain López, Head of Administration and Control of the Iberdrola Group);

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5 See in particular section 4 of the Price Control Financial Handbook; Ofgem; 3 February 2021 (Available here) [NOA1(16)].

6 RIIO-ET2 Price Control Financial Model; Ofgem; 3 February 2021, "*Input*" tab, lines 193 and 202. (Available here) [NOA1(15)].

7 i.e. in the RIIO-ET2 Price Control Financial Model; Ofgem; 3 February 2021, "*Input*" tab, line 194 would replicate line 192 and line 201 would replicate line 200. (Available here) [NOA1(15)].

8 Where it is referred to as "*EO*".

9 In particular, the references to "*expected performance*".

(b) Scott Mathieson (Network Planning and Regulation Director at SP Energy Networks) dated 3 March 2021;

(c) Martin Hill (Head of RIIO-T2 at SPT) dated 3 March 2021;

(d) Craig McTaggart (RIIO-T2 Non-Load Investment Manager at SP Energy Networks) dated 3 March 2021.

(2) Expert reports on economics from:

(a) Dr Richard Hern and Mr James Grayburn of NERA Economic Consulting dated 3 March 2021 (**NERA CAPM Report**) [RH1(1)];

(b) Dr Richard Hern and Mr James Grayburn of NERA Economic Consulting dated 3 March 2021 (**NERA Allowed Returns Report**) [RH2(1)]; and

(c) Mr James Grayburn of NERA Economic Consulting dated 3 March 2021 (**NERA Ongoing Efficiency Report**) [JG1(1)].

D. MATERIAL FEATURES OF THE DECISION

26. The Decision (which is reproduced at [NOA1(10)]) was published on 3 February 2021. The new Special Conditions for SPT which the Decision inserts with effect from 1 April 2021 are reproduced at [NOA1(13)]. These refer in particular to the ET2 (or RIIO-T2) Price Control Financial Model which is reproduced at [NOA1(15)], and to the ET2 (or RIIO-T2) Price Control Financial Handbook which provides commentary on the Price Control Financial Model and is reproduced at [NOA1(16)].

27. Paragraph 6 of the Decision states that "*the reasons and effects for making the modifications can be found at https://www.ofgem.gov.uk/publications-and-updates/decision-proposed-modifications-riio-2-transmission-gas-distribution-and-electricity-system-operator-licences*". This is a reference to the Reasons and Effects document reproduced at [NOA1(12)].

28. Paragraph 7 of the Decision states that "*in addition, further details and background on these licence changes are set out in*" the Statutory Consultation dated 17 December 2020, the Informal Licence Drafting Consultation dated 30 September 2020, the Draft

Determinations dated 9 July 2020, and the Final Determinations dated 8 December 2020. The Core Document for the Final Determinations is reproduced at [NOA1(8)]. The Finance Annex to the Final Determinations is reproduced at [NOA1(18)].[10]

29. GEMA's reasons on matters which give rise to the present appeal can be found in particular in the following locations in the Final Determinations:

Topic	References in Final Determinations
Aiming up	Finance Annex, paras. 3.176-3.186.
Risk-free rate	Finance Annex, paras. 3.6-3.23.
Total market return	Finance Annex, paras. 3.81-3.98.
Cross-checks	Finance Annex, paras. 3.101-3.121.
Outperformance wedge	Finance Annex, paras. 3.122-3.175.
Ongoing efficiencies	Core Document, paras. 5.18-5.29.

30. SPT and GEMA exchanged pre-action correspondence, which was copied to the CMA, and is reproduced at [NOA1(21) and (23)].

E. <u>LEGAL FRAMEWORK FOR THIS APPEAL</u>

31. The basis on which the CMA determines an appeal under section 11C EA 1989 is set out in section 11E, which provides for an appeal on the merits, in the following terms:

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

(2) In determining an appeal the CMA must have regard, to the same extent as is required of the Authority, to the matters to which the Authority must have regard—
(a) in the carrying out of its principal objective under section 3A;
(b) in the performance of its duties under that section; and
(c) in the performance of its duties under sections 3B and 3C.

(3) In determining the appeal the CMA —
(a) may have regard to any matter to which the Authority was not able to have regard in relation to the decision which is the subject of the appeal; but
(b) must not, in the exercise of that power, have regard to any matter to which the Authority would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so.

[10] Note that some Final Determinations documents were subsequently revised by GEMA on 3 February 2021 to take account of various corrections. For completeness, the SPT-specific Annex is reproduced at [NOA1(17)].

(4) The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—
(a) that the Authority failed properly to have regard to any matter mentioned in subsection (2);
(b) that the Authority failed to give the appropriate weight to any matter mentioned in subsection (2);
(c) that the decision was based, wholly or partly, on an error of fact;
(d) that the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 11A(7)(b);
(e) that the decision was wrong in law.

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

32. The matters mentioned in section 11E(2) EA 1989 (to which reference is made in several places in section 11E) are the matters to which GEMA must have regard in the carrying out of its principal objective under section 3A, in the performance of its duties under that section, and in the performance of its duties under sections 3B and 3C. These include materially for the purposes of this appeal:

(1) Section 3A(1B): The furtherance of the principal objective. The "*principal objective*" is:

"*to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems.*"

By Section 3A(1A): The interests of existing and future consumers are their interests taken as a whole, including, in particular:

"*… (a) their interests in the reduction of electricity-supply emissions of targeted greenhouse gases*".

(2) Section 3A(2)(a): The need to secure that all reasonable demands for electricity are met.

(3) Section 3A(2)(b): The need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under (amongst other legislative provisions) Part 1 EA 1989. Electricity transmission licences are granted

under section 6(1)(b), which is within Part 1 EA 1989. A particular way of achieving this is by securing reasonable returns on their capital.[11]

(4) Section 3A(2)(c): The need to contribute to the achievement of "*sustainable development*".

(5) Section 3A(5): The promotion of efficiency and economy on the part of persons authorised by licences or exemptions to (in particular) participate in the transmission of electricity, and to secure a diverse and viable long-term energy supply. However, the requirement on GEMA to carry out its functions in the manner which it considers is best calculated to promote these ends ranks below points (1) to (4) above (to which it is expressly subject). In carrying out these functions, GEMA must have regard "*to the effect on the environment*" of activities connected with the transmission of electricity.

33. It is well established that the CMA is "*not limited to reviewing the decision on conventional judicial review grounds*" and is instead "*not only able, but required by EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute*".[12]

F. GROUND 1: COST OF EQUITY

34. GEMA has under-assessed the cost of equity, as a result of (i) an overall error of approach which reflects a failure to take into account, or to give sufficient weight to, the Sustainability Objectives to which it was obliged to have regard and/or (ii) a series of specific errors.

F1. Ground 1A: aiming up

35. First, at each step in its cost of equity calculation, GEMA has failed to have regard, or to have sufficient regard, to the principle of 'aiming up'. That principle has a pedigree in previous regulatory determinations.[13] In the context of RIIO-T2, it is both necessary and

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11 As is expressly recognised in the comparable provision in Water Industry Act 1991, s. 2(2A)(c). [NOA1(25)].

12 British Gas Trading Limited v. GEMA - Final Determination; CMA; 29 September 2015, at para. 3.24, pages 19 – 20 (Available here) [NOA1(4)/p19-20].

13 NERA CAPM Report; NERA; March 2021, section 6.2. [RH1(1)/p97-100].

appropriate to apply it in light of the considerable further uncertain investments (i.e. investments outside those baseline investments identified in the Business Plan) that are likely to be required in order to attain the Sustainability Objectives and, more specifically, in order to attain the objective of Net Zero. Such uncertain investments include both investments that may be made during RIIO-T2 and investments that may be planned during RIIO-T2 and implemented during future price control periods. For a transmission licensee to be able to undertake such uncertain investments, the return on capital available must be such as to incentivise its equity investors to invest. In this regard, SPT competes for the deployment of capital from its ultimate parent company (Iberdrola SA) with similar electricity network businesses located in other geographic regions, including the US and Spain. Such equivalent international investments are likely to give returns materially in excess of the return allowed by GEMA. Evidence from Iberdrola in this regard is set out in a Note prepared by Juan Luis Ríos Sánchez (Global Planning and Regulation Director for Iberdrola Group's Networks Business) and Daniel Alcain López (Head of Administration and Control of the Iberdrola Group).[14] As explained in detail there and in the witness statements of Frank Mitchell and Scott Mathieson of SPEN, in summary:

(1) Investors can be expected to place their capital where they can expect to obtain the best risk-adjusted return.

(2) The reduction in return on equity from the previous price control is from approximately 7% p.a. to a level equivalent to around 3% p.a. on an RPI adjusted basis.

(3) Such a sharp drop has not been mirrored in other jurisdictions. By contrast, investors in transmission can receive above 6.5% p.a. in the US on a like-for-like basis. The US and the UK are broadly comparable in terms of risk profile, and there is nothing at a country level which would make the US less attractive to investors. In some respects, the US is more favourable in terms of risk profile. The US model is designed to encourage transmission investment.

(4) The consequences for SPT of reduced equity investment will be a disincentive to plan and implement large scale projects, a more cautious approach to innovation, a

[14] Appendix to First Witness Statement of Frank Mitchell.

lower tolerance to design risk, and a need to limit discretionary expenditure. More generally, low returns will lead to a bias to less capital intensive solutions to network requirements. The price signal from the cost of equity is that capital should be conserved and not invested.

36. Secondly, as explained in the NERA CAPM Report, the risks to consumers and social harm from underinvestment are considerably greater than the relatively minor welfare loss to customers from transmission charges that are marginally higher than necessary. As the CMA put it in its January 2021 working paper on the PR19 water price control re-determinations (**PR19**), "*externalities do not have to be large to justify a small difference in the WACC of, say, 0.1%, if that is expected over time to result in more investment*".[15] Such externalities are likely to be of particular significance in the context of electricity transmission given (a) the central role of the transmission sector in delivering the Sustainability Objectives as regards Net Zero; and (b) the high levels of investment as a proportion of transmission owners' RAV which will consequently be required to achieve that in RIIO-T2 and beyond.

37. Accordingly, as the CMA observed in January 2021 in relation to the PR19 water re-determinations, there is a real risk that absent aiming-up, "*the wider social benefits of investment are lost, either because companies do not identify investments or put resources into planning for them*".[16]

38. The reasons GEMA gives for disregarding these arguments for aiming up are erroneous:[17]

    (1) The within-period incentive mechanisms and licence obligations only go some way to reducing the risk of under-investment. As explained above, there remain uncertain investments for the RIIO-T2 period, and investments must be planned in good time during RIIO-T2 to have effect in subsequent periods.

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[15] Water Redeterminations 2020: Choosing a point estimate for the Cost of Capital - working paper; CMA; 8 January 2021, at para. 51, page 19 (Available here) [NOA1(9)/p19].

[16] Water Redeterminations 2020: Choosing a point estimate for the Cost of Capital - working paper; CMA; 8 January 2021, at para. 42(c), page 16 (Available here) [NOA1(9)/p16].

[17] For GEMA's reasons, see RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.176-3.186, pages 66 - 69 (Available here) [NOA1(18)/p66-69].

(2) GEMA does not express a clear view on whether there is asymmetric risk within RIIO-T2.[18] It is clear that there is. Indeed, the risks of not meeting the Sustainability Objectives or of material incidents on the system mean that the downside risk is heightened in the present context (compared with, e.g., PR19, and indeed previous price control periods for SPT).

39. Similarly, GEMA's suggestion[19] that it has, to an extent, 'aimed up' is also incorrect. In fact, GEMA has 'aimed down' at each stage of its cost of equity calculation. In particular:

(1) GEMA's 'step 1' cost of equity (i.e., following application of its CAPM) is 4.55%. GEMA suggests that its 'step 2' cross-checks provide a cost of equity range of 3.8% to 5%, with a mid-point of 4.4%. However, GEMA also notes that stakeholders made representations that those step 2 cross-checks were "*not as strong as we believed and that using a lower value was not a justified use of regulatory discretion*".[20] GEMA further states: "*after consideration of stakeholder responses, we have decided not to adjust the Step 1 mid-point in Step 2*".[21] Given GEMA itself appears to acknowledge that its 'step 2' cross checks were unreliable, its later suggestion that "*a baseline allowed return of 4.30%* [i.e. 4.55% less the 0.25% 'outperformance wedge'] *is arguably consistent with a degree of aiming up, given evidence from cross-checks*"[22] is without any sound foundation. The cross-checks which GEMA has used are inherently unreliable and systematically tend to underestimate the true cost of capital (see section F3 below).

(2) GEMA further suggests that it has acted generously by not making a larger downward adjustment than 25bps to account for expected outperformance. As explained under Ground 2, the 25bps downward adjustment is unprecedented from a regulatory standpoint and theoretically erroneous, as it will serve to dampen efficiency incentives. It is a form of 'aiming down'.

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18 RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.179-3.180, page 67 (Available here) [NOA1(18)/p67].

19 RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.121 and 3.186, pages 55 and 69 (Available here) [NOA1(18)/p55&69]

20 RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.121, page 55 (Available here) [NOA1(18)/p55].

21 RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.121, page 55 (Available here) [NOA1(18)/p55].

22 RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, 3.153, page 61 (Available here) [NOA1(18)/p61].

F2. Ground 1B: CAPM evidence (errors at step 1)

40. At step 1 of its cost of equity calculation, when considering CAPM evidence, GEMA failed to have adequate regard to the Sustainability Objectives and/or made a series of errors of assessment, in particular by:

(1) relying solely on real gilt yields (the lowest figure of the choices available) to estimate the RFR;[23]

(2) relying on an unreliable historical purported CPI series when estimating the TMR (another choice leading to a downward bias in the cost of equity);[24]

(3) ignoring established estimators of expected returns which produce substantially higher TMR estimates;[25] and

(4) placing undue reliance on 10-year averages when considering the beta of National Grid and on the betas of water companies to calculate the appropriate beta (a further example of a choice leading to a downward bias in the cost of equity).[26]

RFR - Exclusive use of real gilt yields

41. The exclusive use of real gilt yields (as opposed to gilt yields adjusted for a convenience premium, AAA-rated corporate bonds or a combination of the two) is manifestly unreasonable and wrong as an estimate of the RFR for companies (as opposed to sovereigns), for the reasons explained in detail in the NERA CAPM Report. In summary:

(1) Real gilts have particular characteristics of liquidity and safety by comparison with other securities, commonly referred to as their "*convenience yield*". In consequence of these unique characteristics, there is a gap between corporate and sovereign risk-free financing rates.[27]

(2) GEMA is incorrect to say that the use of index-linked gilts remains the academically favoured or orthodox approach. On the contrary, as noted in the

23 NERA CAPM Report; NERA; March 2021, section 2.1 [RH1(1)/p23-26].
24 NERA CAPM Report; NERA; March 2021, section 4.2.1 [RH1(1)/p59-65].
25 NERA CAPM Report; NERA; March 2021, section 4.2.2.2 [RH1(1)/p69-72].
26 NERA CAPM Report; NERA; March 2021, section 3.2.1 [RH1(1)/p43-45].
27 NERA CAPM Report; NERA; March 2021, section 2.2 [RH1(1)/p26-28].

NERA CAPM Report, recent academic opinion is to the effect that the market RFR for the purposes of the CAPM should be based on gilt yields adjusted for a convenience premium or adjusted AAA-rated corporate bond yields, or a combination of the two. Accordingly, the RFR lies above the rate of return on government bonds.[28]

(3) In its provisional findings on the four PR19 water appeals currently being heard by the CMA, the CMA observes that corporate bonds with AAA rating provide an input that is both very close to the RFR, and closer to representing a rate that is available to all relevant market participants.[29]

(4) GEMA is incorrect to seek to justify its different approach on the basis that the marginal investor in energy transmission companies is a 'net lender'. Step 1 in the CAPM is seeking to answer the theoretical question of the appropriate RFR for the market as a whole. Further, as NERA observe, it is in fact the case that two of the three electricity transmission licensees in Great Britain are publicly listed companies, as is SPT's ultimate holding company, Iberdrola, and it is not possible to say whether the marginal stock owner in any of these companies is a net lender or net borrower.[30]

(5) GEMA is incorrect to state that indexation will ensure the RFR is accurate. Indexation does not compensate for the downward bias of an assessment of the RFR based exclusively on the return on government bonds.[31]

(6) It is not reasonable to use real gilt yields in isolation and unadjusted, as GEMA has done.

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28 NERA CAPM Report; NERA; March 2021, section 2.2 [RH1(1)/p26-28].

29 Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations - Provisional Findings; CMA; 29 September 2020, para. 9.93, page 526 (Available here) [NOA1(7)/p526].

30 NERA CAPM Report; NERA; March 2021, section 2.3 [RH1(1)/p28-30].

31 NERA CAPM Report; NERA; March 2021, section 2.5 [RH1(1)/p32].

TMR - Exclusive use of CPI

42. The use of a hybrid RPI/CPI historical inflation series when estimating the TMR is manifestly unreasonable and wrong, for the reasons explained in detail in the NERA CAPM Report. In summary:

    (1) RPI is the more reliable measure of historical inflation from which to derive real market returns (by deflating the nominal returns), as recognised by the Office for National Statistics.[32]

    (2) RPI inflation is the only available historical series as a measure of UK inflation going back to 1900 (actual RPI index goes back to 1950 and there are estimates of RPI for 1900-1949). It has been the official measure of UK inflation for most of the period until 2003. CPI is backcast.[33]

    (3) In its PR19 Provisional Findings, the CMA has used both RPI and CPI measures of inflation.[34] Such an approach lies within the range of reasonable approaches.

    (4) It is not, however, reasonable to use CPI measures in isolation, as GEMA has done (despite the CMA's contrary approach in its PR19 Provisional Findings). In particular:

        (a) The hybrid RPI/CPI index used by GEMA is unreliable and overstates historical CPI. It therefore understates real returns in CPI-deflated terms. NERA's detailed review of the Bank of England's Millennium dataset reveals that the historical series labelled as "*CPI*" does not in fact represent historical CPI inflation going back to 1900, or any point before 1988.[35]

        (b) GEMA fails to provide evidence that historical RPI inflation measures are unreliable as a measure of inflation in the *past* (as opposed to the future). It is possible to convert historical RPI deflated returns into a forward-looking

32 NERA CAPM Report; NERA; March 2021, section 4.2.1 [RH1(1)/p59-65].

33 i.e. for years prior to 1988, CPI figures have been estimated retrospectively, based on a model, rather than actually observed.

34 Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations - Provisional Findings; CMA; 29 September 2020, para. 9.166., page 545 (Available here) [NOA1(7)/p545].

35 NERA CAPM Report; NERA; March 2021, section 4.2.1, para. 142 [RH1(1)/p60].

CPI deflated equivalent by using an estimate of the 'historical RPI-CPI wedge'. Alternatively, to the extent that it had grounds for doubting the RPI measure, GEMA could have used both RPI deflated returns and CPI/hybrid deflated returns as evidence of the minimum TMR. Had it taken either such step it would have arrived at a materially higher estimate of TMR.[36]

(5) GEMA's cross-check to its CPI index of using UK returns converted to US dollars and deflated using US inflation is premised upon unjustified assumptions and does not invalidate evidence based on RPI.

<u>TMR - Ignoring established estimators of expected returns</u>

43. As the NERA CAPM Report explains:

(1) GEMA's approach to estimating the TMR based on historical realised returns relies on flawed assumptions of alleged returns predictability presented by UKRN. It ignores established estimators of the TMR developed in academic literature for estimating TMR – in particular:[37]

(a) the estimators developed by Blume and JKM for the purpose of estimating future values of investments (compounding) which support a TMR in the range of 6.6% to 7.5% (real, CPI-deflated) for GEMA's assumed 1- to 10-year investment horizon;[38] and

(b) the estimator developed by Cooper for the purpose of calculating present values of future cash-flows (discounting) which supports a TMR in the range of 7.0% to 7.7% (real, CPI-deflated) for GEMA's assumed 1- to 10-year investment horizon.[39]

All of these TMR estimates are materially higher than GEMA's figure of 6.5% (real, CPIH-deflated), irrespective of which inflation index is used to deflate the historical returns.[40]

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36 NERA CAPM Report; NERA; March 2021, section 4.2.1, [RH1(1)/p59-65].
37 NERA CAPM Report; NERA; March 2021, section 4.2.2 [RH1(1)/p65-72].
38 NERA CAPM Report; NERA; March 2021, section 4.2.2.2, paras. 162 - 168 [RH1(1)/p69-71].
39 NERA CAPM Report; NERA; March 2021, section 4.2.2.2, paras. 169 - 172 [RH1(1)/p71-72].
40 NERA CAPM Report; NERA; March 2021, section 4.2.2.2, para. 162 [RH1(1)/p69].

(2) GEMA's assumption of a 10-year investment horizon is inconsistent with empirical evidence on average holding periods for the types of investors in GB energy networks (and FTSE companies more widely), which supports a holding period of 1 to 5 years. Using a 5-year investment horizon increases the low end of the Blume/JKM estimates by around 10bps and reduces the top end of the Cooper estimate by the same amount.[41]

(3) GEMA has relied on a Dividend Growth Model (**DGM**) developed by CEPA based on erroneous assumptions regarding dividend growth which leads to an understated TMR. GEMA ignores the cross-check based on the Bank of England's DGM which supports TMR estimates even higher than the historical realised returns evidence.[42]

<u>Beta - Exclusive use of very long term averages to calculate the equity beta</u>

44. GEMA correctly bases its equity beta on that of National Grid. It presents evidence of estimation windows of 2 to 10 years, with averaging periods ranging from spot to 10-year data.[43]

45. However, in arriving at its ultimate beta figure, it relies largely upon the 10-year estimation window and the 10-year average of the smaller windows. GEMA was correct to consider National Grid's beta, but manifestly in error in relying upon the 10-year estimation window and 10-year average (as opposed to the shorter averages or estimation windows). For the reasons explained in the NERA CAPM Report, the reasonable approach would have relied exclusively upon the shorter averaging periods and estimation periods:[44]

(1) What is required is an estimate of forward-looking risk. The (exclusive) use of very long estimation periods (10 years, but effectively more since it is a trailing average) does not adequately account for more recent changes to regulatory risk, or changes in the composition of the market portfolio (against which the covariance of National Grid's share price is measured).[45] Such longer periods also capture a time

41 NERA CAPM Report; NERA; March 2021, section 4.2.3. [RH1(1)/p72-74].
42 NERA CAPM Report; NERA; March 2021, section 4.2.4. [RH1(1)/p75-80].
43 NERA CAPM Report; NERA; March 2021, section 3.1. [RH1(1)/p39-43].
44 NERA CAPM Report; NERA; March 2021, section 3.2.1, para 92. [RH1(1)/p45].
45 NERA CAPM Report; NERA; March 2021, section 3.2.1, para 91. [RH1(1)/p43-45].

when National Grid's beta was depressed in the aftermath of the global financial crisis.

(2) The higher future risk for SPT is reflected in GEMA's assumption of 55% notional gearing, as compared with the 60% notional gearing assumption used for the gas distribution networks, which implies higher risk for electricity transmission and therefore a higher beta.

(3) NERA estimate a beta for National Grid stock of 0.33 to 0.36 (assuming zero debt beta).[46]

(4) Drawing on relevant cross-checks supports determining an asset beta for SPT in RIIO-T2 at the top end of the National Grid range, given that relevant EU comparator betas are higher than National Grid betas, with an equivalent range of 0.38 to 0.40 (zero debt beta).[47]

46. Further, insofar as GEMA placed weight upon the betas of UK water network companies (which is unclear from the terms of its Decision[48]), it was incorrect to do so.[49] Investors in energy transmission companies face systematically higher risk than investors in water networks for the reasons set out in detail in NERA CAPM Report and the witness statement of Mr Mathieson.[50]

47. GEMA also incorrectly uses the market value of debt to estimate un-levered betas. See NERA CAPM Report at section 3.2.3.[51]

F3. <u>Ground 1C: cross-checks (errors at step 2)</u>

48. At step 2 of its cost of equity calculation, GEMA considers cross-checks (although in fact chooses not to adjust its step 1 result to take them into account[52]). As the NERA

46 NERA CAPM Report; NERA; March 2021, section 3.3, para. 127. [RH1(1)/p55-56].
47 NERA CAPM Report; NERA; March 2021, section 3.3. [RH1(1)/p55.56].
48 See RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, para. 3.74, which refers to "*putting greater weight on N[ational] G[rid] than the other entities*", page 43 (Available here) [NOA1(18)/p43].
49 NERA CAPM Report; NERA; March 2021, section 3.2.4. [RH1(1)/p49-51].
50 First Witness Statement of Scott Mathieson, para. 118.
51 NERA CAPM Report; NERA; March 2021, section 3.2.3. [RH1(1)/p48].
52 See RIIO-2 Final Determinations: Finance Annex (REVISED); Ofgem, 3 February 2021, para. 3.121: "*Even though these cross-checks in combination generally support a lower cost of equity than is implied by the*

CAPM Report explains, a number of the comparators used by GEMA are either inappropriate or, at best, can be afforded very little weight:[53]

(1) GEMA relies upon evidence of MAR (i.e. market to asset ratios, seeking to measure risk adjusted returns). However, its estimates of these ratios are based upon data from:

(a) National Grid, which is distorted by its US operations; and

(b) two water companies, the enterprise value of which is driven by factors unrelated to the cost of capital (such as non-wholesale regulated activities, pension deficits/surplus and outperformance for wholesale business).[54]

(2) GEMA relies upon evidence from 14 infrastructure funds and seeks to infer their Internal Rate of Return (**IRR**). However, GEMA's analysis overlooks the fact that a market premium can be due to explanations other than the fund discount rate being higher than the market rate. Moreover, GEMA has failed to adjust the IRRs for the differences in business, financial or portfolio risk as compared to energy networks.[55]

(3) GEMA relies upon investor manager surveys. However, such survey evidence cannot be regarded as robust, with results tending to depend on the identity and outlook of the respondents and how they interpret the questions being asked,[56] as the CMA has itself recently observed.[57]

(4) GEMA relies upon evidence from OFTO bids. However, as the NERA CAPM Report explains, OFTO projects typically face lower risks. For example, they usually acquire assets that have been constructed, tested and operated for some time. Purchasers often benefit from a range of contractual protections provided by OFTO vendors, such as indemnities, which further de-risk the assets. In any event,

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Step 1 mid-point, after consideration of stakeholder responses, we have decided not to adjust the Step 1 mid-point in Step 2.", page 55 [NOA1(18)/p55].

53 NERA CAPM Report; NERA; March 2021, section 5.2. [RH1(1)/p84-88].

54 NERA CAPM Report; NERA; March 2021, section 5.2.2. [RH1(1)/p84-88].

55 NERA CAPM Report; NERA; March 2021, section 5.3. [RH1(1)/p88-90].

56 NERA CAPM Report; NERA; March 2021, section 5.5. [RH1(1)/p92-94].

57 NATS (En Route) plc / CAA Regulatory Appeal – Final Report; CMA; 23 July 2020, paras. 13.237-13.238, page 239 (Available here) [NOA1(6)/p239].

bid prices cannot be equated to expected returns, given the potential on such contracts for cost outperformance and other factors.[58]

(5) GEMA's cross-check based on raw equity betas relies on its own TMR and RFR estimates (which are themselves erroneous for the reasons explained under Ground 1B above).[59]

F4. Resultant jeopardy to the Sustainability Objectives

49. As a result of these errors, SPT has been allowed an insufficient return to incentivise the necessary investments that will be required during RIIO-T2 and in future price control periods. GEMA has paid insufficient regard to the need to secure SPT's ability to finance its licensed activities by securing reasonable returns on capital. The Decision risks hampering the fulfilment of SPT's statutory and licence obligations during RIIO-T2 (in particular to develop and maintain an efficient, co-ordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity pursuant to sections 9(2)(a) and (b) EA 1989). The costs to future consumers will consequently be increased.

50. The jeopardy that GEMA's Decision on the cost of equity is liable to cause to potential investment decisions by SPT that would assist in the attainment of the Sustainability Objectives, and in particular the Net Zero objective, is explained in detail in the witness statements of Mr Mitchell and Mr Mathieson.

51. The transition to Net Zero necessitates significant investment in the transmission system. There are very ambitious targets set for the connection of renewable generation, for both 2030 and 2050. SPT needs to increase its ability to transfer power from Scotland to England by almost 400% in the next 15 years alone, from the current 6.6GW to over 25GW. It is already very likely that SPT will need to make significant additional investment of £800m to £900m beyond the baseline levels proposed in its RIIO-T2 business plan, given the likely level of connections required to deliver on the

58 NERA CAPM Report; NERA; March 2021, section 5.4. [RH1(1)/p91-92].
59 NERA CAPM Report; NERA; March 2021, section 5.6. [RH1(1)/p94].

Government's more ambitious offshore wind delivery targets for 2030 in its December 2020 Energy White Paper.

52. In order to deliver Net Zero, SPT will have to continue to innovate in all parts of its business. Innovation carries risk. The sharp drop in the allowed return on equity pursuant to GEMA's Decision will encourage a more cautious and traditional approach. SPT cannot take on innovation risk to the same degree as it did in RIIO-T1. Mr Mitchell describes the consequent lower tolerance for design risk, and the need to limit discretionary expenditure. This will slow progress and result in the loss of efficiencies.

F5. Legal errors

53. In the premises, the Decision was wrong in that:

    (1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

        (a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

            (i) the reduction of electricity-supply emissions of targeted greenhouse gases,

            (ii) the security of the supply of electricity to them;

        (b) the need to secure that all reasonable demands for electricity are met;

        (c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

        (d) the need to contribute to the achievement of sustainable development;

        (e) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

        (f) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) It is irrational (and accordingly wrong in law: see section 11E(4)(e) EA 1989).

G. GROUND 2: OUTPERFORMANCE WEDGE (EXPECTED V. ALLOWED RETURN ON EQUITY)

54. Having already under-assessed the cost of equity (see Ground 1 above), GEMA has then applied an arbitrary and unprecedented "*outperformance wedge*" in order to account for a supposed difference between the expected cost of equity and the allowed return on equity based upon three measures of historic outperformance.

G1. Problems with GEMA's approach

55. The outperformance wedge wrongfully departs from the rigour of the process undertaken to assess costs and set incentives. It is arbitrary and unprecedented. CAPM analysis was used to calculate the cost of equity, which should equate to the allowed return on equity, without any such adjustment. As the NERA Allowed Returns Report explains:

(1) The wedge departs from longstanding regulatory policy to encourage cost reduction by permitting companies to retain the benefits of outperformance. Cost reduction is manifestly in consumers' interests.[60]

(2) There is no regulatory precedent for such an adjustment. The conceptually correct approach is to preserve the incentive to minimise costs by permitting the regulated company potentially to outperform. In the usual way, the regulated company will retain some proportion of the resulting benefit (the other portion accruing to consumers) and that outperformance will be embedded in the next price control. By contrast, the Decision restricts that usual mechanism only to outperformance in excess of an arbitrary minimum. The conceptually correct approach to any perception of likely systematic outperformance – as distinct from outperformance

[60] NERA Allowed Returns Report; NERA; March 2021, section 1.3.1. [RH2(1)/p19-22].

resulting from improved efficiencies achieved during the relevant period – is to correct the cost allowance framework.[61]

(3) Although GEMA seeks to justify its position by reference to claimed evidence of past outperformance across regulated sectors (itself unreliable[62]), the relevant question is not how SPT or others have performed under past price controls, but how they will perform in this one. GEMA's 25 bps adjustment for expected outperformance is not a reasonable expectation of performance over RIIO-T2. There have been numerous adjustments to the cost allowance by comparison with RIIO-T1, in particular, more challenging efficiency and incentive targets. As Mr Mitchell of SPT explains in his witness statement, in practice under RIIO-T2 outperformance will be very difficult to achieve because GEMA has implemented a range of measures which significantly minimise the scope for outperformance – for example, Price Control Deliverables, the Return Adjustment Mechanism, Output Delivery Incentives, and the reduction of the price control period from eight to five years.[63] The assurance steps undertaken for business plans have also materially reduced the ability for companies to outperform.[64] Further, GEMA has additionally (and also inappropriately – see section H below) made substantial adjustment to the totex allowance to account for what it calls "*ongoing efficiency*" (£69.9 million in the case of SPT). All of these should be more than sufficient to reduce the scope for potential outperformance, mitigate the risk of systematic outperformance, and mean that SPT faces asymmetric downside risk for RIIO-T2.[65]

(4) The *ex post* 'true up' does not cure the fundamental problem with GEMA's approach and the diminished incentive to outperform.[66]

61 NERA Allowed Returns Report; NERA; March 2021, section 1.4. [RH2(1)/p23-26].

62 In relation to reliance on the water sector, see NERA Allowed Returns Report; NERA; March 2021, sections 1.2.4 [RH2(1)/p18-19] and 1.4.1. [RH2(1)/p24-26]

63 NERA Allowed Returns Report; NERA; March 2021, section 1.2.1. [RH2(1)/p12-15].

64 First Witness Statement of Frank Mitchell, paras. 126 - 132.

65 NERA Allowed Returns Report; NERA; March 2021, section 1.2.3. [RH2(1)/p17-18] See also First Witness Statement of Scott Mathieson, paras. 85-89.

66 NERA Allowed Returns Report; NERA; March 2021, section 1.3.1. [RH2(1)/p19-22].

(5) In substance GEMA's approach amounts to a policy of 'aiming down' and will damage long term investor confidence and incentives to invest. See Ground 1A above.

(6) In any event, GEMA overstates historic outperformance for the reasons explained in section 1.2.2 of the NERA Allowed Returns Report.

56. As a result, SPT has been allowed an insufficient return to incentivise the necessary investments that will be required during RIIO-T2 and in future price control periods. GEMA has paid insufficient regard to the need to secure SPT's ability to finance its licensed activities by securing reasonable returns on capital. The Decision risks hampering the fulfilment of SPT's statutory and licence obligations during RIIO-T2 (in particular to develop and maintain an efficient, co-ordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity pursuant to sections 9(2)(a) and (b) EA 1989). The costs to future consumers will consequently be increased. See further section F4 above.

G2. Legal errors

57. In the premises, the Decision was wrong in that:

(1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

(i) the reduction of electricity-supply emissions of targeted greenhouse gases,

(ii) the security of the supply of electricity to them;

(b) the need to secure that all reasonable demands for electricity are met;

(c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

(d) the need to contribute to the achievement of sustainable development;

(e) the promotion of efficiency and economy on the part of transmission licensees;

(f) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

(g) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) It is irrational (and accordingly wrong in law: see section 11E(4)(e) EA 1989).

H. GROUND 3: ONGOING EFFICIENCIES

58. GEMA has made a series of errors in its analysis of the ongoing efficiencies which SPT is capable of achieving. The result is that the annual ongoing efficiency challenge of 1.15% for capex and 1.25% for opex is overstated.

H1. The 0.2% uplift for innovation funding allowances in RIIO-T1 is unjustified

59. GEMA introduced a 0.2% uplift to account for the assumed benefits of the innovation funding provided in the past to network companies – specifically, the Network Innovation Competition (**NIC**), the Network Innovation Allowance (**NIA**) and the Innovation Rollout Mechanism (**IRM**). This is unjustified and irrational for the reasons set out in detail in section 3 of NERA's Ongoing Efficiencies Report. In particular:

(1) The uplift is based entirely upon an unjustified assumption that the past innovation funding will generate future efficiencies commencing in the RIIO-T2 period that have not been included in SPT's baseline business plan and will not be included in

any cost assessments submitted to GEMA in respect of future projects financed through the RIIO-T2 uncertainty mechanisms, all without any empirical evidence.[67]

(2) The theoretical assumption is unwarranted, given that RIIO-T1 innovation funding was largely directed towards supporting objectives (such as environmental objectives and ancillary service integration) that had nothing to do with future cost reduction.[68] The witness statement of Craig McTaggart of SPT gives further detail on the various innovation funding schemes with which SPT was involved.[69]

(3) In fact, to the extent that cost savings resulted from innovations in RIIO-T1, they will have been embedded in RIIO-T2 business plans. Indeed, GEMA encouraged their inclusion as 'business-as-usual' in those plans.[70] Therefore, the innovation funding adjustment is liable to double count productivity savings built into SPT's business plan.[71]

(4) Further, the innovation funding adjustment may double count productivity savings achieved in competitive sectors (which are accounted for elsewhere in GEMA's analysis of the scope for ongoing efficiencies).[72]

(5) This is all despite respondents to the Draft Determinations having brought such matters to GEMA's attention. GEMA rejected their comments without any detailed explanation.[73]

(6) The uplift ignores consistent regulatory precedent for an ongoing efficiencies target no higher than 1%.[74]

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67 NERA Ongoing Efficiency Report; NERA; March 2021, section 3.1. [JG1(1)/p42-45].
68 NERA Ongoing Efficiency Report; NERA; March 2021, section 3.2. [JG1(1)/p45-48].
69 First Witness Statement of Craig Wilson McTaggart, sections D and E.
70 RIIO-2 Business Plan Guidance; Ofgem; 31 October 2019, para. 2.67, page 30. (Available here) [NOA1(5)/p30].
71 NERA Ongoing Efficiency Report; NERA; March 2021, section 3.3. [JG1(1)/p48-51].
72 NERA Ongoing Efficiency Report; NERA; March 2021, section 3.4. [JG1(1)/p51-53].
73 NERA Ongoing Efficiency Report; NERA; March 2021, section 3.5. [JG1(1)/p53-54].
74 NERA Ongoing Efficiency Report; NERA; March 2021, section 2.2.1. [JG1(1)/p19-20].

H2. Failure to take into account the GO productivity measure

60. In its calculation of the appropriate ongoing efficiency challenge, GEMA has irrationally failed to take into account measures based upon the established Gross Output (**GO**) measure and has relied solely on the Value Added (**VA**) productivity measure, despite claiming not to have done so. See section 2.3.2 of the NERA Ongoing Efficiency Report for further details. In particular:

    (1) GEMA, and its economic advisor CEPA, rightly recognise that there is a long standing debate over which definition of output (GO or VA) is more appropriate for measuring ongoing efficiency. All recent relevant regulatory decisions have placed weight on both measures, albeit that more recent decisions have tended to regard the GO measure to be preferable for application to regulated utility networks.[75] Economic theory supports this.[76]

    (2) Consistent with this, CEPA recommended that the GO measure should be considered in the Decision in relation to the appropriate ongoing efficiency measure.

    (3) GEMA itself in its Final Determinations (Core Document, para. 5.22) states that it has "*given some weight to GO productivity measures*".

    (4) In fact, however, contrary both to GEMA's own indication and contrary to CEPA's advice, the range actually used by GEMA to arrive at its ongoing efficiency challenge appears to rely exclusively on VA measures. SPT has pointed this out in correspondence with GEMA and, despite SPT pressing for a response, GEMA has not responded.[77]

H3. Incorrect assumption that regulated network companies can improve productivity faster than the wider economy

61. GEMA's efficiency challenge is based upon the incorrect assumption that regulated network companies can improve productivity faster than the economy overall. As the

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75 NERA Ongoing Efficiency Report; NERA; March 2021, section 2.2.3. [JG1(1)/p22-24].
76 NERA Ongoing Efficiency Report; NERA; March 2021, section 2.2.4. [JG1(1)/p24-25].
77 See the letter from SPT to GEMA dated 15 January 2021 [NOA1(19)], and subsequent reply from GEMA dated 21 January 2021 [NOA1(20)] and further SPT reply dated 19 February 2021 [NOA1(22)].

NERA Ongoing Efficiency Report explains, this is an entirely unwarranted assumption, both theoretically and empirically. In particular:

(1) At para. 5.21 of the Core Document, GEMA suggests that economy-wide measures of efficiency could underestimate the efficiency gains likely to be achieved within regulated sectors on the basis that they are less exposed to negative shocks and "*the lack of competitive pressure means they should be able to place greater management focus on driving high efficiency gains*". This is said to justify an ongoing efficiency challenge at the top end of CEPA's range.

(2) As the NERA Ongoing Efficiency Report explains, there is no basis in economics or fact for the supposition that an absence of competitive pressure is liable to drive higher efficiency gains. If anything, the reverse may be assumed to be correct. Equally, there is no basis for the assumption that an absence of shocks in an industry would, over the entire business cycle, lead to any greater efficiency gains.[78]

H4. Failure to take into account the downturn in productivity growth since 2008

62. GEMA's efficiency challenge is based upon productivity growth estimates that use data from the entire period 1997 to 2016. As the NERA Ongoing Efficiency Report observes, in so doing, GEMA ignores the well-recognised phenomenon that since the 2008 financial crisis productivity growth in the UK has fallen sharply and that lower productivity growth is expected to persist for some time. See sections 2.2.6 to 2.2.9 of the NERA Ongoing Efficiency Report. In particular:

(1) Forecasts from most economists and from official bodies (such as the Office of Budget Responsibility and the Bank of England) assume that economy-wide productivity improvement will remain low in the near future and that it is unlikely that it will return to historic trends on a sustained basis for some time.

(2) Whilst apparently recognising that such productivity growth is likely to be lower for the economy as a whole, GEMA apparently assumes that energy network

[78] NERA Ongoing Efficiency Report; NERA; March 2021, section 2.3.1. [JG1(1)].

companies will uniquely be in a different position. There is no empirical or theoretical basis for this arbitrary assumption.

H5. Failure to take into account evidence of efficiency gains in comparable sectors

63. GEMA calculates its ongoing efficiency challenge exclusively by reference to the range based upon the economy-wide data set. This is irrational for the reasons explained at section 2.2.10 of the NERA Ongoing Efficiency Report. In particular:

    (1) GEMA's own economic advisor, CEPA recommended against basing the ongoing efficiency challenge exclusively upon economy-wide data and instead recommended that it was appropriate to use both targeted and economy-wide data sets.

    (2) GEMA obtained and presents data from more targeted comparator sets and has identified construction as the closest comparator set.

    (3) However, in its calculations GEMA, without explanation, ignores the data from that subset of the economy that is most closely comparable to electricity transmission (in particular, construction) and instead calculates its ongoing efficiencies challenge range exclusively on the basis of the economy-wide data set.

H6. Legal errors

64. In the premises, the Decision was wrong in that:

    (1) GEMA failed properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

        (a) the interests of existing and future consumers in Great Britain, including in particular their interests in:

            (i) the reduction of electricity-supply emissions of targeted greenhouse gases,

            (ii) the security of the supply of electricity to them;

(b) the need to secure that all reasonable demands for electricity are met;

(c) the need to secure that SPT as a transmission licence holder is able to finance the activities which are the subject of obligations imposed by its transmission licence (under section 6(1)(b) EA 1989) by securing reasonable returns on capital;

(d) the need to contribute to the achievement of sustainable development;

(e) the effect on the environment of activities connected with the generation and transmission of electricity; and/or

(f) best regulatory practice.

(2) Further or alternatively, GEMA failed to give the appropriate weight to the matters listed in (1) above (section 11E(4)(b) EA 1989).

(3) It is based on errors of fact (section 11E(4)(c) EA 1989).

(4) GEMA's analysis was irrational (and accordingly wrong in law: see section 11E(4)(e) EA 1989).

I. GROUND 4: CIRCUMVENTION OF LICENCE MODIFICATION PROCESS

65. By the Decision, GEMA has improperly sought to retain for itself the ability to amend significant elements of the RIIO-T2 price control by way of future direction, rather than through the statutory licence modification process under section 11A EA 1989. The circumstances in which GEMA will make such directions are not specified. As a result, the effect of the Decision is materially uncertain, and SPT (and others) are denied the procedural protections which the legislator intended to confer.

I1. Extent of reliance on directions

66. In particular, GEMA provides for future directions in respect of:

(1) The Network Asset Risk Metric (**NARM**) regime under Special Condition 3.1.

(2) Net Zero Re-opener under Special Condition 3.6.

(3) Large Onshore Transmission Investments (**LOTI**) under Special Condition 3.13.

(4) Medium Sized Investment Projects (**MSIP**) under Special Condition 3.14.

(5) Access Reform Changes under Special Condition 3.16.

(6) Uncertain Non-Load Related Projects Re-opener under Special Condition 3.29.

(7) Evaluative Price Control Deliverables under Special Conditions 3.9, 3.14, 3.18 and 3.29.

I2. <u>Materiality</u>

67. Martin Hill of SPT describes each of the above elements of the price control in his witness statement.[79] They are highly material to SPT:

(1) SPT's baseline NARM expenditure, which is exposed to being modified by direction, is £335m.[80]

(2) A Net Zero Development is defined broadly so as to include for example changes in government policy relating to the achievement of the Net Zero Carbon Targets. Consequential directions could have far-reaching effects.[81]

(3) A LOTI project by definition is expected to involve at least £100m of capital expenditure. SPT currently has one LOTI project for the RIIO-T2 period which it expects must proceed (Eastern Link). This joint project with National Grid Electricity Transmission plc is expected to cost £[✂]. Allowances for similar projects in RIIO-T1 have all been dealt with by way of licence modification.[82]

(4) SPT's projects likely to be subject to MSIP applications involve approximately £200m of expenditure.[83]

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79 First Witness Statement of Martin Scott Hill.
80 First Witness Statement of Martin Scott Hill, para 27(iii).
81 First Witness Statement of Martin Scott Hill, para 61.
82 First Witness Statement of Martin Scott Hill, para 27(i) and 76.
83 First Witness Statement of Martin Scott Hill, para 27(ii) and 86.

(5) The Access Reform Change Re-opener could in principle be used by GEMA to make changes to SPT's licence arising from GEMA's ongoing Significant Code Review of network access and forward-looking charge arrangements. That Review could effect radical reform to transmission charges.[84]

(6) The Uncertain Non-Load Related Projects Re-opener relates to six projects, with a total anticipated value of £134.8m.[85]

(7) The Evaluative PCDs make up around £[✂] of SPT's baseline spend (Special Condition 3.9 being the largest, accounting for £172m).[86] The PCD Methodology was published over three weeks after the licence modification, and GEMA has even reserved the option to amend that Methodology by way of direction.[87]

I3. The limits of GEMA's powers under section 7(3) and 7(5) EA 1989

68. A mere direction by GEMA is not appealable to the CMA.

69. GEMA's powers to include licence conditions providing for directions to be made at a later date are constrained. Section 7 EA 1989 provides materially:

> "*(3) Without prejudice to the generality of paragraph (a) of subsection (1), conditions included in a licence by virtue of that paragraph may require the licence holder—*
> *(a) to comply with any direction given by the Authority or Secretary of State as to such matters as are* <u>*specified*</u> *in the licence or are of a description so* <u>*specified*</u>*; …*
>
> *(5) Conditions included in a licence may contain provision for the conditions–*
> *(a) to have effect or cease to have effect at such times and in such circumstances as may be* <u>*determined by or under*</u> *the conditions; or*
> *(b) to be modified in such manner as may be* <u>*specified*</u> *in the conditions at such times and in such circumstances as may be* <u>*so determined*</u>."

70. Our underlining in the passage above is to emphasise that GEMA may include such conditions only if they specify the circumstances and the criteria by or under which GEMA will determine the future direction.

84 First Witness Statement of Martin Scott Hill, para 68.
85 First Witness Statement of Martin Scott Hill, para 27(iv) and 104.
86 First Witness Statement of Martin Scott Hill, para 27(v) and 123.
87 SP Transmission Ltd Electricity Licence Special Conditions; Ofgem; 3 February 2021, Special Condition 9.3.6, page 164. (Available here) [NOA1(13)/p164].

71. The reason for those limitations on GEMA's power is to ensure that the effect of the licence is sufficiently certain on the face of the licence. Otherwise:

(1) The CMA cannot properly exercise its appellate jurisdiction over the licence.

(2) The licensee is deprived of its ability to plan and predict the effect of its licence.

72. The Special Conditions presently under consideration do not sufficiently specify the circumstances and criteria for future directions and so are *ultra vires* section 7.

I4. <u>The procedural protections in the legislative scheme</u>

73. Those Special Conditions also cut across the legislative scheme in EA 1989.

74. They have been inserted by the Decision as licence modifications pursuant to section 11A. Sections 11A-H EA 1989 contain procedural protections where a licence is modified in such a way. In particular:

(1) At least 28 days' notice of the modification proposal must be given to specified persons (section 11A(2)-(4)).

(2) GEMA must consider any representations made in response (section 11A(5)).

(3) The Secretary of State has a veto (section 11A(5)).

(4) A formal decision must be published specifying certain matters including its effect and how representations were taken into account (section 11A(7)).

(5) There is a prescribed period of at least 56 days before the modification has effect (section 11A(8)-(9)).

(6) An appeal lies to the CMA (section 11C(1)), which is a specialist tribunal with economic as well as legal expertise.

(7) Citizens Advice and Citizens Advice Scotland have special standing to participate in such an appeal in their capacity of representing consumers (section 11C(2)(d)).

(8) The grounds of appeal before the CMA are more extensive than on an application for judicial review (section 11E(4)).

75. The protections listed above were added to the EA 1989 by the Electricity and Gas (Internal Markets) Regulations 2011 (SI 2011/2704). In the consultation papers which led to those Regulations, the Government explained its view that:

(1) All affected licensees should have an equivalent right of appeal from licence modification decisions to the (then) Competition Commission, being:

> "*... an appeal process which is capable of scrutinising factual issues of an economic/ technical nature to ensure the regulator is held to account for their decisions. We therefore consider that a mechanism over and above an ability to bring a claim for Judicial Review is required in these circumstances.*"[88]

(2) Licence modification decisions differed from other categories of decisions of GEMA, for which a lesser means of challenge might suffice:

> "*The Government is introducing a merits-based appeal process for licence modification decisions, as their broader economic impacts merit factual and economic scrutiny.*"[89]

76. Accordingly, it is plain that the purpose of the right of appeal to the CMA is to ensure that GEMA is held to account by a process capable of scrutinising factual issues of an economic / technical nature.

77. This is in the interests of both consumers and licensees. EA 1989 recognises consumers' interests by granting Citizens Advice and Citizens Advice Scotland rights to be notified of proposed licence modifications and to participate in appeals.[90]

78. By purporting to grant itself unilateral powers to amend licence conditions by direction, especially in situations involving sums material to the price control and likely to involve detailed factual and/or economic inquiry, GEMA is circumventing these procedural protections.

79. However, as a public body, GEMA may only use its statutory powers in order to promote (and not frustrate) the policy and purposes of the Act.[91]

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88 Implementation of the EU Third Internal Energy Package: Consultation on licence modification appeals; DECC; September 2010, para. 1.5, page 8. (Available here) [NOA1(3)/p8].

89 Implementation of the EU Third Internal Energy Package: Government Response; DECC; January 2011, para. 2.18, page 18. (Available here) [NOA1(2)/p18].

90 EA 1989, ss. 11A(4)(b) and 11C(2)(d). [NOA1(24)].

91 *Padfield v. MAFF* [1968] 2 WLR 924. [NOA1(1)].

I5. Legal errors

80. In the premises, the Decision was wrong:

(1) in law (section 11E(4)(e) EA 1989); and

(2) for failing properly to have regard to the following matters referred to in section 11E(4)(a) EA 1989:

(a) the principles under which regulatory activities should be transparent and accountable; and

(b) best regulatory practice.

J. RELIEF

81. For all the above reasons, the relief sought by SPT is modification of the Decision such as would result from the following:

(1) Correction of the cost of equity values in the Price Control Financial Model[92] including the individual CAPM parameters (with consequent adjustment to the values based on them) and associated references and impacts in the Price Control Financial Handbook[93], so as to remedy the deficiencies identified in Ground 1, in the ways identified in the NERA CAPM Report (or in such further or other ways as the CMA thinks fit). SPT contends that the "*Cost of equity at notional gearing*" (RIIO-ET2 Price Control Financial Model, "*Input*" tab, line 200) should be 5.680%.

(2) Deletion of the "*expected outperformance*" values in the Price Control Financial Model[94] (with consequent adjustment to the values based on them, in particular such that "*allowed return on equity*" replicates "*cost of equity*"[95]) and associated

[92] RIIO-ET2 Price Control Financial Model; Ofgem; 3 February 2021, "*Input*" tab, lines 188-192 & 200. (Available here) [NOA1(15)].

[93] See in particular section 4 of the Price Control Financial Handbook; Ofgem; 17 December 2020, pages 30 - 39. (Available here) [NOA1(16)/p30-39].

[94] RIIO-ET2 Price Control Financial Model; Ofgem, "*Input*" tab, lines 193 and 202. [NOA1(15)].

[95] i.e. in the RIIO-ET2 Price Control Financial Model; Ofgem, "*Input*" tab, line 194 would replicate line 192 and line 201 would replicate line 200. [NOA1(15)].

references in Special Condition 2.3[96] and in the Price Control Financial Handbook[97], so as to remedy the deficiencies identified in Ground 2.

(3) Correction of totex values in the Decision (with consequent adjustments to the Price Control Financial Model and licence conditions) so as to remedy the deficiencies identified in Ground 3, in the ways identified in the NERA Ongoing Efficiency Report (or in such further or other ways as the CMA thinks fit). SPT contends that GEMA's annual ongoing efficiency targets of 1.25% (opex) and 1.15% (capex) should be replaced with evidenced-based targets of 0.65% (opex) and 0.5% (capex).

(4) Substitution of the provisions identified in Ground 4 which permit GEMA to make changes by direction with a requirement that any such changes are instead made by licence modification.

82. SPT's primary position is that the CMA can and should make these changes itself.

83. Further or alternatively, the CMA should quash the Decision to the extent that it allows the appeal and remit specific matters to GEMA for reconsideration and determination in accordance with the CMA's directions.

K. <u>CONCLUSION</u>

84. SPT requests permission to appeal.

DANIEL JOWELL Q.C.
GERARD ROTHSCHILD

96 Where it is referred to as "*EO*".
97 In particular, the references to "*expected performance*".

STATEMENT OF TRUTH

SPT believes that the facts stated in this Notice of Appeal are true. I am duly authorised to sign this statement on behalf of SPT.

[✂]

Signed: ....

Name: Frank Mitchell..

Position: Chief Executive Officer of SP Energy Networks ......

Dated: 3 March 2021 ....