BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF APPEALS UNDER SECTION 11C OF THE ELECTRICITY ACT 1989 AND SECTION 23B OF THE GAS ACT 1986

B E T W E E N:

(1) CADENT GAS LIMITED

(2) NORTHERN GAS NETWORKS LIMITED

(3) SOUTHERN GAS NETWORKS PLC AND SCOTLAND GAS NETWORKS PLC

(4) SP TRANSMISSION PLC

(5) WALES & WEST UTILITIES LIMITED

Appellants

- and -

THE GAS AND ELECTRICTY MARKETS AUTHORITY

Respondent

RESPONDENT'S SUBMISSIONS ON PR19 FINAL REPORT (EFFICIENCY AND TOTEX MODELLING)

A. Introduction and Summary

1. These are the submissions of the Gas and Electricity Markets Authority ("**GEMA**"), filed in accordance with the Competition and Markets Authority's ("**CMA's**") procedural letter of 15 April 2021, in relation to the CMA's Final Report in the PR19 water price control.

2. These submissions address the following topics (and in doing so, where relevant, respond to the points raised by Cadent Gas Limited ("**Cadent**"), Northern Gas Networks Limited ("**NGN**"), Southern Gas Networks Plc and Scotland Gas Networks Plc (together, "**SGN**"), SP Transmission Plc ("**SPT**") and Wales and West Utilities Limited ("**WWU**")):[1]

[1] GEMA will file separate submissions on the finance issues including the cost of equity and outperformance wedge.

(1) The ongoing efficiency challenge;

(2) The catch-up efficiency challenge; and

(3) The application by GEMA of a materiality threshold for company-specific claims (relevant to Cadent's Ground 1B arguments on London regional factors).

B. <u>The overall relevance of the CMA's Final Report at PR19</u>

3. The starting position for consideration of the relevance of the CMA's Final Report at PR19 to GEMA's decisions in RIIO-2 is to re-emphasise that GEMA's decisions must be tested against its own statutory framework in relation to the industry it is charged with regulating; and not by reference to assessments made in relation to a different industry under a different statutory framework.[2] In considering PR19 and the CMA's Final Determinations, there is no requirement (as the Appellants appear in part to be suggesting) to carry out some sort of "compare and contrast" exercise.

4. The fact that the CMA has taken a different approach in its PR19 Final Report from the approach GEMA has taken at RIIO-2 does not indicate that GEMA's approach is wrong on any of the specified statutory grounds. Not only are there material differences between the energy sector and the water sector, but regulatory judgements can legitimately differ in relation to similar issues. As the CMA stated in its PR19 Final Report, in the context of a comparison between Ofwat and GEMA's approach to particular regulatory decisions: *"These regulators are regulating different sectors with different companies, so there is limited read across to our decision"*.[3]

5. In addition, it is important to note that there are material differences between the CMA's statutory role in water sector references, which require the CMA to carry out a de novo assessment, and its statutory role in energy price control appeals, which require it to act as an appellate body and to determine whether GEMA's decision was wrong on one of the specified statutory grounds.

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[2] See GEMA's letter to CMA, 29 October 2020 (Akshay Kaul to Kip Meek), **[TSS1/01]**.

[3] CMA (2021), Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – Final report **[TSS1/02]**, §4.493

6. The analysis or consideration by the CMA in PR19 of certain issues which can arise in regulatory assessments generally, or price control decisions in particular, may be informative or instructive for other regulators (and those scrutinising their decisions). The conclusions and reasoning of the CMA in PR19 are not, however, binding on GEMA. GEMA does, nonetheless, pay attention to the approach adopted by other regulators, including the CMA, in making its assessments. In doing so, it is alive to the importance of its own statutory functions, the nature of the industry with which it is concerned and the information available to it.

7. GEMA therefore addresses briefly below the CMA's approach on certain issues at PR19. As noted further below, the approach of the CMA is not inconsistent with GEMA's approach. Insofar as consideration of PR19 is relevant, therefore, it may provide support to GEMA's position that it has not exceeded the bounds of its regulatory discretion or erred on one of the specified statutory grounds.

C. Ongoing Efficiency

(i) The CMA's approach at PR19

8. In its Final Report at PR19, the CMA decided to impose an ongoing efficiency ("**OE**") challenge of 1%. In doing so, it considered the following factors.

9. The CMA considered the average annual productivity growth achieved by comparable competitive sectors through a growth accounting analysis of the EU KLEMS dataset. This produced a "starting point" for its OE challenge of 0.7%.[4] In arriving at this starting point, the CMA took the following approach to its growth accounting analysis:

    (1) The CMA used a set of comparator sectors based on its subjective assessment of industries which shared commonalities with the water industry. In particular, the CMA concluded that the comparators selected by Ofwat's consultants, Europe Economics ("**EE**"), were reasonable. EE's comparator sets included several

[4] **[TSS1/02]**, §4.522

manufacturing sub-sectors, in which productivity growth has historically been high.

(2) The CMA decided not to weight any one comparator more than another but used a central measure of what could be achieved in the relevant comparator sectors.[5]

(3) The CMA selected a time-period of 1990-2007 on the basis that it represented the most recent full business cycle for which data was available.[6]

(4) The CMA focussed on "gross output" measures in arriving at its "starting point" of 0.7% (although, for the reasons given below, it decided also to give some weight to "value added" measures).[7]

10. Having selected a starting point of 0.7%, the CMA then decided to adjust this through consideration of other relevant factors in the round.[8] These factors led it to set a higher OE challenge of 1%. It reasoned as follows:

(1) There were several reasons which suggested that the water companies would be able to achieve productivity gains greater than the 0.7% average comparator estimate.

a. The 0.7% average comparator estimate did not capture productivity growth driven by embodied technical change: "*Illustrative academic evidence in other geographies suggested embodied technical change in some cases could be equal to or higher than the disembodied estimate*".[9]

b. The CMA decided that it would be appropriate to give some weight to "value added" productivity measures in addition to "gross output"

[5] **[TSS1/02]**, §4.522
[6] **[TSS1/02]**, §4.533
[7] **[TSS1/02]**, §4.616
[8] **[TSS1/02]**, §4.522 and 4.616
[9] **[TSS1/02]**, §4.616

measures, because (i) there was a theoretical basis for doing so and (ii) *"gross output estimates may be more prone to error"*.[10]

c. It was further plausible that water companies might be able to achieve some additional productivity growth due to the increased flexibility in the totex and outcomes framework. In this respect, the CMA relied on a report produced by KPMG[11] which demonstrated the potential for additional productivity growth resulting from implementation of the totex and outcomes framework.[12]

(2) More recent comparator data, however, from the period of 2008 to 2014, suggested productivity growth lower than the 0.7% starting point and that *"more broadly wider UK productivity growth had slowed"*.[13] The CMA noted, however, that "*the water sector will be less affected by many of the factors which led more recent UK-wide productivity growth to be lower than the long-term average*" (ibid). It therefore decided to make a "*limited*" downward adjustment to reflect the recent slow-down in productivity growth.

(3) An OE challenge of 1% was further consistent with the frontier shift assumptions put forward by the water companies themselves.

(4) No specific adjustment to the OE challenge should be made to reflect the impact of COVID-19. The CMA considered recent productivity data (for example, produced by the Office of National Statistics, "**ONS**") but noted that it was strongly impacted by short term changes in demand which were unlikely to affect the water sector.[14] The CMA accepted Ofwat's point that the "*water sector is typically less impacted by recessions than other sectors due to stable demand and so we might expect the water sector to have relatively better productivity growth in recessionary years relative to the wider economy*" (ibid). The CMA further placed reliance on the

[10] **[TSS1/02]**, §4.544
[11] KPMG (2018), *Innovation and efficiency gains from the totex and outcomes framework*, **[TSS1/03]**
[12] **[TSS1/02]**, §4.564
[13] **[TSS1/02]**, §4.616
[14] **[TSS1/02]**, §4.590

fact that the time period used in its growth accounting analysis was long and included periods of lower or even negative productivity.[15]

(ii) Relevance to GEMA's approach at RIIO-2

11. It is striking that, notwithstanding that the CMA has in some respects adopted a different approach to that adopted by GEMA in setting an OE challenge, the eventual figure it reached is materially similar to GEMA's core OE challenge of 0.95% for capex and repex and 1.05% for opex. The CMA's OE challenge does not include any "innovation uplift" but – for the reasons given in GEMA's response submissions on totex modelling, efficiency and licencing (**"GEMA's Response"**) dated 23 April 2021 which are not repeated – this uplift was justified on the basis of innovation funding which is unique to the energy sector and which has not historically been received by water companies.

12. There are, moreover, certain similarities and consistencies between the approaches of the CMA and GEMA which are an indication that GEMA's approach cannot be said to be wrong:

(1) Like GEMA, the CMA did not consider the output of its growth accounting analysis in isolation but considered various other factors *"in the round"*.[16]

(2) The CMA used a time-period of 1990-2007 on the basis that it represented the most recent full business cycle for which data was available. However, it decided to place some *limited* weight on the lower productivity growth following the financial crisis, while further noting that the water sector would be less affected by the various factors which led to this lower productivity growth. GEMA similarly used CEPA's analysis, which considered the periods prior to the financial crisis and after the financial crisis by using a time period of 1997-2016, comprising, in its view, two complete business cycles. It equally noted that the

[15] **[TSS1/02]**, §4.592
[16] **[TSS1/02]**, §4.616

regulated energy network companies might be more insulated from the effects of economic downturns than competitive comparators.

(3) Like the CMA in PR19, GEMA decided to give some weight to both gross output and value-added measures (contrary to SPT's suggestion in its PR19 Submissions at §39). As explained in GEMA's Response of 23 April 2021, GEMA's core efficiency challenge corresponded to the upper bound proposed by CEPA, which itself gave some weight to gross output measures (§103). Moreover, both the CMA and GEMA shared the same view that gross output measures may be more prone to error.

(4) The CMA determined that there was a valid conceptual basis for increasing its 0.7% starting point to take account of embodied technical change. This reasoning applies equally to the OE challenge for RIIO-2. GEMA's consultants, CEPA, cited embodied technical change as a factor supporting a more stretching OE challenge (see in particular, the witness statement of Gary Keane, GK1 §§165-173).

(5) The CMA reasoned that there was some limited potential for additional productivity growth above its comparator estimate from the totex and outcomes framework. In doing so, it relied on the KPMG report, which estimated that water companies could make efficiency gains of between 0.2% and 1.2% per year due to the totex and outcomes framework in addition to the productivity growth which could be achieved in comparator sectors. In reaching its conclusions, KPMG drew on evidence from electricity and gas networks regulated by GEMA. KPMG analysed "outperformance" by electricity distribution, gas distribution and transmission companies in RIIO-1 (plus DPCR5 for ED alone) to inform its estimates. The totex and outcomes framework which KPMG considered (and the CMA accepted) would drive additional efficiency gains in the water sector is materially similar to the totex and outputs framework first used in RIIO-GD1 and RIIO-T1, which will again be used in RIIO-GD2 and RIIO-T2. Accordingly, to the extent that there is a conceptual basis for additional efficiency gains in the water sector as a result of the totex and outcomes framework, this should apply equally to the energy sector. GEMA notes that Cadent appears to accept in its PR19

Submissions that there is such a conceptual basis (albeit it contends that the benefits will be limited): §21.

(6) Like GEMA, the CMA decided not to make any reduction to the OE challenge to reflect the impact of COVID-19 but rather considered that the best mechanism was for *"Ofwat to consider [the impact] as part of an industry-wide process"*.[17]

13. The Appellants in their PR19 Submissions stress certain respects in which the CMA's reasoning differs from that of GEMA. However, any such differences do not establish that GEMA's approach was wrong. In particular:

(1) Cadent (§13) and NGN (§25(iii)) highlight the fact that the CMA did not place weight on historical estimates of productivity growth in the water industry. The CMA's decision in this respect, however, referred specifically to the analysis by Frontier Economics in a report produced in 2017 for Water UK.[18] The CMA reasoned that this analysis was "*unlikely to be reliable for the purposes of projecting future productivity gains*"[19] (the CMA further did not consider that there had been significant outperformance in the water sector for the reasons further discussed below). The CMA nevertheless commented that "*benchmarking to a competitive benchmark is more appropriate to prevent any potential periods of underperformance being established as a future target*" (ibid). As explained in GEMA's Response dated 23 April 2021, gas distribution and transmission companies are in a very different position to the water companies, having underspent by very significant amounts in RIIO-1, which could reasonably have been considered to be driven in part by higher efficiency gains than assumed by GEMA at RIIO-1, and this was a factor taken into consideration and used as a cross-check when setting the OE target for RIIO-2 (see §142).

(2) Cadent (§14) and SPT (§37) refer to the fact that the CMA did not place weight on labour productivity measures. However, the CMA's Final Report does not discuss the use of labour productivity measures for opex or suggest that their use would

[17] **[TSS1/02]**, §3.86
[18] Frontier Economics (2017), Productivity improvement in the water and sewerage industry in England since privatisation – Final report for Water UK **[TSS1/04]**
[19] **[TSS1/02]**, §4.570

be wrong. GEMA had good reasons for using labour productivity measures for opex: see GEMA's Response of 23 April 2021, §132; witness statement of Gary Keane, §67.

(3) NGN (§25(i)), SGN (§35) and SPT (§37) contend that the CMA's approach suggests that GEMA placed too much emphasis on an economy-wide comparator set. However, the CMA's Final Report does not suggest that it was wrong for GEMA to have regard to both the unweighted average of a narrow set of certain comparator sectors and the weighted average of the entire economy. Furthermore, there were more sectors in the comparator set used by the CMA, including certain manufacturing sub-sectors which have historically seen high productivity growth.

(4) Cadent (§15) and NGN (§25(iv)) refer to the fact that the CMA did not include any "innovation uplift". However, GEMA's decision to include such an uplift was driven by the fact that energy network companies had received entirely unique innovation funding over the course of RIIO-1. Water companies have not historically received this type of funding.

(5) Cadent contends that, had the CMA used a data window similar to that used by GEMA (i.e. 1997-2016), *"its final target would have been around 0.85 percent per year, assuming the same increase of around 0.3 percent to account for the qualitative factors listed above"* (§20). However, in its decision to apply an upwards adjustment of 0.3% to its starting point of 0.7%, the CMA appears to have taken into account that this starting point was not based on data from the period following the financial crisis. Therefore, it is speculation for Cadent to suggest that the CMA would have applied the same increase had it started from a different point based on more recent data.

D. <u>The Catch-Up Efficiency Challenge</u>

(i) <u>The CMA's approach at PR19</u>

14. In its Final Report at PR19, the CMA decided to set a catch-up efficiency challenge at the upper quartile. It did so for reasons which were very similar to those it had advanced in its Provisional Findings. In summary, the CMA reasoned that a benchmark at the upper

quartile *"balances our objective of setting a challenging benchmark while acknowledging the limitations of the econometric modelling (and the consequent risk that the company will have insufficient allowed revenue)"*.[20] The CMA considered the overall model effectiveness and whether there had been substantial econometric modelling improvements compared to the models used by Ofwat and concluded that there had not been.[21] It further explained that it placed *"little or no weight"* on the following factors:[22]

(1) The fact that GEMA had chosen an efficiency challenge *"tougher"* than the upper quartile. The CMA stated, *"These regulators are regulating different sectors with different companies, so there is limited read across to our decision"*.

(2) Evidence that the absolute level of the efficiency challenge had fallen, particularly for wastewater.

(3) Evidence on past outperformance of the industry, which showed an average overspend on wholesale totex allowance of 1%. The CMA noted that, *"This is only a relatively modest over-spend and multiple factors could have led to this outcome"*.

(4) A comparison of the companies' business plans with the modelled allowances.

(5) Although *"Ofwat is correct that monopolies may be less efficient than companies operating in competitive sectors, the regulatory regime is designed to mimic aspects of competitive pressure and reduce any x-inefficiency"*.

(6) The fact that the CMA's Bristol PR14 Determination used an average efficiency challenge. The CMA noted that that decision, *"employed a different methodology and therefore comparisons of modelling accuracy between that approach and our current approach are inapposite"*.

(ii) <u>Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2</u>

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[20] **[TSS1/02]**, §4.494
[21] **[TSS1/02]**, §4.492
[22] **[TSS1/02]**, §4.493

15. The CMA's decision to use the upper quartile as the catch-up efficiency challenge in PR19 does not establish that GEMA was wrong to set an efficiency challenge at the upper quartile for the first year of RIIO-2, moving to the 85th percentile in the last two years of RIIO-1 with a straight line glidepath. For the reasons explained in GEMA's Response of 23 April 2021:

(1) GEMA's decision was justified on the basis of: (i) GEMA's confidence in the modelling results, driven principally by the materially improved data it had collected during RIIO-GD1; and (ii) the fact that all GDNs had consistently and materially outperformed on their allowances at RIIO-GD1, which suggested it was appropriate to tighten the catch-up efficiency challenge (§261(1)-(2)).

(2) The fact that other regulators in other industries may set efficiency benchmarks at different levels does not impugn the decision of GEMA in this case (§261(4)). The CMA itself recognised that there was limited read across between its decision in relation to the water sector and GEMA's decision in relation to energy. Further, GEMA's efficiency benchmark was well within the range of regulatory precedents and not materially more challenging than the benchmark set at RIIO-GD1 when considered in absolute terms (§273).

16. The relevant Appellants (NGN and SGN) contend that the CMA's decision at PR19 suggests that GEMA was wrong to have regard to factors other than the robustness of its econometric model in selecting the catch-up efficiency challenge. These arguments are without merit for the reasons given in GEMA's Response of 23 April 2021 at §§288-291 and 299. The fact that the CMA decided to have little or no regard to other factors in its Final Report in PR19 does not suggest that similar factors are irrelevant in other contexts. The question of what is or is not a relevant consideration is a matter for GEMA to determine in the exercise of its regulatory discretion.[23]

E. <u>Materiality threshold for company-specific claims</u>

[23] See e.g. *R (Khatun) v Newham London Borough Council* [2005] QB 37, §35 per Laws LJ, **[TSS1/05]**

(i) The CMA's approach at PR19

17. For PR19, Ofwat applied materiality thresholds when assessing companies' "Cost Adjustment Claims" ("CACs").[24] The thresholds applied by Ofwat ranged from 1% to 6% of business plan (5-year) totex, depending on the price control in question.[25] Ofwat considered that the materiality threshold *"balance[d] a proportionate regulatory approach with companies' exposure to claim costs"*.[26]

18. The CMA, in its PR19 Provisional Findings, agreed with the application of materiality thresholds when assessing CACs. The CMA considered the application of materiality thresholds was sensible and pragmatic, given the need to prioritise resources and the fact that companies are in practice likely only to request adjustments that increase their allowances.[27]

19. The CMA maintained this position when assessing CACs in its Final Report on PR19: *"The application of materiality thresholds here is sensible, consistent with Ofwat's approach and pragmatic, given that companies are more likely to raise complaints about specific circumstances than to report where they benefit from specific circumstances."*[28]

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

20. CACs were considered by Ofwat as *post*-modelling costs assessment adjustments. GEMA's *pre*-modelling company-specific factor adjustments at RIIO-GD2 were made for similar purposes. GEMA set the materiality threshold for such claims at 0.5% of gross

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[24] The CACs process set out by Ofwat in PR19 allowed each company to apply for an adjustment to its cost allowance to the extent that Ofwat's modelled baseline was not already deemed to account adequately for such differences. The circumstances giving rise to CACs included unique operating circumstances, legal requirements or atypical expenditure, all of which resulted in higher efficient costs for the company relative to other water companies. Water companies submitted CACs in their business plans with supporting evidence, and Ofwat assessed them based on criteria set out in the final methodology for PR19. See Ofwat (2017), *Delivering Water 2020: Our final methodology for the 2019 price review*, **[TSS1/06]** Chapter 9; and *Delivering Water 2020: Our methodology for the 2019 price review, Appendix 11: Securing cost efficiency* **[TSS1/07]**.

[25] See MW7, §59; and Ofwat (2019), *Technical appendix 2: Securing cost efficiency – our approach for setting efficient cost baselines at the IAP*, **[TSS1/08]** p.23

[26] Ofwat (2017), *Delivering Water 2020: consultation on PR19 methodology*: *Appendix 12: Securing cost efficiency*, **[TSS1/09]** p.4

[27] CMA PR19 Provisional Findings, **[TSS1/10]**, §§4.580 and 6.30; see also GEMA's Response of 23 April 2021, §382

[28] **[TSS1/02]**, §4.931

un-normalised totex. It adopted this threshold for similar reasons to those Ofwat relied on to justify its materiality threshold (see MW7, §§51-60 and GEMA's Response of 23 April 2021, §381 for GEMA's justification).

21. In circumstances where (a) Ofwat's PR19 materiality threshold for CACs was higher than GEMA's threshold for company specific claims, and (b) overall, Ofwat's PR19 evidential bar was arguably more demanding than GEMA's (see MW7, §49), the CMA has upheld a more stringent approach to materiality in its PR19 Final Report than that adopted by GEMA at RIIO-GD2. It follows that there is nothing in the CMA's decision which indicates GEMA exceeded the bounds of its expert judgement in applying the materiality threshold it did.

10 May 2021