

**BEFORE THE COMPETITION AND MARKETS AUTHORITY**

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

**B E T W E E N :**

**NATIONAL GRID ELECTRICITY TRANSMISSION PLC**

**NATIONAL GRID GAS PLC**

**Appellants**

**and**

**GAS AND ELECTRICITY MARKETS AUTHORITY**

**Respondent**

**REPLY TO GEMA'S RESPONSE  
ENERGY LICENCE MODIFICATION  
RIIO-2**

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## SECTION 1: INTRODUCTION

- 1.1 On 23 April 2021, GEMA provided its response (the **Response**) to the Notices of Appeal and supporting documentation (the **March Appeal Documents**) submitted by National Grid Electricity Transmission plc (**NGET**) and National Grid Gas plc (**NGG**) (together, the **Appellants**). This reply to GEMA's Response (the **Reply**) is made by the Appellants in support of their appeals against GEMA's RIIO-T2 Decision made on 3 February 2021 (the **Appeals**).<sup>1</sup>
- 1.2 In accordance with the CMA's correspondence,<sup>2</sup> and consistent with the overriding objective, the Appellants have sought to ensure that this Reply is targeted solely at points contained in GEMA's Response and does not duplicate previous submissions.<sup>3</sup>
- 1.3 Taking the above into account, the Appellants have structured this Reply in four parts:
- (a) the first addresses the main themes in GEMA's Response and summarises the Appellants' key points in reply (Section 2);
  - (b) the second sets out the Appellants' more detailed points of reply on Ground 1: COE<sup>4</sup> (Section 3);
  - (c) the third sets out the Appellants' more detailed points of reply on Ground 2: Outperformance Wedge (Section 4); and
  - (d) the fourth addresses certain legal points that arise in GEMA's Response (Section 5).
- 1.4 This Reply is supported by the documents in Exhibit R1, an Expert Witness Statement of Mike Huggins, Director, Frontier Economics dated 10 May 2021 (**MH3**) and the exhibit "Reply to Ofgem's Response to RIIO-2 Appeals" prepared for National Grid, dated 10 May 2021 (the **Frontier May Report**).

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<sup>1</sup> The CMA granted permission to hear the Appeals on 31 March 2021 subject to the Appeals being heard together.

<sup>2</sup> Letters from the CMA to all parties dated 7 and 15 April 2021, and email from the CMA to all parties dated 27 April 2021.

<sup>3</sup> Where the Appellants do not comment on points arising in GEMA's Response this should not be taken as an endorsement of those points.

<sup>4</sup> Where appropriate, the Appellants have adopted the same defined terms in this submission as were used in the March Appeal Documents.

## SECTION 2: SUMMARY

### A. Introduction

- 2.1 In this section the Appellants focus on three key themes that arise from GEMA's Response, namely: the **failure to address many of the errors** raised by the Appeals; GEMA wrongly stating that its decisions on the COE and outperformance wedge **fall within the scope of regulatory discretion** and therefore are not susceptible to appeal; and GEMA wrongly suggesting that **none of the alleged errors are capable of giving rise to consumer harm** so there is nothing for the CMA to remedy.

### B. GEMA has failed to address many of the errors raised by the Appeals

- 2.2 In its Response, GEMA fails to respond to many of the specific points raised in the Appellants' March Appeal Documents.
- 2.3 Most notable on Ground 1: COE is GEMA's failure to adequately address the issues within the **Insufficient COE Error**. Notwithstanding the Appellants' position that GEMA has made errors at each stage in setting the COE, namely in selectively setting the CAPM parameters, applying erroneous cross-checks and failing to aim up, the Appellants' overarching argument is that these failures resulted in GEMA wrongly setting the COE at an insufficient level for RIIO-2.<sup>5</sup>
- 2.4 In the Response GEMA fails to justify why its overall COE is sufficient for the Appellants for RIIO-2. A particular difficulty GEMA faces is that, on the one hand, it has determined that the beta for energy companies should be higher than that for water companies (recognising the higher systematic risks faced by the energy sector) and yet, on the other hand, GEMA has set an overall COE that is lower than the CMA set for the water sector. This is a clear indicator that GEMA's decision is wrong.
- 2.5 In addition to not engaging with the key error identified in Ground 1 of the Appellants' Notices of Appeal, GEMA has not commented on parameter-level errors identified in the March Appeal Documents, such as GEMA's sole reliance on ILGs as a proxy for the RFR,<sup>6</sup> and evidence that the CED/CPI data series is likely to materially overstate CPI inflation.<sup>7</sup>
- 2.6 On Ground 2: Outperformance Wedge, GEMA's Response again fails to address all of the points raised in the Appeals. GEMA's position is that the outperformance wedge is necessary because 'companies always outperform'. Yet GEMA has ignored (a) the in-principle arguments against a significant deduction from allowed returns after the price control has been calibrated, (b) the many changes it has introduced since RIIO-1 which make outperformance far less likely in RIIO-2, as shown by its own data, and (c) the discriminatory and disproportionate impact on NGET and NGG, even on its own adjusted figures.
- 2.7 GEMA has failed to adequately address the Appellants' claims that the outperformance wedge is unjustified and harmful. GEMA has largely ignored evidence that the outperformance wedge will materially harm incentives and provided insufficient answers to the risks of underinvestment at a time when vital transformation is required.
- 2.8 The Appellants note GEMA's disclaimer to the effect that, where it does not expressly respond to a particular paragraph of any Notice of Appeal, it should not be taken to be accepting the relevant submission.<sup>8</sup> However, GEMA is required to respond to the errors identified in the Notices of Appeal. The Appellants submit that, in the absence of any adequate response, the Appeals

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<sup>5</sup> See NGET, Notice of Appeal, Section E and NGG, Notice of Appeal, Section E.

<sup>6</sup> NGET, Notice of Appeal, paragraphs 3.31 to 3.47; NGG, Notice of Appeal, paragraphs 3.31 to 3.47.

<sup>7</sup> NGET, Notice of Appeal, paragraphs 3.155 to 3.169; NGG, Notice of Appeal, paragraphs 3.155 to 3.169.

<sup>8</sup> Response, Finance Issues, paragraph 2.

should be allowed and the CMA should apply the relief sought by the Appellants in the March Appeal Documents.

### **C. GEMA is wrong to state errors fall within the scope of regulatory discretion**

- 2.9 A core theme pervading the Response is GEMA's reliance on 'regulatory discretion and judgement' which it uses liberally, along with 'materiality', as a form of 'get out of jail free' card.
- 2.10 However, taking a selective rather than a balanced view of evidence is not within the scope of regulatory discretion. It is plainly wrong to suggest that GEMA's discretion is so broad that none of the points raised by the Appellants can be classified as errors. Even if the CMA were to accept that individual errors raised were within the scope of regulatory judgement (which the Appellants dispute), the cumulative impact exposes the materiality and importance of the errors made. At 4.3%, GEMA's allowed equity return inclusive of the outperformance wedge is 80bps below the PR19 CMA outcome for the water sector adjusted for GEMA's own view of the energy network beta of 5.1%.<sup>9</sup> Notwithstanding other errors in GEMA's FD, for NGET and NGG 80bps is the equivalent of around £400m of revenue in the RIIO-2 period.
- 2.11 The Appellants have no doubt that the CMA will want to focus its time and attention on determining these substantive errors rather than on re-examining the legal standard of review (given this has been well-established in previous appeals). However, to assist the CMA, the Appellants have provided a brief reply to these legal points in section 5.

### **D. GEMA is wrong to suggest that there is no risk to consumers**

- 2.12 GEMA further stretches credibility in its Response by adopting the position that none of this matters in any event. According to GEMA, RIIO-2 is no different from RIIO-1<sup>10</sup> and, even if the COE is set too low and the wedge distorts companies' incentives to perform, any risk of consumer harm is low.<sup>11</sup> Indeed, GEMA goes so far as to suggest that the COE can be uplifted at any point if set too low<sup>12</sup> and states that the outperformance wedge is a "*modest*"<sup>13</sup> and "*conservative*"<sup>14</sup> adjustment which "*reflects information asymmetry rather than effort*".<sup>15</sup> In fact, nothing could be further from the truth. GEMA recognises that "*the drive towards Net Zero (i.e. net zero carbon emissions by 2050) is creating an unprecedented demand for investment in the network*".<sup>16</sup> Yet, GEMA's Response is divorced from this reality and fails to engage with the substantive risks and challenges that the networks face in RIIO-2 arising from the transition to Net Zero.
- 2.13 It is telling that the biggest challenge of our generation, namely the impact of climate change, hardly warrants a mention in GEMA's Response. There is no doubt that meeting the Net Zero carbon target by 2050 will require fundamental change. This is certainly the case in both the electricity and gas transmission sectors where transformational change is needed in the next five years to enable the UK's target of 40GW of offshore wind generation by 2030 – an increase of 30GW from today – and at least 5GW of hydrogen production capacity by 2030 from a position of almost zero today.
- 2.14 To connect the required offshore wind to the onshore network, NGET alone will have to start work on at least ten schemes of over £100m each in RIIO-2 when it has only undertaken two in the eight years of RIIO-1. These projects will also have to be delivered quicker than ever as the current timelines of seven to ten years will not deliver the progress the Committee on Climate Change consider is necessary to enable the UK to meet its long-term Net Zero targets. As owner

<sup>9</sup> NGET and NGG, Submission on PR19 FR, paragraph 1.9.

<sup>10</sup> Response, Finance Issues, paragraph 314.

<sup>11</sup> Response, Finance Issues, paragraph 8.2.

<sup>12</sup> First Witness Statement of Simon Wilde, paragraph 108.7; First Witness Statement of Akshay Kaul, paragraph 82.3.

<sup>13</sup> Response, Finance Issues, paragraph 308.

<sup>14</sup> Response, Finance Issues, paragraph 291.

<sup>15</sup> Response, Finance Issues, paragraph 350.

<sup>16</sup> Response, Totex Modelling, Efficiency and Licensing, paragraph 187(3).

## NON-SENSITIVE VERSION

of the only cross-GB gas network, NGG will need to form the backbone of a hydrogen network to transport that gas across the country and into the local distribution networks, testing, developing and implementing new technologies on a network with assets which are over 40 years old.

- 2.15 GEMA itself recognises that at least £10bn of investment above baseline allowances will be required in RIIO-2, with over £5bn of that projected in National Grid. The majority of this investment is linked to Net Zero targets. GEMA says that its flexible RIIO-2 framework and licence obligations will mean this investment can progress but it is missing a simple point. Networks need to bring these projects forward for assessment. Faced with a return that does not match the risk involved with the transformational change requirements of greater innovation, pace and scale of delivery, networks will hold back and de-risk.
- 2.16 It is not in consumers' interests to get this wrong. To suggest insufficient returns and the outperformance wedge will have no impact on investment and productivity levels is clearly a flawed conclusion. And to take that risk at a time when the UK needs returns consistent with the transformation required for Net Zero shows a striking disregard for the real world consequences.

## SECTION 3: GROUND 1 - COE

### A. Introduction

- 3.1 In this section the Appellants set out the main points in reply to GEMA's Response insofar as they concern Ground 1: COE. The Appellants also request that the CMA reads sections 3 to 9 of the Frontier May Report for further details.
- 3.2 As a preliminary point, the Appellants note that GEMA has continued not to engage with the evidence presented by the Appellants on the COE. Given that the Appellants' positions on these issues are set out in the March Appeal Documents, they are not repeated here other than to provide some examples of the key points in the COE ground where GEMA's Response fails to adequately address the Appellants' concerns.

### B. CAPM Selectivity error

- 3.3 Section B of Ground 1 of the Notices of Appeal sets out in detail the series of errors made by GEMA in setting the COE for RIIO-2. When assessing each COE parameter (RFR, beta and TMR), GEMA consistently selected the methodologies or data that would tend towards a low and insufficient COE. In its Response, GEMA repeatedly fails to provide adequate reasoning for its decision, but rather seeks to justify its decision on the COE by reference to the exercise of its "expert regulatory judgement".<sup>17</sup> The Appellants fundamentally disagree with this purported justification. A decision to take a selective approach to evidence fails to take account of all relevant considerations and is not a legitimate exercise of regulatory judgement. As set out in Annex 1 to the Notices of Appeal, such a decision is wrong.<sup>18</sup>
- 3.4 In relation to the RFR, the Appellants make two observations in relation to GEMA's Response. First, GEMA failed to take proper account of the shortcomings of ILGs as a proxy for the RFR. Second, GEMA was wrong not to take account of AAA-rated corporate bonds as a proxy for the RFR.<sup>19</sup>
- 3.5 Taking the first of these points, as set out in the Notices of Appeal, GEMA's decision to rely solely on ILGs when estimating the RFR resulted in an RFR that was too low.<sup>20</sup> GEMA argued in the Response that the Appellants' objections are a disagreement with how GEMA has exercised its discretion.<sup>21</sup> GEMA's position is untenable, as demonstrated by the PR19 FR, where the CMA clearly signalled that the approach of using ILGs as the sole proxy for the RFR will understate the RFR.<sup>22</sup>
- 3.6 GEMA appears to recognise these concerns in the Response and notes that "*GEMA has not taken the view that ILGs provide a perfect, error-free proxy for the RFR*" (emphasis added).<sup>23</sup> However, although GEMA has recognised this error in its approach, it has not corrected it.
- 3.7 Despite this error, GEMA has sought to justify its reliance on ILGs as a proxy for the RFR because it is "*simpler*".<sup>24</sup> Simplicity is not an adequate justification for GEMA's decision to exclude the more robust, practical alternatives put forward by the Appellants.

<sup>17</sup> See for example, Response, Finance Issues, paragraph 8.1.

<sup>18</sup> The Appellants set out the statutory grounds of their appeals in detail in Annex 1 of their respective Notices of Appeal.

<sup>19</sup> GEMA notes in paragraph 66 of Response, Finance Issues, that the energy network companies proposed AAA-rated corporate bonds as a proxy after the DD. However, the CMA had already by that point considered this proxy in the NATS Appeal and PR19 Redeterminations, in which GEMA intervened (see NGET DP1, paragraphs 71 to 73, and NGG DP1, paragraphs 75 to 77).

<sup>20</sup> NGET, Notice of Appeal, paragraphs 3.31 to 3.47; NGG, Notice of Appeal, paragraphs 3.31 to 3.47.

<sup>21</sup> Response, Finance Issues, paragraph 69.

<sup>22</sup> PR19 FR, paragraph 9.106 [MH2/2.1].

<sup>23</sup> Response, Finance Issues, paragraph 73.

<sup>24</sup> Response, Finance Issues, paragraph 76.

- 3.8 With regard to the second point, GEMA sought to challenge the use of AAA-rated corporate bonds based on the number of adjustments it considers would be necessary to derive an appropriate RFR.<sup>25</sup> As a preliminary point, the Appellants note that GEMA's criticisms of the use of AAA-rated corporate bonds as a proxy for the RFR are immaterial and exaggerated.<sup>26</sup> More significantly, GEMA's concern about the need to make adjustments misses the point. Even without making any complex adjustments to ILGs and AAA-rated corporate bonds, GEMA could have estimated the RFR more robustly than by using ILGs alone. The CMA recognised this and adopted a more robust approach in the PR19 FR.
- 3.9 GEMA has already introduced a RIIO-2 framework which is very complex. So refusing to undertake a methodological approach to determining the RFR for reasons of simplicity is not consistent with GEMA's approach in other aspects of the RIIO-2 framework. In any event, as explained in the Frontier May Report, the increase in complexity of indexing an RFR that blends the use of ILGs and AAA-rated corporate bonds is only slight and the input data is readily available as the data service required is also used by GEMA in setting the cost of debt allowance.<sup>27</sup>
- 3.10 Further, indexation of the RFR does not justify GEMA's approach of setting it too low to begin with. GEMA claims indexation will prevent the COE falling out of line as the market moves<sup>28</sup> but fails to appreciate that it has set the RFR too low to begin with. Indexation will not correct GEMA's error but will perpetuate it; an indexed RFR will move with the market and, in so doing, will continue to be at too low a level.
- 3.11 In relation to equity beta, GEMA characterises the errors as being issues of regulatory judgement which "*in many cases have no material impact on the RIIO-2 allowed return unless combined with other alleged errors*".<sup>29</sup> Table 4 of DP1 demonstrated that, with everything else equal to the FD, a more appropriate weighting of National Grid plc's beta adds between 24 and 47bps to the COE. This is a material value.
- 3.12 In terms of failing to place adequate weight on National Grid plc's beta, GEMA's Response is highly selective. GEMA selectively chose data points from its tables to support its point estimate (0.311), but a more balanced consideration of all the evidence (recognising issues such as sample length, energy versus water, book value of debt basis) shows that GEMA's data points support higher values. As shown in the Notices of Appeal,<sup>30</sup> 0.311 is below 80% of GEMA's own data points for National Grid plc across 2-year, 5-year and 10-year estimation windows.<sup>31</sup> Therefore, to highlight one example where its beta is in line with that of National Grid plc is selective and fails to reflect the underlying evidence. GEMA's reliance on this single estimation window – to the exclusion of other evidence – does not change the basic error that the beta has been set too low.
- 3.13 In relation to TMR, GEMA similarly claims the various errors are disagreements with its regulatory judgement. GEMA asks the CMA not to supplant GEMA's judgement:<sup>32</sup>
- There is no justification for doing so on the basis of a "slight" difference, especially when GEMA's mid-point of 6.5% is identical to the CMA's decision in NATS and where GEMA's range overlaps considerably with the CMA's PR19 range.*
- 3.14 In the Notices of Appeal, the Appellants explained that the CMA undertook an incomplete and less detailed assessment of TMR in the NATS Appeal than in the PR19 PFs.<sup>33</sup> In its Response, GEMA does acknowledge the CMA's findings on TMR in the PR19 Redeterminations, claiming

<sup>25</sup> Response, Finance Issues, paragraph 86.

<sup>26</sup> Frontier May Report, paragraphs 3.2.20 to 3.2.28 [MH3/1].

<sup>27</sup> Frontier May Report, paragraph 3.2.8 [MH3/1].

<sup>28</sup> Response, Finance Issues, paragraph 86.

<sup>29</sup> Response, Finance Issues, paragraph 141.

<sup>30</sup> NGET, Notice of Appeal, figure 2 at paragraph 3.106; NGG, Notice of Appeal, figure 2 at paragraph 3.106.

<sup>31</sup> Frontier May Report, paragraphs 4.2.11 to 4.2.14 [MH3/1].

<sup>32</sup> Response, Finance Issues, paragraph 123.

<sup>33</sup> NGET, Notice of Appeal, paragraph 3.168; NGG, Notice of Appeal, paragraph 3.168.



that the “*range overlaps considerably*”.<sup>34</sup> However, it is wrong for GEMA to point to similarities between the CMA’s findings on TMR in the PR19 FR and GEMA’s decision in the FD given that the top of GEMA’s range does not even reach the mid-point of the CMA PR19 FR range.<sup>35</sup>

- 3.15 GEMA has also failed to address the issue raised in the March Appeal Documents<sup>36</sup> that the CPI-deflated TMR would result in the TMR range being understated, choosing simply to criticise RPI-deflated measures rather than considering the underlying error in the data it relied on.
- 3.16 Instead, GEMA suggests that the Appellants have “*provided no evidence that adequately addresses the problems with the CED/RPI data series*”.<sup>37</sup> GEMA’s statement is incorrect. The Appellants acknowledged the problems associated with the CED/RPI data series<sup>38</sup> and considered both CPI- and RPI-deflated measures in their proposed TMR range.<sup>39</sup>
- 3.17 Selectivity is also a theme running through GEMA’s defence of the TMR estimation. The Frontier May Report explains<sup>40</sup> that of the four sources of evidence considered, two (DDM and investment manager forecasts) sit within the set of forward looking, short run sources of evidence that the CMA determined were insufficiently reliable to be relied on in its work on PR19. Reliance on these measures would also fly in the face of GEMA’s own stated intent, which was to rely primarily on evidence from long run historical averages.<sup>41</sup> A third, (the US\$ cross-check) has again been rejected by the CMA as essentially uninformative, as it would only yield a reliable estimate of UK returns if purchasing power parity holds.
- 3.18 GEMA’s approach to selective use of data is also evident from the data source used to justify GEMA’s uplift between arithmetic and geometric returns and its approach to holding periods.<sup>42</sup>
- 3.19 In contrast, the Appellants and Frontier considered a broad range of evidence for the TMR and achieved a far greater overlap with the range identified in the CMA PR19 FR.

### C. Cross-checks error

- 3.20 GEMA’s Response to the various errors in its application of cross-checks is somewhat confusing and fails to address the key criticisms raised in the Appellants’ submissions. GEMA identifies that different appellants have criticised different cross-checks, and argues that there is “*no clear or united front in respect of the objections the Appellants wish to raise*”.<sup>43</sup> In fact, all eight appellants have submitted that GEMA’s cross-checks are wrongly applied, and therefore do present a “*united front*” on the key issue. Where different appellants have focussed on different problems with GEMA’s cross-checks, this does not mean any of those individual criticisms are invalid, but rather shows just how many flaws there are in GEMA’s approach.
- 3.21 GEMA continues to rely on a set of cross-checks that are flawed. As explained in the Frontier May Report,<sup>44</sup> these cross-checks do not reliably support the low COE range that GEMA derived from them once the methodological flaws, selective use of data and inherent uncertainties within them are taken into account. The Frontier May Report also explains that GEMA, in supporting its claim that cross-checks are a “*well-established feature of regulatory decision making*”,<sup>45</sup> has misrepresented the previous regulatory decisions which it cites.<sup>46</sup> The Frontier May Report further

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<sup>34</sup> Response, Finance Issues, paragraph 123.

<sup>35</sup> Appellants, Submission on PR19 Final Report, 23 April 2021, paragraph 2.22.

<sup>36</sup> NGET, Notice of Appeal, paragraphs 3.155 to 3.169; NGG, Notice of Appeal, paragraphs 3.155 to 3.169; NGET, DP1, paragraphs 251 to 253; NGG, DP1, paragraphs 247 to 249.

<sup>37</sup> Response, Finance Issues, paragraph 118.

<sup>38</sup> NGET, DP1, paragraphs 251 to 253; NGG, DP1, paragraphs 247 to 249.

<sup>39</sup> Cost of Equity Report, Figure 10 and Section 5.5 [MH3/1].

<sup>40</sup> Frontier May Report, paragraphs 5.2.3 to 5.2.5 [MH3/1].

<sup>41</sup> SSMD, Finance Annex, paragraphs 3.44 and 3.104 [NOA1/5].

<sup>42</sup> Frontier May Report, paragraphs 5.2.14 to 5.2.15 [MH3/1].

<sup>43</sup> Response, Finance Issues, paragraph 178.

<sup>44</sup> Frontier May Report, Section 6 [MH3/1].

<sup>45</sup> Response, Finance Issues, paragraph 183.

<sup>46</sup> Frontier May Report, paragraphs 6.2.12 to 6.2.20 [MH3/1].

highlights that GEMA has offered no response to the series of important concerns the Appellants have raised with the whole approach adopted by GEMA, concerning the dangers of relying on flawed cross-checks that depend on data that is short-run, volatile and noisy.<sup>47</sup>

- 3.22 Further, GEMA has misunderstood the Appellants' submission that its refusal to include additional cross-checks proposed by stakeholders was an error. GEMA states "*the appropriate focus in an appeal is whether there is an error in the regulator's approach, and not whether some alternative approach might be better*".<sup>48</sup> This misinterprets the Appellants' submission. It is not that GEMA must follow an alternative approach but rather that GEMA has failed to take into account a full range of cross-checks, which would have provided a more robust cross-check. GEMA's reliance on a narrow range of cross-checks is selective. GEMA's reasons for not considering three cross-checks which would give a higher COE do not stand up to scrutiny,<sup>49</sup> as explained in the Frontier May Report.<sup>50</sup> GEMA wrongly dismisses these cross-checks out-of-hand, rather than including them alongside its own chosen cross-checks which are subject to similar, if not greater, failings.
- 3.23 Even more problematic are GEMA's ambiguous comments on the purpose and significance of its cross-checks. As explained in the Frontier May Report,<sup>51</sup> GEMA concedes that many of its cross-checks involve assets with different risk profiles and gearing levels to GB regulated energy utilities. In spite of this, readers are advised not to worry about the shortcomings of GEMA's chosen cross-checks; as they are not primary evidence, there is "*simply no room*"<sup>52</sup> for them to have a material effect on its decision, and GEMA argues that they therefore cannot give rise to a material error. Yet readers are also told that the use to which the cross-checks were put, of lowering the top of the COE range, is "*fundamentally important*",<sup>53</sup> and that they give GEMA confidence that the COE is not too low<sup>54</sup> and has even acted conservatively (in favour of network companies).<sup>55</sup>
- 3.24 There is a clear inconsistency in GEMA's argument. On the one hand GEMA claims that the cross-checks had immaterial (or no) effect on the COE because the point value of 4.55% was not adjusted, but elsewhere GEMA uses its approach to cross-checks to argue that it has aimed up from a cross-check range midpoint of 4.4%. Both of these positions cannot hold true. The Appellants maintain their position that GEMA:
- (a) used cross-checks as primary evidence, by adjusting downwards its CAPM-produced COE range based on the range produced by its selection of cross-checks in the FD; and
  - (b) did not aim up when setting the COE, as has been further evidenced by statements in GEMA's Response (see paragraph 3.26 below).
- 3.25 Having considered GEMA's Response, the Appellants are increasingly of the view that GEMA deliberately adopted an ambiguous, convoluted and non-transparent position on cross-checks in the FD. This is a further example of GEMA's approach breaching the principles of best regulatory practice.<sup>56</sup>

## D. Aiming up error

- 3.26 GEMA seeks to downplay the significance of its error to not aim up, describing this as "*an arid linguistic quibble*".<sup>57</sup> However, GEMA's Response fails to engage with the substance of the errors

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<sup>47</sup> Frontier May Report, paragraph 6.2.10 [MH3/1].

<sup>48</sup> Response, Finance Issues, paragraph 239.

<sup>49</sup> Response, Finance Issues, paragraphs 240 to 243.

<sup>50</sup> Frontier May Report, paragraphs 6.2.25 to 6.2.31 [MH3/1].

<sup>51</sup> Frontier May Report, paragraph 6.2.3 [MH3/1].

<sup>52</sup> Response, Finance Issues, paragraph 246.

<sup>53</sup> Response, Finance Issues, paragraph 181.

<sup>54</sup> First Witness Statement of Simon Wilde, paragraph 64.

<sup>55</sup> Response, Finance Issues, paragraph 182.

<sup>56</sup> Section 3A(5A) EA89 [NGET NOA1/30] and section 4AA(5A) GA86 [NGG NOA1/30].

<sup>57</sup> Response, Finance Issues, paragraph 259.

set out in the Appellants' March Appeal Documents. In the interests of concision, the Appellants focus here on just three of these errors.

- 3.27 First, GEMA's decision not to aim up is poorly reasoned and relies on flawed assumptions and evidence.<sup>58</sup>
- 3.28 GEMA's Response displays the same poor reasoning and flawed assumptions as applied in the FD. In particular, GEMA's Response exhibits a serious case of cognitive dissonance: on the one hand, GEMA readily acknowledges that the real COE "*can never be truly known*", calling estimation of the COE "*an exercise in the unknown*".<sup>59</sup> However, GEMA elsewhere shows absolute faith that its own assessment of the COE (based on its flawed set of cross-checks) is adequate – if not more than adequate – such that there is simply no need to aim up to address the acknowledged risk of setting the COE too low.<sup>60</sup>
- 3.29 GEMA's Response repeats the basis for its decision not to aim up in the FD, but fails to respond to the arguments set out in the Appellants' Notices of Appeal as to why the decision not to aim up is poorly reasoned and relies on flawed assumptions and evidence:
- (a) GEMA refers heavily to the treatment of aiming up in the NATS PFs<sup>61</sup> without responding to the Appellants' point that the NATS assessment was incomplete and that PR19 represents a far more relevant precedent.<sup>62</sup>
  - (b) GEMA references CMA precedent for Bristol Water (PR14) and mischaracterises this decision as not involving aiming up when in fact the opposite is true,<sup>63</sup> as the Appellants explained in their Notices of Appeal.<sup>64</sup>
  - (c) GEMA also states that the New Zealand Commerce Commission (**NZCC**) has "*shift[ed] away from aiming up*".<sup>65</sup> As Frontier has already pointed out, this is simply incorrect: the NZCC decided not to aim up in the 'factual context' of regulating fibre networks based on the same analytical framework it has used for other regulated sectors in respect of which it aimed up.<sup>66</sup>
  - (d) While GEMA purports to identify a limited number of exceptions where there was no aiming up, its examples of not aiming up in regulatory decisions are either wrong or the result of atypical circumstances.<sup>67</sup> Moreover, GEMA fails to acknowledge the fact that in general, the principle of aiming up is well-established, including in its own previous decisions.<sup>68</sup> GEMA's decision to now disagree with the principle of aiming up does not change the fact that aiming up has been and continues to be well-established best practice, as was made clear by the cases cited in the Appellants' Notices of Appeal,<sup>69</sup> and as has been acknowledged by the CMA.<sup>70</sup>
  - (e) GEMA fails to appreciate that the widespread use of uncertainty mechanisms increases rather than mitigates the need to aim up.<sup>71</sup> Where the COE is set too low, companies will

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<sup>58</sup> NGET, Notice of Appeal, paragraphs 3.350 to 3.364; NGG, Notice of Appeal, paragraphs 3.350 to 3.364.

<sup>59</sup> Response, Finance Issues, paragraph 59.

<sup>60</sup> First Witness Statement of Simon Wilde, paragraph 64.

<sup>61</sup> First Witness Statement of Simon Wilde, paragraph 79.

<sup>62</sup> NGET, Notice of Appeal, paragraph 3.352; NGG, Notice of Appeal, paragraph 3.352.

<sup>63</sup> First Witness Statement of Simon Wilde, paragraph 75.

<sup>64</sup> NGET, Notice of Appeal, paragraph 3.356; NGG, Notice of Appeal, paragraph 3.356.

<sup>65</sup> First Witness Statement of Simon Wilde, paragraph 104.

<sup>66</sup> Cost of Equity Report, page 100, footnote 243 [MH1/1].

<sup>67</sup> Frontier May Report, paragraphs 6.2.12 to 6.2.20 [MH3/1].

<sup>68</sup> First Witness Statement of Simon Wilde, paragraph 72.

<sup>69</sup> NGET, Notice of Appeal, paragraphs 3.332 to 3.346; NGG, Notice of Appeal, paragraphs 3.332 to 3.346.

<sup>70</sup> PR19 FR, paragraph 9.1226 [MH2/2.1].

<sup>71</sup> Response, Finance Issues, paragraph 257.7.

not choose to bring forward discretionary investments covered by uncertainty mechanisms where they are value destructive.

- (f) GEMA fails to appreciate that RFR indexation does not mitigate against the risk of setting the COE too low to begin with.<sup>72</sup>
- (g) GEMA confuses whether companies will propose additional investment projects with whether they are incentivised to be efficient in delivering a project, which are two separate issues (see below).<sup>73</sup>

3.30 Second, GEMA's failure to aim up is harmful because it will undermine companies' incentives to invest and undermine investor confidence, and any failure to invest will give rise to material harm to consumers.<sup>74</sup> GEMA simply dismisses the consumer harm that will be caused by undermining the incentives for companies to invest.<sup>75</sup> The Appellants comment further on this in Section E below.

3.31 Third, GEMA was wrong not to have due regard to the weight of regulatory precedent which supports aiming up.<sup>76</sup>

3.32 In defending against the weight of regulatory precedent which was cited by the Appellants in their Notices of Appeal, GEMA claims that *"there is no general rule that 'aiming up' is required"*.<sup>77</sup> In support of GEMA's position, Simon Wilde selectively refers to a handful of decisions, going back as far as 1997, to support his point.<sup>78</sup> GEMA's Response is dismissive of the weight of regulatory precedent for aiming up, which it simply describes as *"uninformative"*.<sup>79</sup> Contrary to GEMA's assertions elsewhere, Simon Wilde makes clear that GEMA's decision was not to aim up, stating: *"In principle, we are strongly in favour of aiming straight within the CAPM range"*.<sup>80</sup> In doing so, GEMA chose to disregard the established body of regulatory precedent and the rationale for aiming up.

3.33 GEMA's Response fails to give adequate consideration to the fact that the CMA recently considered the issue of aiming up in great depth in the PR19 Redeterminations. As the most recent assessment of the rationale and framework applicable to aiming up, GEMA ought to have had regard to the CMA's position in the PR19 Redeterminations when making the FD. In its Response, GEMA has again chosen to ignore the CMA's approach.

3.34 The result of ignoring the CMA's approach in the PR19 Redeterminations is that GEMA cannot be said to have aimed up at RIIO-2, despite claiming to have adopted an approach which was *"arguably consistent"* with this. First, GEMA did not aim up in the overall COE range, despite the CMA setting out a framework for doing so that applies equally, if not more so, to energy as it does to water, where 25bps of aiming up was considered appropriate. Second, GEMA did not aim up at the CAPM parameter level, which is illustrated by the fact that:

- (a) GEMA's RFR is the bottom of the CMA PR19 FR range; and
- (b) GEMA's TMR range is below the mid-point of the CMA PR19 FR range.

3.35 In support of GEMA's Response, Simon Wilde refers to the CMA's assessment in PR19 that the risk of capital loss from the sector was less than first thought<sup>81</sup> but fails to acknowledge that,

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<sup>72</sup> Response, Finance Issues, paragraph 257.4.

<sup>73</sup> First Witness Statement of Simon Wilde, paragraphs 127 and 135.

<sup>74</sup> NGET, Notice of Appeal, paragraphs 3.371 to 3.384; NGG, Notice of Appeal, paragraphs 3.371 to 3.384.

<sup>75</sup> Response, Finance Issues, paragraph 257.2; First Witness Statement of Akshay Kaul, paragraphs 81.1 to 81.2.

<sup>76</sup> NGET, Notice of Appeal, paragraphs 3.332 to 3.346; NGG, Notice of Appeal, paragraphs 3.332 to 3.346.

<sup>77</sup> Response, Finance Issues, paragraph 262.

<sup>78</sup> First Witness Statement of Simon Wilde, paragraphs 72 to 83.

<sup>79</sup> Response, Finance Issues, paragraph 264.

<sup>80</sup> First Witness Statement of Simon Wilde, paragraph 106.

<sup>81</sup> First Witness Statement of Simon Wilde, paragraph 83.

irrespective of that assessment, the CMA still considered aiming up to be appropriate despite the lack of a black out risk in water.<sup>82</sup>

- 3.36 GEMA also seeks to cast doubt on whether there is asymmetry in the RIIO-2 settlement, describing as “*subjective*”<sup>83</sup> the Appellants’ articulation of evaluative uncertainty mechanisms and Use it or Lose it (**UIOLI**) allowances as asymmetric. On the contrary, there is nothing subjective about saying UIOLI is asymmetric when there is no scope to outperform these allowances but companies bear one hundred percent of the risk of overspending and unrecovered costs.

## E. Insufficient COE Error

- 3.37 The Appellants’ Ground 1: COE concludes that GEMA’s overall decision to set the COE at 4.55% for RIIO-T2 was wrong.<sup>84</sup> As a result of the CAPM Selectivity error, Cross-checks error and Aiming up error, GEMA’s COE is insufficient and below any reasonable measure of the appropriate equity return.
- 3.38 GEMA’s Response fails to address the issues identified in relation to the Insufficient COE error. While purporting to respond to a few of the specific points raised by the Appellants, the Response does not address the cumulative impact of the introduction of multiple erroneous methodological choices that result in the insufficient COE for RIIO-2. GEMA repeats what its financeability assessment did consider but does not, and indeed the Appellants would say cannot, explain why investors would choose to invest substantial equity in a business offering inadequate returns. With regard to the harm to consumers that an inadequate COE would cause, GEMA simply denies there will be harm and ignores economics and common sense.
- 3.39 The insufficiency of GEMA’s COE is clear from a comparison of the FD and the PR19 Redeterminations. GEMA acknowledges that energy network risk is higher than in the water sector as it sets a beta above the water sector average. It also states that returns should be set based on CAPM, where a higher return is required for higher risk. Despite this, however, GEMA wrongly concludes that the allowed COE for energy networks is lower than that for the water sector. This is untenable. As explained in the Appellants’ submission on the PR19 FR,<sup>85</sup> adopting the CMA’s methodology to determining the COE in PR19 and overlaying GEMA’s energy networks’ beta value would give a COE of 5.1%. This is some 55bps higher than the insufficient COE set by GEMA, even before taking account of errors in GEMA’s determined beta and introduction of the outperformance wedge.<sup>86</sup>
- 3.40 The closest GEMA comes to addressing the insufficiency of the COE is in its attempt to defend the Cross-checks and Aiming Up errors, where it relies on its “*expert judgement*” that it does not consider can be challenged. This premise is flawed. As set out in paragraph 2.10 above, GEMA cannot simply assert that it has discretion to make a flawed decision with an impact of over £500 million on the Appellants<sup>87</sup>, plus further impacts on consumers and other stakeholders.
- 3.41 Rather than engage with the Insufficient COE error, GEMA’s Response attempts to distract and obfuscate. In addition to repeatedly stating that the error is within its expert judgement, GEMA fails to accept the impact of that error on consumers. The witness statements of Akshay Kaul and Simon Wilde go so far as to claim that it does not matter if GEMA has got the COE wrong because it can always adjust the return in RIIO-2 “*in extremis*”.<sup>88</sup> This is not a satisfactory answer. The ability to reopen a price control in highly limited and unusual circumstances is not a means

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<sup>82</sup> PR19 FR, paragraph 9.1274 [MH2/2.1].

<sup>83</sup> First Witness Statement of Simon Wilde, paragraph 99.

<sup>84</sup> NGET, Notice of Appeal, paragraph 3.385; NGG, Notice of Appeal, paragraph 3.385.

<sup>85</sup> NGET and NGG’s submission on the PR19 FR, paragraph 1.9.

<sup>86</sup> The Appellants recognise that GEMA is yet to submit its representations on the Appellants’ submissions on the PR19 FR. However, GEMA’s Response should have addressed the errors identified in the March Appeal Documents, which referenced the CMA’s PR19 PFs (and have since been confirmed in the PR19 FR). Nevertheless, GEMA’s Response mostly fails to acknowledge the PR19 FR.

<sup>87</sup> Revenue impact of moving from 4.55% COE to at least 5.6%.

<sup>88</sup> First Witness Statement of Simon Wilde, paragraph 108.7; First Witness Statement of Akshay Kaul, paragraph 82.3.



of absolving GEMA of the responsibility of getting the COE right in RIIO-2. Moreover, reopening the price control would not address the consumer harm caused by setting the COE too low.

- 3.42 Despite definitively stating that cross-checks are not determinative of the COE, and can never be used to establish error in the COE,<sup>89</sup> GEMA repeatedly seeks to deploy two points to convince the CMA that the overall COE is adequate.
- 3.43 First, it refers to National Grid plc's purchase of Western Power Distribution (**WPD**) at a premium to the RAV.<sup>90</sup> However, the Frontier May Report demonstrates clearly that no conclusions relating to the COE can be drawn from that transaction.<sup>91</sup> This is aligned with CMA precedent, where it has placed limited weight on MAR evidence.<sup>92</sup>
- 3.44 Second, GEMA speculates that if the COE is too low, rather than harming investment, it would observe a fall in share prices which can then be adjusted for.<sup>93</sup> GEMA's approach not only fails to appreciate the challenges with making conclusions based on short term market data,<sup>94</sup> but also the difference between average and marginal returns. Investors hold shares based on the returns they expect on their investment. This is an average return and will include performance from ODIs, totex and the base return.
- 3.45 Rather than speculating, the Appellants note that there are real world examples showing the impact of an insufficient COE. First, investors will expect the company to appeal any regulatory settlement that includes an insufficient COE. This is borne out by the RIIO-2 process, where every TO and GDN has appealed the COE. Second, as set out in the March Appeal Documents,<sup>95</sup> investors will expect the relevant company not to bring forward value destructive investment opportunities unless obliged to do so or if it would be more value destructive not to do so.
- 3.46 GEMA asks the CMA to believe there is no harm from setting the COE too low, and that the errors it has made in setting the COE are inconsequential. It asks the CMA to believe that the COE has no bearing on whether investors will be prepared to invest.<sup>96</sup> It observes that companies spent less than their totex allowances in RIIO-1, despite the COE being considered higher than necessary by some parties.<sup>97</sup> GEMA's conclusion is that if companies spent less than allowed when getting a high return there is no reason to believe setting the return too low will prevent investments being brought forward for consideration. Not only does this misrepresent the RIIO-1 experience, it also fails to appreciate the difference between incentives to bring forward investment at all versus the incentive to deliver those investments efficiently.
- 3.47 Contrary to GEMA's assertions, National Grid plc did bring forward additional discretionary investment projects for consideration during RIIO-1 which were stakeholder-supported. By way of example, allowances of £116m and £43m have been provided for Visual Amenity Impact Projects in Dorset and Peak East with a further claim under RIIO-1 arrangements of over £300m for Snowdonia in progress.
- 3.48 GEMA concludes that the underspend observed in RIIO-1 was about failing to bring forward investments. This is wrong. The underspend was a result of the incentive for companies to deliver projects efficiently. Dynamic efficiency is incentivised by the RIIO framework and valued by consumers.

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<sup>89</sup> Response, Finance Issues, paragraph 246.

<sup>90</sup> Response, Finance Issues, paragraph 209.

<sup>91</sup> Frontier May Report, Section 9 [MH3/1].

<sup>92</sup> CMA's Redetermination for Bristol Water (2015), paragraph 10.208 [NOA1/22]; and PR19 FR, paragraph 9.1362 [MH2/2.1].

<sup>93</sup> Response, Finance Issues paragraph 267.1.

<sup>94</sup> NGET, Notice of Appeal, paragraphs 3.282 to 3.284; NGG, Notice of Appeal, paragraphs 3.282 to 3.284.

<sup>95</sup> NGET, DP1, paragraphs 516 to 528; NGG, DP1, paragraphs 507 to 516.

<sup>96</sup> Response, Finance Issues, paragraph 257.2.

<sup>97</sup> *Ibid.*, and the First Witness Statement of Akshay Kaul, paragraph 83.

- 3.49 It is important to recognise that statutory and licence obligations and service standards only cover a proportion of the capital investment required. GEMA implies that the scope for discretionary investment in RIIO-T2 is very limited given the obligations imposed upon licensees.<sup>98</sup> While it is correct that the Appellants are subject to general statutory duties to develop and maintain the network and certain licence obligations which drive the need for investment, the transition of the network to meet Net Zero objectives, and the pace at which that transition takes place, are not matters subject to specific statutory or licence obligations. There is broad scope for proactive discretionary investment in meeting those future objectives which will be needed if the targets are to be met. Uncertainty mechanisms will provide allowances for these investments, but the process starts with networks submitting proposals to invest.
- 3.50 Not only is GEMA's assessment of the COE at 4.55% too low but, when combined with the erroneous outperformance wedge, GEMA is setting the allowed return below the level it considers to be the actual COE. It would be irrational for an investor to choose to support additional discretionary investment projects if they will earn a lower marginal return than their actual COE. To do so would be value destructive.
- 3.51 The insufficient COE will have an impact on capital investment. It will reduce the pace and scale of investment, it will fail to encourage networks to bring forward the investments under uncertainty mechanisms to deliver Net Zero, it will negatively impact the level of ambition in business plans in future controls such as RIIO-T3, and it will reduce investability in the sector as explained in section L of DP1. Rather than inconsequential, the consumer harm from GEMA's error in setting the COE too low will be considerable.

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<sup>98</sup> First Witness Statement of Akshay Kaul, paragraph 82.1; First Witness Statement of Simon Wilde, paragraph 133.

## **SECTION 4: GROUND 2 – OUTPERFORMANCE WEDGE**

### **A. Introduction**

- 4.1 In this section, the Appellants set out the main points in Reply to GEMA's Response insofar as it concerns Ground 2: Outperformance Wedge.
- 4.2 Section C of Ground 2 in the Appellants' Notices of Appeal details the errors made by GEMA. It sets out that GEMA's outperformance wedge is unjustified and harmful, and the Appellants address each of these errors in turn below.
- 4.3 The Appellants also request that the CMA reads section 10 of the Frontier May Report for further details.

### **B. GEMA's outperformance wedge is unjustified**

- 4.4 Section C of Ground 2 in the Appellants' Notices of Appeal sets out that GEMA's outperformance wedge is unjustified because:
- (a) it is wrong to make a final, significant deduction from allowed returns after the price control has been calibrated;
  - (b) there is no need to make a final, significant deduction from allowed returns given the extensive range of existing and new regulatory tools available, and used, in RIIO-T2 to address information asymmetry effectively;
  - (c) GEMA's decision is poorly reasoned and relies on fundamentally flawed assumptions and evidence; and
  - (d) it has a discriminatory and disproportionate impact on different licensees for no good reason.
- 4.5 In its Response, GEMA:
- (a) does not engage with the in-principle arguments against making a final, significant deduction from allowed returns after the price control has been calibrated;
  - (b) does not provide evidence to explain why existing and new regulatory tools are insufficient to address information asymmetry;
  - (c) provides evidence intended to show that the outperformance wedge does not have a discriminatory and disproportionate impact, but which actually supports the Appellants' arguments; and
  - (d) is wrong to claim that the introduction and application of the outperformance wedge is a matter within the scope of regulatory judgement.
- 4.6 In Reply, the Appellants briefly address the points identified in paragraph 4.5 above, providing clear cross-references to the Frontier May Report as appropriate.



**(1) GEMA does not engage with the in-principle arguments against making a final, significant deduction from allowed returns after the price control has been calibrated**

- 4.7 Despite devoting twelve paragraphs of its Response to this point, GEMA does not engage with the in-principle arguments against the introduction of the outperformance wedge. It states only that “[t]here is no general principle of regulatory theory or practice prohibiting a lump-sum adjustment to allowed returns on equity”<sup>99</sup> and “nor is there any principled reason why an adjustment to reflect a systemic bias in the regulatory framework should not be made”.<sup>100</sup> This is insufficient to address such a fundamental challenge. As a result, GEMA still has not addressed the in-principle objections raised by Burns in his dissenting opinion in the UKRN Report and reiterated by the Appellants in their Notices of Appeal.
- 4.8 GEMA has also failed to engage with the research performed by John Earwaker and Nick Fincham<sup>101</sup> which identified significant concern amongst the ex-regulators surveyed in relation to adjusting allowed returns for expected future outperformance. As set out in Chris Bennett’s witness statement, 25 out of the 32 respondents disagreed with the statement that “After setting a firm’s expenditure allowances and output targets a regulator should make a final lump-sum deduction from allowed revenues to capture otherwise overlooked scope for the regulated firm to make cost savings and/or output improvements”.<sup>102</sup> GEMA has not provided any response to this.
- 4.9 GEMA ignores the fact that outperformance delivers benefits to consumers through the sharing of totex performance both within the price control and then in perpetuity over subsequent price controls. As the CMA observed in the PR19 Cost of Capital Working Paper, “operational outperformance is a desirable outcome. If companies are able to outperform, this delivers benefits to customers both from the actual improvements and from Ofwat being able to use the evidence in its comparisons in future periods”.<sup>103</sup>

**(2) GEMA does not provide evidence to explain why existing and new regulatory tools are insufficient to address information asymmetry**

- 4.10 GEMA devotes a substantial proportion of its Response to setting out what it describes as “compelling”<sup>104</sup> evidence that companies will outperform RIIO-2. However, this is false and misleading. The evidence mainly relates to GEMA’s historical database. However, whatever GEMA’s historical database tells us about past performance, it cannot tell us anything about RIIO-2 performance and is therefore irrelevant. For the reasons set out in Chris Bennett’s witness statement,<sup>105</sup> RIIO-2 is a fundamentally different price control to RIIO-1 and earlier controls. The cumulative effect of the existing and new measures employed at RIIO-2 are (arguably more than) sufficient to address GEMA’s information asymmetry concerns.
- 4.11 In its Response, GEMA simply dismisses this point, stating that it has “controlled for RIIO-2 parameters in the data”.<sup>106</sup> This is incorrect. First, GEMA’s restatement of RIIO-1 outperformance on a RIIO-2 basis adjusts for only three of the many changes it made in RIIO-2.<sup>107</sup> Second, as set out in the Frontier May Report,<sup>108</sup> GEMA’s restatement of RIIO-1 outperformance on a RIIO-2 basis does not provide evidence to support the introduction of the outperformance wedge. On the contrary, it demonstrates that the regulatory tools available to GEMA are sufficient and the outperformance wedge is therefore unnecessary. This is because GEMA’s own modelling shows that if a small number of design changes made in RIIO-2 had applied in RIIO-1, the great majority of RIIO-1 outperformance would not have occurred.<sup>109</sup> GEMA therefore has the tools necessary to deal with any outperformance due to information asymmetry.
- 4.12 The Appellants reproduce Figure 6 from the Frontier May Report below to illustrate this point. The figure shows GEMA’s own restatement of RIIO-1 performance for the four TOs on a RIIO-2

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<sup>99</sup> Response, Finance Issues, paragraph 308.

<sup>100</sup> Response, Finance Issues, paragraph 308.

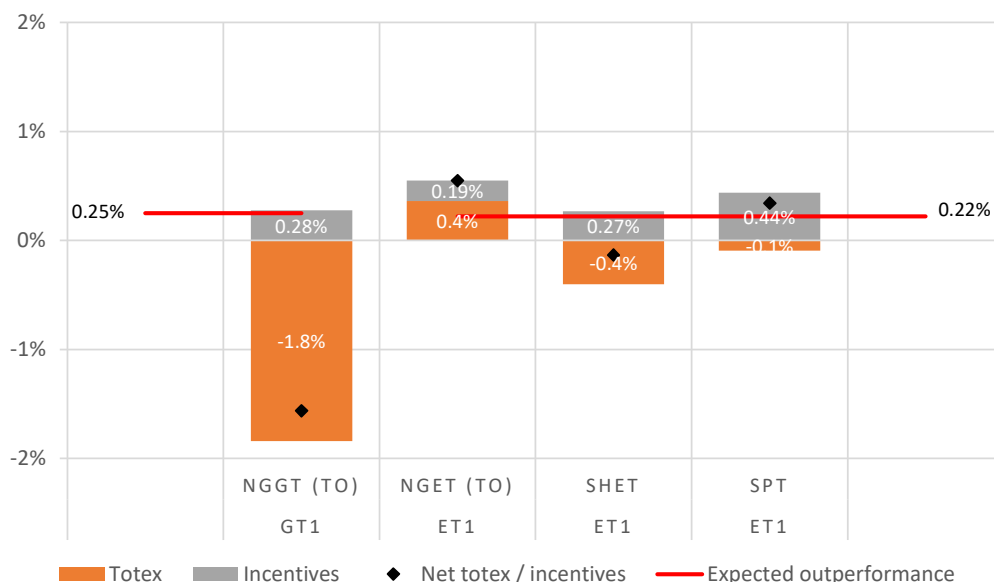
<sup>101</sup> The Wedge Survey [CB1/11].

<sup>102</sup> CB1, paragraph 48.

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basis with adjustments for RPE indexation, sharing factors, totex : RAV ratios and gearing. In addition, Frontier has adjusted for the Information Quality Incentive (IQI) which applied in RIIO-1 but does not apply in RIIO-2.

**Figure 6: Ofgem’s assessment of RoRE outperformance at RIIO-1 on a RIIO-2 basis, across totex, incentives for the TO sector – after removing the effect of the IQI**



Source: Frontier, Adapted from McCloskey 80. Residual Outperformance CMA Final. “Dashboard” tab.

- 4.13 This Figure powerfully demonstrates the impact of a subset of the tools that GEMA has deployed during its development of RIIO-2.<sup>110</sup> It shows that three of the TOs would have underperformed on totex and two would have underperformed overall with these in place. Overall, the weighted average of performance would have been zero. It should also be noted that, on this basis, NGG would have underperformed by ~1.5% (which the Appellants note is telling given that NGG is the licensee most negatively impacted by the outperformance wedge).

<sup>103</sup> CMA Working Paper: Choosing a point estimate for the Cost of Capital, PR19 Redetermination, paragraph 81(a) [NOA1/18].

<sup>104</sup> Response, Finance Issues, paragraph 311.

<sup>105</sup> CB1, Section D.

<sup>106</sup> Response, Finance Issues, paragraph 324.

<sup>107</sup> Response, Finance Issues, paragraph 312. See also Frontier May Report, paragraph 10.2.16 [MH3/1].

<sup>108</sup> Frontier May Report, paragraphs 10.2.5 to 10.2.35 [MH3/1].

<sup>109</sup> Frontier May Report, paragraphs 10.2.5 to 10.2.35 [MH3/1].

<sup>110</sup> It does not take account of the additional scrutiny applied to company business plans, the introduction of PCDs and UMs, the application of an extremely high on-going efficiency assumption, the down adjustment to allowances arising from the BPI and the reduction in the length of the price control from 8 years to 5 years.

- 4.14 In addition to the limited design changes modelled above, Chris Bennett's witness statement sets out the many other ways that GEMA has "*tightened the screws*" in RIIO-2 to address information asymmetry effectively.<sup>111</sup> These include the introduction of Price Control Deliverables (**PCDs**), the extensive use of uncertainty mechanisms to deal with uncertainties in need or cost (an 'if in doubt take it out' approach to setting ex ante allowances in RIIO-2), the toughening of benchmarks, the replacement of IQI with the mainly penalising Business Plan Incentive (**BPI**), and by setting an on-going efficiency assumption above GEMA's consultants' high case. These will all reduce the performance potential even further in RIIO-2.
- 4.15 The combined effect of all the measures available to GEMA are therefore sufficient to enable it to address any harmful effect of information asymmetry in RIIO-2, without needing to introduce the harmful outperformance wedge. Indeed, GEMA itself acknowledges in its Response that "*underperformance or neutral performance is possible*" and outperformance is not "*inevitable*".<sup>112</sup> Put another way, overall the information above and GEMA's Response begs the question "Where is the evidence that existing and new tools are insufficient?"

**(3) GEMA provides evidence intended to show that the outperformance wedge does not have a discriminatory and disproportionate impact, but which actually supports the Appellants' arguments**

- 4.16 In its Response, GEMA performs Frontier's calculation of the degree of totex challenge implied for each of the individual TOs and GDNs by the blanket 25bps outperformance wedge using the totex levels assumed in its own Net Zero 2 scenario, rather than using baseline allowances.<sup>113</sup> GEMA states that this evidence shows "*outperformance can be earned by similar degrees of underspending*".<sup>114</sup>
- 4.17 In fact, it shows nothing of the sort and only serves to reinforce the discriminatory and disproportionate nature of the outperformance wedge. On GEMA's calculation – which the Appellants dispute as a more appropriate comparison than their own analysis<sup>115</sup> – the implied totex challenge for NGG and NGET remains highly material at 2.4% and 2.1% respectively. It also remains significantly higher than for any other network and around double the efficiency stretch that is imposed on the least effected licensee, SPTL, whose implied efficiency stretch is 1.1% on GEMA's calculation.

**(4) GEMA is wrong to claim that the introduction and application of the outperformance wedge is within the scope of regulatory judgement**

- 4.18 GEMA positions the 25bps outperformance wedge adjustment as "*modest*"<sup>116</sup> and "*conservative*"<sup>117</sup> and well within its margin of appreciation. This is not the case. As set out in Chris Bennett's witness statement, the 25bps outperformance wedge is equivalent to a stretch totex efficiency saving of 3.6% or £224m and £75m for NGET and NGG respectively. As Chris Bennett notes: "*If a 3.6% stretch challenge was placed on totex with as little evidence as has been used to justify the outperformance wedge, then the error of its inclusion would be clear*".<sup>118</sup>

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<sup>111</sup> CB1, Section D.

<sup>112</sup> Response, Finance Issues, paragraph 328.

<sup>113</sup> First Witness Statement of PJ McCloskey, Table 5.

<sup>114</sup> First Witness Statement of PJ McCloskey, paragraph 164.

<sup>115</sup> The Appellants submit that their analysis is the most appropriate basis. It is not appropriate to assume that companies can deliver the same degree of outperformance from uncertainty mechanisms as ex ante funded projects as it is likely to be more challenging for networks to outperform totex allowances that are set using uncertainty mechanisms. This is because these allowances will be set during the price control period and it is reasonable to expect that GEMA will adjust them to capture the benefit of any in flight efficiency programmes that networks have delivered (and revealed) prior to the point when the allowances are set.

<sup>116</sup> Response, Finance Issues, paragraphs 8.2, 286.1, 308, 326 and 351.

<sup>117</sup> Response, Finance Issues, paragraph 333.

<sup>118</sup> CB1, Section D, paragraph 58. The Appellants note further that, in his witness statement, Roger Witcomb describes the outperformance wedge as "*in essence, just a mechanism for reducing the network companies' totex allowances*" (First Witness Statement of Roger Witcomb, Section C, paragraph 17).

This is on top of the on-going efficiency challenge of 0.2% per annum above the top of the range set out by GEMA's own consultants, CEPA (which is itself the subject of appeal).

- 4.19 GEMA also mischaracterises the Appellants' argument that GEMA's action in introducing and applying the outperformance wedge was contrary to its overarching statutory duty to have regard to the principles under which regulatory activities should be "*targeted only at cases in which action is needed*".<sup>119</sup> GEMA asserts that this is "*unreal*" and "*on the Appellants' logic, no novel tool could ever be deployed until every other change could be controlled for*".<sup>120</sup> This is obviously not the error identified by the Appellants, which related to the need for measures to be targeted. RIIO-2 includes other novel tools which are targeted and which the Appellants have not appealed.

### **C. GEMA's outperformance wedge is harmful**

- 4.20 Section C of Ground 2 in the Appellants' Notices of Appeal sets out that GEMA's outperformance wedge is harmful to existing and future consumers because:
- (a) it will undermine productivity incentives, damage incentives to invest, damage investor confidence leading to an increase the cost of capital in the long run, and undermine equity financeability in RIIO-2; and
  - (b) the ex-post adjustment mechanism does not fix these problems but exacerbates the harmful properties of the outperformance wedge.
- 4.21 GEMA's Response seeks to marginalise these critical considerations around consumer harm, and appears to ignore the significant benefits that appropriately calibrated incentives create for consumers. Specifically, GEMA:
- (a) fails to properly engage with the "double ratchet" explanation and resulting harm to productivity incentives;
  - (b) fails to recognise the further harm to incentives caused by the backstop; and
  - (c) fails to properly engage with the other consumer harms identified by the Appellants, namely the damage to incentives to invest, the damage to investor confidence and the undermining of equity financeability in RIIO-2.
- 4.22 GEMA also asserts, by way of further defence, that both the outperformance wedge and the backstop were consulted on widely. This is clearly not an argument against consumer harm given the strength of the negative responses received by GEMA. Also, notably, GEMA appears to concede that the RIIO-2 Impact Assessment,<sup>121</sup> published to comply with its statutory duty under section 5A Utilities Act 2000, did not address the effects of the outperformance wedge (including the backstop mechanism).<sup>122</sup>
- 4.23 In Reply, the Appellants briefly address the points identified in paragraph 4.21 above, providing clear cross-references to the Frontier May Report as appropriate.

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<sup>119</sup> NGET, Notice of Appeal, paragraph 4.60; NGG, Notice of Appeal, paragraph 4.60.  
<sup>120</sup> Response, Finance Issues, paragraph 326.  
<sup>121</sup> RIIO-2 Final Determinations: Impact Assessment Annex [NOA1/13].  
<sup>122</sup> Response, Finance Issues, paragraph 334.

**(1) GEMA fails to properly engage with the “double ratchet” explanation and resulting harm to productivity incentives**

- 4.24 First, GEMA fails to properly engage with the point that the outperformance wedge will materially weaken the incentive to deliver productivity savings. As set out in the Frontier May Report,<sup>123</sup> GEMA misrepresents the harm – suggesting (inaccurately) it is argued that the outperformance wedge will switch off the incentive to deliver productivity savings completely – and, in so doing, fails to address it. This is not the Appellants’ argument. The outperformance wedge itself does not completely switch off incentives (other than in the deadband zone created by the ex-post adjustment mechanism, which is covered in part 2 below, where it does). The outperformance wedge does, however, materially diminish incentives due to the “double ratchet”, as outperformance now brings not only tougher targets but also lower returns in the next period.<sup>124</sup>
- 4.25 Second, GEMA asserts that the initial 25bps of outperformance “*reflects information asymmetry rather than effort*”, so productivity incentives remain undiminished.<sup>125</sup> However, GEMA continues to provide no evidence for this assertion, other than pointing to its historical database, which – as shown above – tells us nothing about RIIO-2.
- 4.26 Third, GEMA also asserts that the feedback loop is weaker when addressing information asymmetry,<sup>126</sup> meaning that the incentive harms caused by the outperformance wedge and the backstop are minimal. This is unsubstantiated and without logic. As noted in the Frontier May Report, “*no decipherable argument*” is presented to support GEMA’s assertion.<sup>127</sup>
- 4.27 Fourth, in misconstruing or misrepresenting the Appellants’ arguments regarding information asymmetry, GEMA ignores the importance of the “*incentive to discover*”. As set out in the Frontier May Report:<sup>128</sup>

*Further, Ofgem disregards the critical point we make about information that is unknown to both the company and the regulator. It is a crucial that a regulatory framework provides an “incentive to discover” for companies. Consideration of this form of information asymmetry is notably absent from Ofgem’s response.*

**(2) GEMA fails to recognise the further harm to incentives caused by the backstop**

- 4.28 GEMA’s Response to the points made by the Appellants regarding the harmful properties that arise as a result of the ex-post adjustment (or ‘backstop’) mechanism, and the deadband this creates, appear to rely on assertions that (a) it is unlikely that networks will find themselves earning between 0 and 25bps of outperformance, (b) the wedge is based on asymmetry not effort, and (c) the impact on any incentives is likely to be minimal.
- 4.29 As set out in the Frontier May Report, none of these assertions are substantiated or have any merit. On the contrary, it will be very challenging for networks to outperform RIIO-2. For those that do, there is a real possibility that their performance sits in the 0-25bps range, meaning that the power of incentives are switched off, undermining the incentive properties of the framework (across both ODIs and the totex incentive mechanism).

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<sup>123</sup> Frontier May Report, paragraph 10.2.42 [MH3/1].

<sup>124</sup> Frontier May Report, paragraph 10.2.46 [MH3/1].

<sup>125</sup> Response to Finance Issues, paragraph 350.

<sup>126</sup> First Witness Statement of PJ McCloskey, paragraph 178.

<sup>127</sup> Frontier May Report, paragraphs 10.2.43 to 10.2.52 [MH3/1].

<sup>128</sup> Frontier May Report, paragraph 10.2.57 [MH3/1].

**(3) GEMA fails to properly engage with the other consumer harms identified by the Appellants, namely the damage to incentives to invest, the damage to investor confidence and the undermining of equity financeability in RIIO-2**

- 4.30 GEMA does not properly engage with the harm to incentives to invest. It fails to grasp the point that there will be *“transformative projects which would otherwise be progressed, but which may not go ahead under RIIO-T2”*.<sup>129</sup> As noted in Section 3 (Ground 1: COE) above, GEMA also misrepresents the scale of the point about discretionary investment, implying that such investment is negligible.<sup>130</sup> GEMA states that no incentive is perfect and, if an investment were not to proceed as a result of the outperformance wedge, it may not have gone ahead anyway. As set out in the Frontier May Report: *“This is no kind of adequate response to an incentive effect that seems highly likely to cause consumer harm.”*<sup>131</sup> GEMA provides no answer of any kind to the danger of underinvestment. Moreover, GEMA’s reliance on the WPD transaction as an apparently “complete” defence to this point is weak and misinformed, for the reasons set out in the Frontier May Report.<sup>132</sup>
- 4.31 GEMA also fails to engage with the harms around investor confidence and equity financeability in its Response. The points raised in defence do not counter the Appellants’ arguments at all. In this regard, it is noteworthy that GEMA’s Response hardly mentions Net Zero – in this context or any other – which seems remarkable given the clear linkage with, and profound consumer interest in, meeting the Government’s 2050 target.
- 4.32 In summary, GEMA’s Response lacks any supporting evidence or analysis. The idea that an outperformance wedge can be introduced and applied and it will not change company behaviour at all is fundamentally flawed. GEMA’s assertion that the Appellants’ arguments are *“generic”* and *“invariably raised whenever a regulator acts to tighten targets, reduce cost allowances, or curb returns”*<sup>133</sup> is simply deflection and fails to address the specific issues. GEMA’s Response does nothing to address the lack of evidence supporting the outperformance wedge in the FD. GEMA’s introduction of the outperformance wedge fails to satisfy the need for new mechanisms to be *“robust, evidence-based decision-making [which is] central to protecting the interests of consumers”*<sup>134</sup> and *“targeted at risks which are not effectively addressed by the existing regime”*.<sup>135</sup>

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<sup>129</sup> Response, Finance Issues, paragraph 352.

<sup>130</sup> First Witness Statement of Akshay Kaul, Section C, paragraph 82.1. First Witness Statement of Simon Wilde, Section E, paragraph 133. See CB1, paragraph 109 (NGG) / 110 (NGET) for the Appellants’ position on this point.

<sup>131</sup> Frontier May Report, paragraph 10.2.52 [MH3/1].

<sup>132</sup> Frontier May Report, Section 9 [MH3/1].

<sup>133</sup> Response, Finance Issues, paragraph 351.

<sup>134</sup> NPg Final Determination, paragraph 4.59 [NOA1/21].

<sup>135</sup> PR19 PFs, paragraph 9.624 [NOA1/17].



## SECTION 5: LEGAL ISSUES

### A. Introduction

- 5.1 In this section the Appellants address three key legal points which feature strongly in GEMA's Response, namely: regulatory discretion/judgement; materiality; and selectivity/bias. In each case, the Appellants explain why GEMA's position is wrong. Additionally, the Appellants address the implications of proposed changes to the licences.

### B. Regulatory discretion / judgement

- 5.2 Throughout GEMA's Response, the use of regulatory discretion and judgement as key aspects of its defence strategy is evident. Specifically:
- (a) the errors alleged by the Appellants are legally repackaged as "*issues*", "*objections*" or "*complaints*" which, it is said, amount to no more than disagreements with GEMA's exercise of its "*expert regulatory discretion*";<sup>136</sup> and
  - (b) the relevant aspects of the RIIO-2 price control are positioned as an "*exercise in the unknown*",<sup>137</sup> with GEMA acting within the scope of its "*expert regulatory judgement*"<sup>138</sup> to navigate that uncertainty (and, it suggests, benefitting from a greater margin of appreciation accordingly<sup>139</sup>).
- 5.3 On this basis, the Appellants are (repeatedly) said to have failed to disclose any appealable error and the CMA should dismiss their appeals.
- 5.4 In Reply, the Appellants make four points.
- 5.5 **First, GEMA has taken the point on regulatory discretion and judgement too far.** Based on GEMA's Response, its discretion and scope for judgement is so extensive that it is difficult to envisage a circumstance in which any regulated company could ever legitimately appeal – and the CMA could ever "*interfere with*"<sup>140</sup> – its price control decisions.
- 5.6 More particularly, GEMA's Response suggests that:
- (a) GEMA's approach to estimating the COE and the CAPM parameters is not appealable;<sup>141</sup>
  - (b) the introduction of the outperformance wedge, which is a novel deduction from allowed returns (albeit repackaged as a "*modest adjustment*" to rectify a "*systemic imbalance*") is "*well within the bounds of the regulator's judgement*"<sup>142</sup> and cannot be challenged;<sup>143</sup> and
  - (c) in fact, any aspect of a price control package should not be disturbed because (according to GEMA) everything is intrinsically interlinked and "*a change to one of the components ... risks making the ... package unbalanced and skewed*".<sup>144 145</sup>

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<sup>136</sup> Response, Finance Issues, paragraph 6.

<sup>137</sup> Response, Finance Issues, paragraph 59.

<sup>138</sup> Response, Finance Issues, paragraph 6.

<sup>139</sup> Response, Finance Issues, paragraph 43.

<sup>140</sup> Response, Finance Issues, paragraph 110.

<sup>141</sup> Response, Finance Issues, paragraph 8.1.

<sup>142</sup> Response, Finance Issues, paragraphs 8.2 and 308.

<sup>143</sup> Response, Finance Issues, paragraph 8.2.

<sup>144</sup> First Witness Statement of Akshay Kaul, Section D, paragraphs 103 to 113.

<sup>145</sup> As set out in the March Appeal Documents, there is no reason to interfere with other parts of the price control when remedying the errors which have been raised. Nothing in GEMA's Response changes this position. Given GEMA proposes to address the issue as part of its submissions on remedies, the Appellants do not go into further detail in this submission.

- 5.7 This must be wrong, and is clearly demonstrated to be so by previous energy licence modification appeals under the relevant legislation. The Appellants therefore ask the CMA to disregard GEMA's transparent positioning of the FD in these areas as non-appealable.
- 5.8 Second, in setting out the legal framework GEMA quotes uncontested principles from previous CMA appeals, whilst also subtly misstating the standard of review by setting out principles which have no support in previous appeals.
- 5.9 For example, there is no principle that an appeal must fail if it relates to a judgement on which "*reasonable people may disagree*".<sup>146</sup> Neither did the CMA, in *BGT*, reject the submission that the statutory regime requires it to form a view on whether weight given to certain considerations was appropriate.<sup>147</sup> The CMA is required where relevant to determine whether the decision "*was wrong on one of the prescribed statutory grounds*".<sup>148</sup>
- 5.10 Third, GEMA incorrectly signals that it "*enjoys a greater margin of appreciation*"<sup>149</sup> due to matters of uncertainty. It does so by relying on a judicial review precedent relating to the judicial review standard, which is of marginal relevance in a bespoke statutory appeal regime which requires the CMA to consider the merits of the decision and which by its nature makes a determination on the uncertainties of an ex ante price control.
- 5.11 Fourth, it is notable that GEMA almost entirely **fails to engage with the Appellants' detailed statutory grounds matrices** (annexed to their Notices of Appeal), whilst simultaneously maintaining that the Appellants have disclosed no appealable errors.
- 5.12 The Appellants clearly articulate GEMA's errors within the meaning of section 11E(4) EA89 and section 23D(4) GA86 in the Statutory Grounds matrices. It is, for example, obviously not the case that relying on flawed evidence or assumptions, acting in defiance of logic, making methodological errors or reaching conclusions without adequate supporting evidence is within the scope of expert regulatory judgment or discretion.

### C. Materiality

- 5.13 GEMA's Response also seeks to use materiality as part of its defence, adopting a '**divide and conquer**' approach to the Appellants' COE errors (opting, in fact, to not adequately address the Insufficient COE Error that forms the core of Ground 1 of the Appeals). As set out in the Notices of Appeal, in addition to the material errors on the parameters, aiming up and cross-checks, GEMA's overall decision to set the COE at an insufficient level, 4.55%, for RIIO-T2 was materially wrong.<sup>150</sup>
- 5.14 Specifically, GEMA's Response states that "*The alleged "errors" identified by the Appellants, ... in many cases have no material impact on the RIIO-2 allowed return on equity unless combined with other alleged errors.*"<sup>151</sup> Moreover, GEMA's Response further submits "*...that the test of materiality should be applied to each of the specific errors advanced by an Appellant*".<sup>152</sup>
- 5.15 In Reply, the Appellants consider it striking that – despite a lengthy (11 page) Legal Framework section, including detailed reference to the CMA's decision in *Firmus Energy*<sup>153</sup> – GEMA's Response makes no reference to what the CMA said in *Firmus Energy* regarding materiality, namely:<sup>154</sup>

<sup>146</sup> Response, Finance Issues, paragraph 36.

<sup>147</sup> Response, Finance Issues, paragraph 39.

<sup>148</sup> *BGT v GEMA*, paragraph 3.43 [NOA1/20].

<sup>149</sup> Response, Finance Issues, paragraph 43.

<sup>150</sup> NGET, Notice of Appeal, paragraph 3.385; NGG, Notice of Appeal, paragraph 3.385.

<sup>151</sup> Response, Finance Issues, paragraph 8.1(c).

<sup>152</sup> Response, Finance Issues, paragraph 50.

<sup>153</sup> Response, Finance Issues, paragraph 31.

<sup>154</sup> *Firmus Energy (Distribution) Limited v NIAUR* [2017], paragraph 3.26 [NOA1/23].



*In case it is of assistance to parties to future appeals to the CMA, we would note the following points made by the CC on the matter of aggregation of errors:*

*(a) No formal general approach has been identified that would determine when, if at all, immaterial errors should be aggregated. The CC was mindful that to aggregate immaterial errors would have the effect of converting an error that was in and of itself immaterial into a material error through its combination with other immaterial errors. Those other errors may be unrelated and may lie in different and discrete aspects of the price control.*

*(b) The CC did not rule out the possibility that there may be cases in which such aggregation was justifiable where the cumulative effect of discrete errors had a highly significant impact on the price control set by the regulator.*

*(c) However, as a general approach, the CC stated it would be cautious about elevating the immaterial into the material. It observed that aggregation might encourage a scattergun approach on the part of the appellants, which was not the purpose of the appeal process.*

- 5.16 The Appellants also note the concession in GEMA's Response that: "*The RIIO-2 allowed return on equity is the outcome of multiple individual, but interconnected, decisions taken by GEMA ...*".<sup>155</sup> This is consistent with the errors identified in the Notices of Appeal, which demonstrate that GEMA failed to take proper account of relevant evidence when estimating the RFR, equity beta and TMR (the CAPM Selectivity error), which was a significant contributing factor, together with the Cross-checks error and the Aiming up error to the overall Insufficient COE Error.<sup>156</sup> Each of these errors is material, for the reasons set out in the Notices of Appeal. But, in any case, the Insufficient COE Error is, at least in part, an accumulation of other errors (and GEMA's actions and omissions which gave rise to them).

#### **D. Selectivity / bias**

- 5.17 GEMA's Response rejects the suggestion that GEMA has been selective and adopted evidence with a downward bias. On the contrary, it states that it "*has in fact based its decision on a balance of evidence across the board*"<sup>157</sup> – although it fails to substantiate this assertion (and this, of course, goes to the heart of some of the errors in the Appellants' Notices of Appeal).
- 5.18 In contrast, GEMA seeks to position the Appellants as selective and biased stating, by way of example:
- (a) "*It is the Appellants, not GEMA, who take a selective approach to the evidence base regarding TMR ...*";<sup>158</sup> and
- (b) "*It is clear, then, that the Appellants accept that utility may be derived from this cross-check; they simply favour its selective use*".<sup>159</sup>
- 5.19 In Reply, the Appellants make three points.
- 5.20 First, the Appellants do not consider that they have been selective or biased. Indeed, the degree of consistency of the Appellants' case with other appealing parties on Grounds 1 and 2 in terms of highlighting flaws in GEMA's evidence base provides clear evidence to the contrary. Further, the Appellants' Notices of Appeal set out the selectivity applied by GEMA in determining the CAPM parameters with reference to balanced evidence sets – in many cases using the same approach and evidence set that the CMA used in the PR19 redeterminations.

<sup>155</sup> Response, Finance Issues, paragraph 277.

<sup>156</sup> NGET, Notice of Appeal, paragraphs 3.3 and 3.11; NGG, Notice of Appeal, paragraphs 3.3 and 3.11.

<sup>157</sup> Response, Finance Issues, paragraph 99.

<sup>158</sup> Response, Finance Issues, paragraph 124.

<sup>159</sup> Response, Finance Issues, paragraph 233.

5.21 Second, there are clear instances of selectivity and downward bias in GEMA's Response. For example:

- (a) GEMA's approach to read-across between different sectors appears to have changed at some point around publication of the PR19 PFs when it became apparent that GEMA's views were out of step with the CMA's. Prior to the PR19 PFs, GEMA indicated that there could be read across, noting in response to the NATS Appeal that "*The CMA's decision in this case may have read-across for RIIO-2 as the Total Market Return (TMR) is not unique to the RP3 price control*".<sup>160</sup> This recognition of read-across stands in marked contrast to GEMA's position after the PR19 PFs, where it asked the CMA to "*emphasise clearly in its final decision that ... the decisions and judgments in this case concern its particular statutory role in relation to water and focus only on the water industry*".<sup>161</sup> GEMA repeats this position in its Response, stating that it has discretion not to follow the CMA's approach in PR19 as a "*regulator taking a different decision for a different sector, under a different statutory scheme*".<sup>162</sup>
- (b) GEMA's positioning in terms of the relevance of the political environment (e.g. the NAO Report and NIC Report), namely that its decision was not "*unduly influenced by considerations of political risk*" but these reports "*influenced the development and shape of Ofgem's thinking on the RIIO-2 price controls*",<sup>163</sup> is careful but instructive as to the degree to which GEMA approached the price control with an open mind around the entirety of the evidence base and the underlying drivers behind its decision.<sup>164</sup>
- (c) GEMA opts to ignore the scale and materiality of the differences between RIIO-1 and RIIO-2, and indeed hardly mentions Net Zero in its Response.

5.22 Third, to bring things full circle, these are clearly not matters within the scope of expert regulatory discretion or judgement. Where regulators are faced with choices it cannot be considered a legitimate exercise of judgement to default to the choice which excludes balanced options to get a low overall number.

## E. Changes to the licences

5.23 In accordance with the overriding objective, it is relevant to the current appeals that on 14 April 2021 GEMA published a statutory consultation on further modifications to the Appellants' licences, in particular to address what GEMA considers to be "*minor snagging issues*" and to make a number of corrections. GEMA has not proposed substantive changes to any provisions of the Appellants' licences which are subject to appeal. However, minor changes are proposed to the licence documents. The Appellants have not at this stage updated Annex 1 to DP1 or Annex 1 to CB1, which set out the steps that would need to be taken to achieve the relief sought (if the consultation changes are implemented), but propose to do so following the CMA's publication of its provisional determination if appropriate.

<sup>160</sup> Ofgem letter to the CMA regarding NATS En-route Limited (NERL) RP3 Price Control Determination, 31 December 2019 [R1/1]. Available at: [https://assets.publishing.service.gov.uk/media/5e0f650340f0b6280cec1aa0/Ofgem\\_representation\\_letter\\_Redacted\\_-\\_pdf](https://assets.publishing.service.gov.uk/media/5e0f650340f0b6280cec1aa0/Ofgem_representation_letter_Redacted_-_pdf).

<sup>161</sup> Ofgem letter to the CMA regarding Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Provisional Findings, 29 October 2020 [R1/2]. Available at: [https://assets.publishing.service.gov.uk/media/5fa298d88fa8f57896ad0276/Ofgem\\_response\\_to\\_PR19\\_Provisional\\_Findings\\_291020\\_Redacted.pdf](https://assets.publishing.service.gov.uk/media/5fa298d88fa8f57896ad0276/Ofgem_response_to_PR19_Provisional_Findings_291020_Redacted.pdf).

<sup>162</sup> Response, Finance Issues, paragraph 90.

<sup>163</sup> First Witness Statement of Akshay Kaul, Section A, paragraph 30.

<sup>164</sup> See, in particular, NGET, Notice of Appeal, paragraph 3.387; NGG, Notice of Appeal, paragraph 3.387.

**SECTION 6: STATEMENT OF TRUTH**

The Appellants believe that the facts stated in this Reply are true.

Signed:

Dated: 10 May 2021

Chris Bennett, Director of UK Regulation, National Grid plc  
For and on behalf of National Grid Electricity Transmission plc and National Grid Gas plc