

**BEFORE THE COMPETITION AND MARKETS AUTHORITY**

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

**SP TRANSMISSION PLC**

**and**

**Appellant**

**THE GAS AND ELECTRICITY MARKETS AUTHORITY**

**Respondent**

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**REPLY OF SP TRANSMISSION PLC  
TO GEMA'S RESPONSE TO THE APPEALS**

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## A. INTRODUCTION & SUMMARY

1. GEMA has rightly acknowledged that SPT “*submitted a rigorous, well researched, well evidenced and well thought through business plan*”.<sup>1</sup> GEMA’s Challenge Group “*found Scottish Power very easy to deal with, very responsive and open*”.<sup>2</sup> It is against this background of constructive engagement with the process that SPT has found it necessary to appeal contending that:
  - (1) GEMA’s determination of the overall allowed return on equity (Grounds 1 & 2), and scope for ongoing efficiencies (Ground 3), lie outside the bounds of reasonable regulation. GEMA has arrived at outcomes that seriously jeopardise the fundamental statutory objectives that GEMA is obliged to pursue.
  - (2) Certain provisions for substantial changes to be made to the price control without a formal licence modification fall outside the scope of GEMA’s statutory powers, denying the procedural protections which Parliament intended to confer and also conflicting with principles of best regulatory practice (Ground 4).
2. As to Grounds 1 to 3, it appears clear from GEMA’s evidence<sup>3</sup> (and was also apparent from its comments made in the course of consultation) that the origin and heart of GEMA’s approach to these aspects of RIIO-2 lie in its conviction, held from the outset of its consultation if not before, that historical returns have been overly generous. GEMA considers that this perceived generosity has been at the expense of value for money to consumers. In short, GEMA has approached the matter in a campaigning spirit, determined to redress perceived historical imbalances.
3. Whether GEMA’s conviction is justified is largely irrelevant for present purposes. What is plainly relevant is that GEMA’s one-sided focus on reducing short-term costs to consumers has created an unfortunately blinkered approach that has led it into serious error in the circumstances of RIIO-2.

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<sup>1</sup> Transcript of Open Meeting with SP Energy Networks; Ofgem; 22 October 2020: comments of Akshay Kaul (Regulatory Director – Networks) at p. 2.

<sup>2</sup> Transcript of Open Meeting with SP Energy Networks; Ofgem; 22 October 2020: comments of Roger Whitcomb (Chair of the Challenge Group) at p. 16.

<sup>3</sup> e.g. First Witness Statement of Akshay Kaul, paras. 36-49.

4. In this regard, the single most salient feature of RIIO-2 is that it takes place in the context of the UK and Scottish Governments' well-justified, but highly challenging, targets of achieving Net Zero by 2050 and 2045 respectively. Achieving these targets is the great challenge of our generation, especially for those working in relevant industries such as SPT and GEMA. GEMA has acknowledged that it is obliged to take into account the need to achieve Net Zero and it is plainly right to do so, not least by reason of the 'Sustainability Objectives' (as defined in SPT's Notice of Appeal at footnote 1) that it is directed to by EA 1989. If Net Zero is to be accomplished in practice, however, significant steps must be taken in the course of RIIO-2 to achieve it. As SPT observed in the evidence served with its Notice of Appeal, those steps will need to involve not only investment on an unprecedented scale but also innovation and forward planning. The taking of the necessary innovation risk through discretionary investment will not be assured without adequate reward.
5. GEMA's case is instead that it has sought to cater for the achievement of Net Zero by the use of 'uncertainty mechanisms' and 'reopeners' that will permit the potential deployment of additional investment by SPT and others towards sustainability goals (in many cases by a method of GEMA determination which circumvents the CMA's jurisdiction: see Ground 4). Such an approach, however, has a critical lacuna. It ignores the fundamental fact that unless the return on equity is also adequate to attract investment into the GB transmission sector then the innovation and planning that is essential to deliver this against the aggressive timescales anticipated by the Net Zero challenge will simply not take place. This is the issue at the heart of SPT's appeal.
6. GEMA's Response abounds with rhetorical flourish. However, no amount of rhetoric, or repeated references to GEMA's exercise of regulatory judgment, can obscure the fact that GEMA's approach to Net Zero is bound to fail unless the allowed return on equity is adequate. Despite the extensive evidence served by SPT on this point, GEMA's evidence in response fails to answer it. SPT's point is simply identified by GEMA in a single sentence of its Response,<sup>4</sup> but without any mention of the witness statements of Messrs Mitchell<sup>5</sup> and Mathieson.<sup>6</sup> It is then brushed aside in a catch-all comment about

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<sup>4</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 276.

<sup>5</sup> First Witness Statement of Frank Mitchell.

<sup>6</sup> First Witness Statement of Scott Hamilton Mathieson.

“*regulatory judgment*” in the following paragraph.<sup>7</sup> When scrutinising GEMA’s case at the forthcoming hearings, the CMA should not allow such evasion.

7. This Reply is necessarily brief, as per the CMA’s request. SPT’s appeal is maintained in its entirety; omission to address a point made by GEMA should not be read as acceptance.

## **B. GROUND 1-3**

### **B1. Standard of review**

8. SPT and its experts consider that GEMA has made fundamental errors in important parameters that go towards its assessment of the allowed return on equity and the scope for ongoing efficiencies. GEMA’s Response has sought to brush off each of these errors by reference to the repeated refrains that each element in isolation is a ‘reasonable’ exercise of regulatory judgment and within the margin of its discretion, or an ‘esoteric’ or ‘immaterial’ point with which the CMA should not concern itself. SPT does not agree.
9. Whilst of course it is true that GEMA is to be allowed some margin of appreciation as an “*expert regulator*”, this does not give GEMA *carte blanche*. It must not be allowed to denude the CMA of its own expert regulatory function. Parliament has provided for merits-based licence modification appeals to the CMA in order to ensure that GEMA is subject to the scrutiny of a specialist body, and thereby also to ensure some degree of consistency between the regulators which are subject to that same overseer. The grounds of appeal which are available before the CMA are not confined to the grounds available before a court of law on an application for judicial review, for the reason that the level of scrutiny expected of the CMA is more intensive. GEMA should not be allowed to hide from scrutiny simply by labelling a decision a matter of “*regulatory discretion*”. Rather, SPT has been meticulous in identifying in its Notice of Appeal the specific grounds by reference to which it claims that GEMA has erred. The CMA is asked to re-read the summary in section B of SPT’s Notice of Appeal with this in mind.

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<sup>7</sup> GEMA’s Response to Appeals on Finance Issues and TNUoS, para. 277.

10. A further beguiling contention in GEMA's Response is the suggestion that "*the test of materiality should be applied to each of the specific errors advanced by an Appellant*".<sup>8</sup> If by this GEMA is suggesting that SPT's first three Grounds of Appeal<sup>9</sup> may each be further fragmented into elements to be assessed in isolation for materiality, despite the fact that each of those three grounds feeds into a single aspect of the price control, that is a misguided submission. An error is an error, even if it could theoretically be subdivided into a multitude of smaller errors.
11. Allowed return on equity is a critical element of any price control; to make GEMA's decisions on the allowed return on equity excessively difficult to appeal removes an important protection for investors, at the very time when investors need to be persuaded to commit unprecedented sums to long-term investments to meet the Net Zero challenge.

## **B2. Overview**

12. In relation to the Risk Free Rate, GEMA's decision to use exclusively the lower return index-linked gilts to the total exclusion of any adjustment or inclusion of corporate bonds is irrational, inconsistent with CAPM theory and contrary to the approach taken by the CMA in PR19.
13. In relation to Total Market Return, GEMA opts to derive this based exclusively on the lower historical CPI-deflated returns to the total exclusion of the established historical RPI-deflated returns – again irrational, downwardly biased and contrary to the approach taken by the CMA in PR19.
14. In relation to the beta, GEMA has without proper explanation chosen a figure that is irrationally at the very bottom end of the range of National Grid betas – relying, in particular, on beta estimates for National Grid estimated over excessively long periods of 10+ years as well as on beta estimates for lower risk water companies.
15. In relation to ongoing efficiencies, GEMA has given no weight to GO measures (notwithstanding that it acknowledges their validity in addition to VA measures) and has even chosen a figure above the VA measures and a further, wholly un-evidenced, 'double

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<sup>8</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 50.

<sup>9</sup> On no view could a low financial threshold be used to justify error of law, which is the focus of Ground 4, and it is not apparent that GEMA even seeks so to contend.

count’ based upon the supposed contribution of past innovation funding to future cost efficiency.

16. As well as each of these matters constituting individual errors by GEMA, it is important also not to lose sight of the wider picture and their cumulative effect. In almost every relevant respect, on almost every significant decision, GEMA has chosen to take an outer-bound conservative position so as at each stage to reduce the allowed return.
17. GEMA has then compounded this approach by two further quite unorthodox features: (i) a decision not to ‘aim up’ within the range for cost of equity; and (ii) the imposition of a novel 25 bps outperformance wedge.
18. The justification for not aiming up is said to lie in GEMA’s supposed very high level of confidence in the robustness of its estimates.<sup>10</sup> The supposed ‘confidence’ is rather surprising in circumstances where the parameters GEMA has used to arrive at its assessment of the cost of equity are incorrect and, on any view, systematically downwardly biased by comparison with the approach of the CMA in PR19. GEMA’s stated basis for its supposed confidence is, it indicates, the result of its application of its cross-checks.<sup>11</sup> However, such basis is fatally undermined by the fact that, even by GEMA’s own account, these cross-checks are, by their nature, no more than an indicative range, designed only as a ‘sense check’.<sup>12</sup> GEMA’s actual estimate of the cost of equity does fall within the range – but certainly not above the range (and, indeed, once adjusted for the ‘outperformance wedge’, falls below its mid-point). Accordingly, GEMA’s stated confidence based on the cross-checks is unfounded and contrary to its own identification of the role such cross-checks are intended to perform. It may be added that the cross-checks are themselves downwardly biased by reason of excluding other more relevant cross-checks, and being based on parameters that contain GEMA’s own conservative assumptions.<sup>13</sup>
19. The addition of the 25bps wedge is a further novel and dangerous component. Most representatives on GEMA’s Challenge Group were rightly “*extremely doubtful about*

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<sup>10</sup> See: GEMA’s Response to Appeals on Finance Issues and TNUoS, paras. 8.1(e), 257.3, 257.4, 266-268 and 274; First Witness Statement of Simon Wilde, paras. 64 and 111.

<sup>11</sup> GEMA’s Response to Appeals on Finance Issues and TNUoS, paras. 61, 257.3 and 267.1.

<sup>12</sup> GEMA’s Response to Appeals on Finance Issues and TNUoS, para. 179.

<sup>13</sup> See NERA CAPM Report, sections 5.4 and 5.6 [RH1].

*whether that was a good idea*"; albeit it appears that they later "*decided it probably isn't a very good idea but is better than all the others to address [the problem of outperformance]*".<sup>14</sup> As NERA and other experts (most notably Frontier) have explained, this regulatory novelty is fundamentally misconceived not least because in many realistic scenarios it is highly likely to dampen, or even entirely remove, incentives to improve cost efficiency. More generally, the use of this wedge corroborates the fact that GEMA's concern with remedying the perceived past wrong of historical outperformance has blinded it to the critical challenge for the future: ensuring the achievement of Net Zero and providing the necessary incentives to SPT and others to invest, plan and innovate to achieve it. In so doing, GEMA has failed to take proper account of the Sustainability Objectives and violated its statutory obligations, including the requirement to have regard to principles of best regulatory practice. GEMA asserts in its Response<sup>15</sup> that it "*had careful regard to those principles*". But nowhere in its Response does it explain how it reconciled the wedge with the principle that regulatory activities should be "*transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed*".<sup>16</sup> The wedge is unprecedented in the history of GB utility regulation and plainly inconsistent with basic principles of incentive regulation.

20. Attached to this Reply is a responsive report by NERA in relation to return on equity, the outperformance wedge and the ongoing efficiency target (**NERA Reply Report**).<sup>17</sup> Below we summarise NERA's conclusions in relation to the main points of appeal.

### **B3. Risk Free Rate**

21. As identified in SPT's Notice of Appeal at paragraph 41, GEMA erred in exclusively using the spot rate for index linked gilts (**ILGs**) as a proxy for the risk free rate (**RFR**). ILG spot rates do not represent rates at which non-government entities can borrow. They therefore understate the CAPM RFR, violating CAPM theory. As to the points raised by GEMA in its Response, NERA make 4 key points:

<sup>14</sup> Transcript of Open Meeting with SP Energy Networks; Ofgem; 22 October 2020: comments of Roger Whitcomb (Chair of the Challenge Group) at p. 17.

<sup>15</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 326.

<sup>16</sup> EA 1989, s. 3A(5A).

<sup>17</sup> Observations on GEMA responses on finance issues and efficiency on behalf of SPT; R Hern and J Grayburn, NERA Economic Consulting; 10 May 2021.

- (1) Indexation based on ILG spot rates does not address the fundamental issue that the ILG rate estimated over any period is an underestimate of the RFR for non-government borrowers.<sup>18</sup>
- (2) Recent regulatory precedent does not support the use of unadjusted spot ILGs, and GEMA's reliance on the findings in the NATS/CAA appeal is misplaced.<sup>19</sup>
- (3) GEMA's cross-checks based on nominal gilts and SONIA do not support use of ILGs.<sup>20</sup>
- (4) The identity of the marginal investor in the energy sector is irrelevant, as the RFR is a market-wide parameter, and the marginal investor in energy is not a net lender in any case.<sup>21</sup>

#### **B4. Total Market Return**

22. As identified in SPT's Notice of Appeal at paragraphs 42 and 43, GEMA erred by placing sole reliance on the unreliable and downward-biased measure of historical CPI inflation and should have also relied on the established historical RPI measure. As to the points raised by GEMA in its Response:
  - (1) GEMA's assertion that the CED/CPI series is more reliable than the CED/RPI series as a measure of historical UK inflation is not supported by any cogent evidence. It ignores the fact that reliable historical CPI inflation data going back to 1900 does not exist, as CPI was only introduced in the 1990s, with GEMA's index relying on 40 years of back-cast data which the Office for National Statistics (ONS) considers as "*indicative*" only and another almost 50 years of an index intended to replicate historical RPI. In contrast, RPI has been the official inflation measure over most of the historical period and is also considered the more appropriate measure of historical UK inflation by the ONS.<sup>22</sup>

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<sup>18</sup> NERA Reply Report, para. 7.

<sup>19</sup> NERA Reply Report, paras. 12-14.

<sup>20</sup> NERA Reply Report, paras. 16-17.

<sup>21</sup> NERA Reply Report, para. 10.

<sup>22</sup> NERA Reply Report, para. 21.



- (2) GEMA's concern that the Appellants make a "*leap from the CED/RPI historical data series ... to RPI data reflecting investors' current expectations for future inflation*"<sup>23</sup> overlooks that NERA adjusted historical RPI-deflated returns so that they could be used in the context of a CPI(H)-indexed price control by use of the historical RPI-CPI wedge, which takes into account any potential impact of the 2010 methodological change on the RPI data.<sup>24</sup>
- (3) Contrary to its assertions, GEMA has not applied the established estimators from academic literature when uplifting the geometric mean to estimate TMR, resulting in a TMR well below the range supported by these estimators.<sup>25</sup>
- (4) GEMA's cross-checks suffer from material flaws, and are of no evidential value.<sup>26</sup>

#### **B5. Beta**

23. As identified in SPT's Notice of Appeal at paragraphs 44 to 47, GEMA erred in assessing beta based upon the 10-year betas for National Grid stock, which were unusually depressed during the Global Financial Crisis (**GFC**) and subsequent Sovereign debt crisis due to 'flight to quality' effects. The effect was to use a beta at the lower end of GEMA's estimates. As to the points raised by GEMA in its Response:

- (1) GEMA's argument that it is generally better to use longer data sets ignores the fact that there is no reason to believe flight to quality during GFC/debt crisis is relevant for RIIO-2 forward-looking risks.<sup>27</sup> NERA's estimates rely on historical data for up to seven years, which strikes a balance between ensuring statistical robustness and being reflective of forward-looking risks.
- (2) GEMA is wrong to place weight on the water companies' betas given the lower risk of the water sector as compared with the energy sector.<sup>28</sup>

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<sup>23</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 120.

<sup>24</sup> NERA Reply Report, para. 25.

<sup>25</sup> NERA Reply Report, paras. 26-28.

<sup>26</sup> NERA Reply Report, paras. 29-31.

<sup>27</sup> NERA Reply Report, paras. 33-35.

<sup>28</sup> NERA Reply Report, paras. 36-37.

- (3) GEMA ignores the betas of European energy companies despite their obvious relevance by way of cross-check.<sup>29</sup>
- (4) GEMA's beta assessment cannot be characterised as "*balanced*"<sup>30</sup> in circumstances where GEMA's estimate is at the bottom end of its own estimates for National Grid.<sup>31</sup>

#### **B6. Aiming up and cross-checks**

24. As identified in SPT's Notice of Appeal at paragraphs 35 to 39, GEMA has declined to 'aim up' in assessing the cost of equity, notwithstanding that this is well established in regulatory practice as a means of ensuring the optimal level of socially beneficial investment in the context of an uncertain cost of equity, investment which is particularly vital in the context of Net Zero.<sup>32</sup>
25. The principal defence raised by GEMA in this regard is to assert it has high 'confidence' that it has not underestimated the true cost of equity. The basis for this confidence is stated to be its analysis at 'Stage 2', namely its cross-checks. However, GEMA's confidence is clearly unwarranted:
  - (1) As GEMA acknowledges elsewhere in its Response,<sup>33</sup> the purpose of the cross-checks is purely, in summary, to approximate a range as a sense check and not to give a precise estimate of the cost of capital. Given this, the fact that the cost of equity from stage 1 of the CAPM (4.55%) is within the range (3.85% to 5%) cannot rationally justify the inference, let alone the confidence, that the cost of equity is not underestimated.<sup>34</sup>
  - (2) GEMA incorrectly claims that no cross-check supported a cost of equity above 5% CPIH.<sup>35</sup>

<sup>29</sup> NERA Reply Report, paras. 38-39.

<sup>30</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 154.

<sup>31</sup> NERA Reply Report, para. 44.

<sup>32</sup> See NERA Reply Report, section 4.

<sup>33</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 179.

<sup>34</sup> NERA Reply Report, paras. 69-70.

<sup>35</sup> NERA Reply Report, paras. 61-62.

- (3) The cross-checks used by GEMA are either unreliable (MAR evidence<sup>36</sup> and investment manager surveys<sup>37</sup>), circular because they reflect GEMA's own erroneous CAPM assumptions (MM),<sup>38</sup> or reflect assets with significantly different risk profiles (OFTOs and infrastructure funds).<sup>39</sup>
- (4) GEMA's repeated *ex post* reliance on the MAR derived from the WPD transaction is entirely misplaced: this unique transaction represents a strategic change in the portfolio of National Grid and cannot be used as a reliable basis for the cost of capital.<sup>40</sup>
- (5) In its international comparison of regulatory decisions, GEMA does not compare like with like. In particular, GEMA examines allowed returns (and so includes cost of debt allowances) and considers publicly-owned networks (despite the fact that allowed returns may not be so important for public shareholders).<sup>41</sup>

#### **B7. Outperformance wedge**

26. As SPT's Notice of Appeal makes clear (Ground 2), GEMA's novel introduction of an 'outperformance wedge' is based upon an unfounded assumption that previous regulatory experience will be repeated in RIIO-2 and is wrong in principle, as it is bound to dampen incentives to improve cost efficiency. In its Response, GEMA seeks to argue that it is entitled to introduce a regulatory innovation of this nature, that the expectation of outperformance in RIIO-2 is justified and that the dampening of incentives will only arise in limited circumstances. As to this:

- (1) GEMA's unparticularised contention that it "*has had careful regard*"<sup>42</sup> to principles representing the best regulatory practice including the principles under which regulatory activities should be transparent and consistent (per EA 1989, s.

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<sup>36</sup> NERA Reply Report, para. 47.

<sup>37</sup> NERA Reply Report, paras. 57-58.

<sup>38</sup> NERA Reply Report, para. 46.

<sup>39</sup> NERA Reply Report, paras. 51-56.

<sup>40</sup> NERA Reply Report, paras. 49-50.

<sup>41</sup> NERA Reply Report, para. 72.

<sup>42</sup> GEMA's Response to Appeals on Finance Issues and TNUoS, para. 326.

3A(5A)) is not understood. GEMA's novel outperformance wedge has no regulatory precedent.<sup>43</sup>

- (2) The expectation of outperformance fails to take into account significant changes to price controls, particularly under a substantially more demanding RIIO-2 framework.<sup>44</sup>
- (3) GEMA's assertion that the dampening of incentives will arise only in very limited circumstances is based on its view of companies' historical cost performance, which by definition cannot reflect the RIIO-2 regime. At RIIO-2, NERA expects a far greater number of companies to face no or limited incentives to drive cost efficiency.<sup>45</sup>

#### **B8. Ongoing efficiencies**

27. SPT has appealed GEMA's ongoing efficiency estimate of 0.95% for capex and 1.05% for opex, with a further "*innovation uplift*" of 0.2%. GEMA's Response does not adequately address any of the key points made by SPT in its appeal on this issue, most notably:

- (1) Even based upon its own estimates, GEMA has given no weight at all to the lower GO measures of efficiency and instead only relied upon the very top end of the VA measures (and then imposed a further 0.2% uplift).<sup>46</sup> This was identified in SPT's letter of 15 January 2021 to GEMA and referred to in the Notice of Appeal at para. 60(4), which GEMA has conspicuously failed to address in its Response.<sup>47</sup>
- (2) Nor has GEMA given any weight to its own targeted set of comparators, instead relying on economy-wide measures.<sup>48</sup>

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<sup>43</sup> NERA Reply Report, paras. 74-75.

<sup>44</sup> NERA Reply Report, para. 77.

<sup>45</sup> NERA Reply Report, para. 79.

<sup>46</sup> NERA Reply Report, paras. 85-86 and 89-94.

<sup>47</sup> See GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 122, which includes an erroneous and cryptic cross-reference in footnote 76 to "*§40 above*".

<sup>48</sup> NERA Reply Report, para. 87.

- (3) The innovation funding is already embedded in both the economy-wide measures and in SPT's own business plan.<sup>49</sup>
  - (4) The innovation funding was never principally aimed at cost savings.<sup>50</sup>
  - (5) As to the derivation of the 0.2% "*innovation uplift*", GEMA does not even pretend to provide justification for it at Response para. 162, saying merely that it was a "*high-level estimate based on simplifying assumptions.*"<sup>51</sup>
28. These points are unanswerable and show that on no rational basis ought GEMA to have imposed an efficiency target as high as 0.95% (capex) or 1.05% (opex), let alone 1.15% (capex) and 1.25% (opex).

#### **C. GROUND 4: CIRCUMVENTION OF LICENCE MODIFICATION PROCESS**

29. Ground 4 of SPT's appeal raises a point of law as to the proper scope of the power under section 7(3) and 7(5) EA 1989. Contrary to GEMA's contentions, no question of "*substantial discretion*"<sup>52</sup>, "*regulatory judgment*"<sup>53</sup> or "*Wednesbury rationality*"<sup>54</sup> arises. Contrary to the suggestion of GEMA's witness, it is not a question of what GEMA "*considers*" Parliament "*envisaged*".<sup>55</sup> It is an issue of law.<sup>56</sup>
30. At Response paras. 220-230, GEMA attributes confusing labels to what it sees as the two parts of SPT's Ground 4. GEMA's labels are "*alleged failure in drafting*" and "*alleged circumvention of procedural protections*".<sup>57</sup> The CMA should not use these labels.
31. "*Alleged failure in drafting*" is GEMA's erroneous summary of section I3 of SPT's Notice of Appeal, which makes a much more fundamental complaint than that there has been a mere drafting failure. SPT's complaint is rather that, unless the licence condition specifies the circumstances and the criteria by or under which GEMA will determine the

<sup>49</sup> NERA Reply Report, paras. 90-92.

<sup>50</sup> NERA Reply Report, para. 93.

<sup>51</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 162.

<sup>52</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 185.

<sup>53</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 226.

<sup>54</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 225.

<sup>55</sup> cf. First Witness Statement of Min Zhu, para. 116.

<sup>56</sup> As to "*regulatory judgment*" as a defence generally, see also section B1 above.

<sup>57</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, paras. 220-230.

future direction, the licence condition is *ultra vires*. GEMA simply has no power to make an open-ended licence condition with vague and uncertain consequences. GEMA is trying to achieve ends which section 7(3) and 7(5) do not permit and is pursuing an approach that is in conflict with principles of best regulatory practice, notably the requirement that regulatory activities should be “*transparent*”.<sup>58</sup> For example:

- (1) In relation to a Large Onshore Transmission Investment (**LOTI**), a Project Assessment Direction will set out amendments to Appendix 2 (i.e. outputs, delivery dates and allowances) – but the licence condition does not say how those outputs, delivery dates and allowances will be determined.<sup>59</sup>
  - (2) For a Medium Sized Investment Project (**MSIP**) Price Control Deliverable (**PCD**), the direction will set out the value of MSIPROt (i.e. adjustments to be made for the relevant MSIP outputs not being Fully Delivered) – but the licence condition does not explain how those adjustments will be made, other than by GEMA in accordance with the PCD Reporting Requirements and Methodology Document (which are not themselves licence conditions and so cannot be appealed to the CMA).<sup>60</sup>
32. SPT’s submission is supplemented by the Witness Statement of Mr Martin Scott Hill, in particular paragraphs 31 to 35 thereof, which GEMA fails to address, instead claiming that it finds it “*difficult to decipher the basis for SPT’s objection*”.<sup>61</sup>
33. “*Alleged circumvention of procedural protections*” is GEMA’s summary of section I4 of SPT’s Notice of Appeal. SPT’s complaint there is based on the principle that, as a public body, GEMA should only use its statutory powers in order to promote (and not frustrate) the policy and purposes of EA 1989.<sup>62</sup> That is the principle behind SPT’s contention that circumvention of the procedural protections in EA 1989 is unlawful.

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<sup>58</sup> EA 1989, s. 3A(5A).

<sup>59</sup> Special Condition 3.13.23. See further First Witness Statement of Martin Scott Hill, paras. 74-83.

<sup>60</sup> Special Condition 3.14.14 & 3.14.11. See further First Witness Statement of Martin Scott Hill, paras. 84-92.

<sup>61</sup> GEMA’s Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 221.

<sup>62</sup> This is the general public law principle derived from *Padfield v. MAFF* [1968] 2 WLR 924. Parliament has also expressly provided for licence conditions to be “*requisite or expedient having regard to the duties imposed by sections 3A to 3C*” EA 1989: see EA 1989, s. 7(1)(a).

34. GEMA's Response and supporting evidence reinforce the extraordinary extent of potential amendment of the RIIO-2 price control by way of direction. Ms Zhu of GEMA does not shy away from recognising that GEMA's approach "*develops the position taken over the RIIO-1 Price Control*"<sup>63</sup> in respect of what she calls "*Self-Modification*". Mr Hill of SPT describes the step-change from RIIO-1 to RIIO-2 in paras. 39 to 45 of his statement.<sup>64</sup> GEMA now says in its Response that the ratio of baseline allowances set upfront at the start of the price control compared to allowances flowing through uncertainty mechanisms is estimated to be potentially 50:50 or 60:40 in RIIO-2, as compared to closer to 80:20 in RIIO-1.<sup>65</sup> GEMA estimates that the volume of small and medium sized projects coming through the MSIP reopener could exceed £1bn.<sup>66</sup> GEMA is seeking to remove an enormous financial value from the CMA's jurisdiction. This financial value relates to projects of importance and complexity in relation to which it is appropriate that the protection of the CMA's expertise should be available to licence holders, qualifying bodies and associations and the designated consumer representatives.<sup>67</sup>
35. GEMA appears to acknowledge that there are limits to the circumstances in which the section 7 powers may be used, claiming that "*it approached carefully the analysis of when such alternative powers should be implemented in licence conditions at the outset of the price control*"<sup>68</sup> and that their use in this particular case is justified because this is "*necessary and appropriate*".<sup>69</sup> Reference is made to "*a careful and considered delineation of approach*".<sup>70</sup> However, GEMA's approach and the principles which it claims to have applied have not been transparent or obvious.
36. The essence of GEMA's case on Ground 4 is that requiring future changes in the seven categories identified by SPT at Notice of Appeal para. 66<sup>71</sup> to be effected by way of

<sup>63</sup> First Witness Statement of Min Zhu, para. 31.

<sup>64</sup> First Witness Statement of Martin Scott Hill, paras. 39-45.

<sup>65</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 187(3).

<sup>66</sup> First Witness Statement of Min Zhu, para. 113.

<sup>67</sup> i.e. those listed in EA 1989, s. 11C(2).

<sup>68</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 172.

<sup>69</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 173.

<sup>70</sup> GEMA's Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 226.

<sup>71</sup> There are errors in Table 1 in Annex MZ1 to the First Witness Statement of Min Zhu of GEMA, which purports to list the licence conditions appealed by SPT. Special Conditions 3.2, 3.3, 3.4, 3.15, 3.17 and 8.1 should not be listed.

licence modification would be inconvenient. GEMA does not say that it would be impossible, but rather the curious word that it chooses to use is “*sub-optimal*”.<sup>72</sup>

37. None of this is relevant to statutory construction. Parliament’s intention in section 7 EA 1989 is primarily to be ascertained by reference to the text and context of the statute, not GEMA’s view today of how the system ought to have been designed for its convenience.
38. To the extent that (contrary to SPT’s primary case) the CMA considers GEMA’s views on convenience to be of any relevance, the CMA is respectfully requested to probe the assertion about “*sub-optimality*” rigorously and sceptically. This is especially important in circumstances where both GEMA and the CMA are mandated by EA 1989 to have regard to the principles under which regulatory activities should be transparent and accountable.<sup>73</sup> GEMA makes four points in this regard at Response para. 190.<sup>74</sup>
39. First, GEMA says that its approach “*results in a price control that is both responsive and flexible*”. Making a subsequent determination by licence modification in the seven cases that SPT has identified would also allow the price control to be responsive and flexible.
40. Secondly, GEMA says that it “*enables outcomes to be delivered more quickly*” referring to the 56-day standstill period before a licence modification can take effect. In the scale of a 5-year price control, and in relation to the significant matters affected by this Ground 4, a 56-day standstill period is of no real adverse consequence.<sup>75</sup> For example, GEMA’s Guidance for LOTI under Special Condition 3.13 indicates that the approval process for a LOTI can take up to 6 years.<sup>76</sup> In any event, 56 days is the minimum standstill period that Parliament considered appropriate before a licence modification should have effect,<sup>77</sup> and it is not for GEMA to overrule Parliament.

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<sup>72</sup> GEMA’s Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 189.

<sup>73</sup> EA 1989, s. 3A(5A)(a) and 11E(2). Further, s. 7(1)(a) expressly refers to the duties imposed by s. 3A in relation to the conditions that may be imposed in a licence.

<sup>74</sup> GEMA’s Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 190.

<sup>75</sup> See First Witness Statement of Martin Scott Hill, para. 37.

<sup>76</sup> Large Onshore Transmission Investments (LOTI) Re-opener Guidance and Submissions Requirements Document; Ofgem; 29 March 2021, para. 1.15 ([link](#)).

<sup>77</sup> EA 1989, s. 11A(8).



41. Thirdly, GEMA says that up-to-date information can be “*reflected on the face of the licence in a timely fashion.*” The seven cases that SPT has identified are not concerned with minor adjustments to reflect simple updating of information.
42. Fourthly, and most significantly, GEMA refers to a “*disproportionate administrative burden*” of making licence modifications.<sup>78</sup> GEMA’s assessment of disproportion is one-sided. GEMA means inconvenience to the regulator. Disproportion is properly to be assessed also taking into account the countervailing benefits to licensee, consumer and other interested parties of maintaining the protections inherent in the licence modification scheme (as to which see section I4 of the Notice of Appeal).
43. Ms Zhu describes the burden as “*the rigidity of the Statutory Modification process, including the lead time for GEMA to prepare multiple consultation and decision documents, serving hard copy documents by post to all network companies (SoS, CitA and CAS), the 56-day standstill period*”.<sup>79</sup> This is exaggerated:
- (1) GEMA consults on significant decisions in any event, whether or not they involve a licence modification. Moreover, consultation is beneficial; it can flush out issues at an early stage, enhancing the robustness of the resultant decision and thus reducing the need for adversely affected parties to resort to other means of challenge *ex post*.
  - (2) GEMA does not identify any relevant requirement to serve documents by post,<sup>80</sup> and in any event this is not a credible inconvenience.
  - (3) A CMA appeal (the process for challenging a licence modification) may be speedier than a claim for judicial review (the process for challenging a determination). A CMA appeal must be commenced within 20 working days,<sup>81</sup> unlike a claim for judicial review which must be commenced within a maximum of three months. The CMA must make its permission decision within 10 working days following GEMA’s representations,<sup>82</sup> whereas there is no deadline for a court

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<sup>78</sup> GEMA’s Response to Appeals on Totex Modelling, Efficiency and Licensing, para. 190(4).

<sup>79</sup> First Witness Statement of Min Zhu, para. 36.

<sup>80</sup> The s. 109 EA 1989 requirements for delivery of documents only apply where EA 1989 requires documents to be “*served*”, which is not a concept used in the provisions on licence modification in s. 11A-11C.

<sup>81</sup> EA 1989, Sch. 5A, para. 1(3).

<sup>82</sup> EA 1989, Sch. 5A, para. 1(10).

decision on permission to proceed with a claim for judicial review. The CMA must then decide a non-price-control appeal within four (or at most five) months,<sup>83</sup> whereas there is no deadline for the determination of judicial review claims.

44. The submission by Ms Zhu that SPT would have an effective remedy by way of judicial review against an assessment by GEMA as to whether or not a change or impact is “*significant*” is unrealistic, particularly in circumstances where:

- (1) Of the seven licence conditions identified in SPT’s Ground 4, only one is identified as containing a “*significance*” test – namely, Special Condition 3.13 (LOTI).
- (2) There is no source in the EA 1989 for GEMA to determine whether or not to proceed by way of licence modification by reference to a test of “*significance*”.
- (3) Any assessment of significance is subjective. On any challenge by way of judicial review to its assessment of significance, GEMA can be expected to raise the defence of “*regulatory judgment*”, the pervasiveness of which in its thinking is apparent even in this CMA appeal.<sup>84</sup>
- (4) In any event, SPT’s case is that all of the seven licence conditions identified in Ground 4 concern matters of significance: see Notice of Appeal, para. 67.

#### **D. CONCLUSION**

45. For all the above reasons, SPT maintains its appeal.

46. In its Response and supporting evidence, GEMA appears to be claiming interlinkages which it has not previously identified between matters subject to appeal and other aspects of the price control. SPT does not accept that there are any relevant interlinkages between the matters subject to appeal and other aspects of the price control. However, any issue as to interlinkages is properly a matter to be considered (if at all) at the remedies stage, at which SPT reserves the right to make further submissions.

DANIEL JOWELL Q.C.  
GERARD ROTHSCILD

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<sup>83</sup> EA 1989, s. 11G.

<sup>84</sup> First Witness Statement of Min Zhu, paras. 52 and 98.

**STATEMENT OF TRUTH**

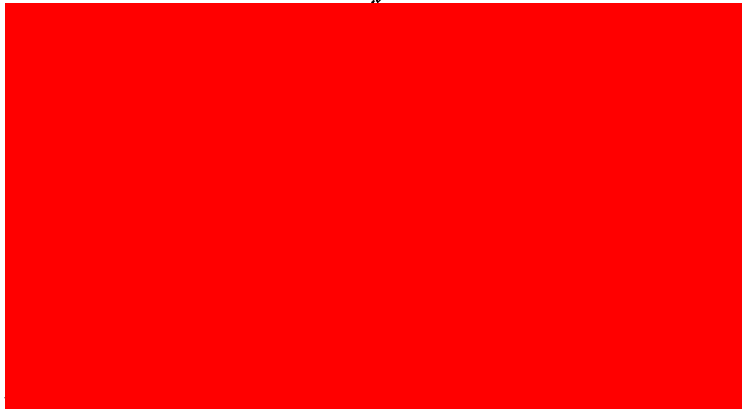
SPT believes that the facts stated in this Reply are true. I am duly authorised to sign this statement on behalf of SPT.

Signed:

Name:

Position:

Dated:



Non-confidential