NON-CONFIDENTIAL VERSION

BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL

UNDER SECTION 23B OF THE GAS ACT 1986

B E T W E E N : -

WALES & WEST UTILITIES LIMITED

Appellant

and

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

REPLY TO OFGEM'S RESPONSE
ENERGY LICENCE MODIFICATION
RIIO-GD2 PRICE CONTROL (2021-2026)

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PART I. INTRODUCTION

1 INTRODUCTION

1.1 This document constitutes the submissions made on behalf of Wales & West Utilities Limited (**WWU**) in reply to the representations and evidence filed by the Gas and Electricity Markets Authority (**Ofgem**) in this appeal on 23 April 2021.

1.2 Collectively, we refer to Ofgem's representations as the **Response**. This document, together with the further evidence submitted alongside it, is the WWU **Reply**.

1.3 As requested by the CMA, WWU has focused on addressing the matters which are raised in the Response. It seeks to do this in as succinct a manner as possible, while noting that it has pleaded six heads of appeal, and that Ofgem has submitted a considerable volume of material in response to them, including evidence and arguments that WWU is seeing for the first time.

1.4 For the purpose of assisting the CMA in this appeal process, WWU has sought to reply to all of the principal elements of these materials, so that the issues between the parties are clear, but without repeating its principal case as set out in the Notice of Appeal and accompanying documents filed on 3 March 2021 (the **NoA**).

1.5 Respecting the fact that the CMA has asked for short and focused submissions, and taking into account the time restrictions on the preparation of this Reply, WWU does not set out here a line-by-line rebuttal of the Response. However, the absence of a rejoinder to any particular argument or piece of evidence should not be taken either as an acceptance of that argument or evidence or generate the assumption that it is not disputed.

1.6 Words or expressions which have a meaning attributed to them in the NoA should be treated as having the same meaning in this Reply, except where the context clearly requires otherwise or a different meaning is specified.

2 CROSS-CUTTING ISSUES

2.1 There are a number of cross-cutting issues raised by the Response which are relevant to the approach taken by Ofgem in respect of all, or a number, of WWU's heads of appeal. To avoid a repetition of WWU's response to these issues throughout this document, it is appropriate to address them first on a general basis, before turning to the more detailed points which Ofgem has raised in respect of each individual head of appeal.

2.2 We have addressed the cross-cutting issues in the following order –

(a) Ofgem's approach to this appeal as a matter of law,

(b) Ofgem's approach to interlinkages,

(c) Ofgem's failure to address significant parts of the NoA,

(d) Ofgem's mischaracterisations of WWU's case,

(e) Ofgem's use of previous CMA decisions,

(f) Ofgem's interpretation of its statutory duties.

3 OFGEM'S APPROACH TO THIS APPEAL AS A MATTER OF LAW

Introduction – the Nature of this Appeal

3.1 Five statutory grounds of appeal are set out at section 23D(4) of the Gas Act 1986 (the **Act**).

3.2 Only one of these grounds is expressly legal in nature – '*that the decision was wrong in law*' (section 23D(4)(e)). This allows for the full range of legal argument that would be available on a judicial review to be advanced in an appeal before the CMA. The decision will be '*wrong in law*' if it could successfully be challenged in a court of law on any of the legal grounds that are applicable in respect of Ofgem decisions.[1]

3.3 Two of the other grounds of appeal are that Ofgem '*failed properly to have regard to*' any part of its duties (section 23D(4)(a)) and/or '*failed to give the appropriate weight to*' any part of its duties (section 23D(4)(b)).

3.4 There is a potential confusion here which must be clarified. It arises from the fact that a failure to have due regard to a relevant matter is a standard public law ground of challenge in judicial review[2], and the Act uses similar language to this legal standard. However, compliance with the general law is already encompassed within another statutory ground ('*wrong in law*'). What the statute provides in the case of these two grounds is designed to supplement, and go beyond, these narrow legal requirements.

3.5 The principal difference is that, in public law, a court will display considerable 'deference' to an expert body, and will not regard its role as being to substitute itself for that body and re-consider the decision from first principles. In particular, any questions as to the appropriate

[1] These will include (non-exhaustively) any grounds of challenge that relate to an alleged breach of public law, incompatibility with EU law, or failure to comply with the Human Rights Act 1998.

[2] It is the second half of the well-known *Wednesbury* test – *Associated Provincial Picture Houses v Wednesbury Corporation* [1947] 2 All ER 680.

weight to be given to a particular matter will be for the sole judgment of the decision-maker, so long as it acts rationally.

3.6 In contrast, under the Act, the CMA is named as the appellate body precisely because it is a specialist economic regulator in its own right, and (unlike a court) is therefore in the position to assume Ofgem's role, re-consider the case as if it were the primary decision-maker, and reach its own expert judgment as to what constitutes '*proper*' regard or *'appropriate weight*' in respect of any matter. This function is commonly described as determining a 'merits' appeal.

3.7 The government understood itself, when legislating to create the current appeal regime, to be introducing a right of appeal of this nature: '*on the technical merits of Ofgem's decisions… going beyond what judicial review would normally consider*'[3]. Its rationale specifically was as follows –

> 'The main difference between a merits based approach and a judicial review approach is that economic and market questions would be more likely to be considered in scrutinising the decision. Allowing appeals on the merits of the case in relation to the specified grounds is likely to mean that more appeals are allowed, as compared with stricter grounds for appeal. This would be expected to result in higher costs overall from an increase in the number of appeals.
>
> However, appeals based on the merits of a case should also mean higher associated benefits, particularly around competition and consistency of economic regulation. In addition a merits-based appeal would provide a greater challenge function to decisions with costs to business…
>
> The government intends to introduce a carefully defined right of appeal on the merits, in relation to the specified grounds. We believe that this balances the costs and benefits of the different options best…'[4]

3.8 The CMA shares this understanding of the purpose and effect of the legislation –

> 'We agree that we are not limited to reviewing the decision on conventional judicial review grounds and that we are not only able, but required [by statute], to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute.'[5]

3.9 The statutory grounds at section 23D(4)(a) and (b) of the Act are therefore policy-related grounds of appeal, allowing appellants to advance the case that Ofgem was wrong not merely

[3] *Proposals for implementation of licence modification appeals under the EU Third Package – Final Impact Assessment* (DECC, June 2011 – the **Impact Assessment**), page 16.

[4] Impact Assessment, page 20.

[5] CMA – *NPg* Final Determination (2015), paragraph 3.23; CMA – *BGT* Final Determination (2015), paragraph 3.24

in law but on the merits, that it made poor decisions as to regulatory policy, and that the CMA should recognise this error and form its own view as to the correct approach

Ofgem's Approach

3.10 WWU is fully aware of the decisions made previously by the CMA about the standard of review carried out in this appeal process. It understands that the regulator is entitled to a margin of discretion when making its decisions and that: *'Our view is therefore that the CMA should not substitute its views for GEMA's solely on the basis that it would have taken a different approach'*[6]. No issue is taken with the approach that the CMA has outlined in prior cases.

3.11 However, we have begun by stressing that this process remains an appeal on the merits as well as the law because it is clear from the nature of so many of its submissions as set out in the Response that Ofgem would like to encourage the CMA to treat it as if it were merely a form of judicial review to be decided on narrow legal grounds only.

3.12 This begins with Ofgem citing judicial review case law as if it applied in an unqualified way to this appeal process – the well-known *Cellcom* case (cited at §43 of Ofgem's Response on Finance Issues and TNUoS (the **Finance Response**)). *Cellcom* indicates the requirement for a very high degree of deference applicable to a judicial review where the court is reviewing the decisions of an '*expert and experienced decision-maker*'. It is not applicable in an appeal where the CMA is, on the subject-matter of economic regulation, an expert and experienced decision maker in its own right.

3.13 More generally, Ofgem's approach to the appeal as a whole appears to be to suggest that, so long as it has followed due process and exercised its discretion, there is no basis for the CMA to interfere with its decisions.

3.14 For instance, Ofgem dismissively states in §6 of the Finance Response that the appellants' complaints are '*no more than disagreements with the way in which GEMA has exercised its expert regulatory discretion*'. It contends that since it engaged in '*extensive consultation*', and since the appeals '*concern matters within the scope of GEMA's expert regulatory judgment*', the appeals are '*without merit*' – as if the mere fact of prior consultation and the existence of a discretion immunised its decisions from scrutiny within this appeal process.

3.15 This approach is wholly disingenuous. Ofgem certainly has a margin of discretion open to it. However, it does not have an unfettered regulatory discretion in the manner it wishes to

[6] CMA – *NPg* Final Determination, paragraph 3.42; *BGT* Final Determination, paragraph 3.43

suggest. Simply pointing to the existence of discretion is not a shield that serves as a defence against any head of appeal.

3.16 In particular, in previous appeals, the CMA has made it clear that it will not defer to Ofgem if it considers that this is not warranted based on the evidence advanced. This is evident from the decision in *NPg*, where the CMA stated that: '*there has to be, in our view, a limit to the discretion of regulators*'.

3.17 It is WWU's case that Ofgem is, on a number of heads of appeal, wrong in law, and has also sometimes made decisions based on an error of fact (section 23D(4)(c)). Where WWU shows this to the satisfaction of the CMA, it no longer becomes an area for regulatory discretion – it is an error which should attract a remedy. WWU strongly disputes the notion advanced in the Response that its case is solely made up of differences of opinion as to how it has exercised its discretion.

3.18 But some decisions are also challenged in this appeal on the merits. Those challenges are not restricted to narrow legal grounds; they are about the inadequacy of the manner in which Ofgem has exercised its discretion. And they cannot be answered by Ofgem seeking to treat this process as if it were a judicial review on legal grounds alone.

4 INTERLINKAGES

4.1 Recognising the risk of knock-on effects that changing one aspect of a complex and integrated regulatory decision might have, the CMA has previously noted in energy appeals that –

> 'We consider that the question as to whether there are sufficient links between the parts of the Decision which are challenged and parts which are not challenged must be decided on a case-by-case basis taking into account the circumstances of each case. Where there are such links, we would, in the first instance, have expected Ofgem to have highlighted these and addressed them in its response.'[7]

4.2 In this appeal, Ofgem has sought to stretch this concept beyond all original intent, and to turn it into something that it cannot possibly be.

4.3 A price control is the sum of a series of complex parts. Where a regulatory error has been made in determining one of those parts, it should be corrected, and as a result of the correction it should be expected that this will have an effect on the allowance generated by the price control as a whole. The concept of interlinkages exists to ensure that each of these parts is not looked at in complete isolation of others that may be unavoidably related to it.

[7] CMA - *NPg* Final Determination (2015) paragraph 3.51

4.4 Ofgem, however, appears to come very close to saying that almost every aspect of each price control is interlinked to every other, that price controls are interlinked across appellants, and that regardless of any individual component of a price control which needs to be amended in the light of an identified error, the overall allowance should not be disturbed because it must be assumed to be correct on an 'in the round' basis. This bears no relation to the concept of interlinkages originally recognised by the CMA, and stretches it to breaking point.

4.5 Consequently, far from identifying interlinkages in its Response as required by the CMA, Ofgem has sought to make generalised statements as to the nature of the interlinkages.

4.6 It has also sought to mischaracterise the CMA's letter of 20 April 2021 as relieving it of the obligation to state its case clearly on interlinkages in its Response, by interpreting the CMA's statement that the appropriate time to consider submissions on remedies is after the CMA's Provisional Determinations. Both we and the CMA would have expected Ofgem to adequately set out in its Response the facts and matters which it relies on in respect of interlinkages, as the CMA has indicated in its letter in response to Ofgem's letter of 30 October 2019, that[8]:

(a) if the interlinkages form part of a regulator's response to an appeal then while stating that an error in one part of the price control is linked to another part, the regulator is encouraged to explain any interlinkages and the reasons for such interlinkages in their decision documentation; and

(b) the submissions for both the appellant and the regulator have higher credibility if they are clear on all relevant information and supporting material and the relevant interlinkages are explained succinctly.

4.7 Ofgem has made a variety of statement in its Response on interlinkages which we address as follows –

Ofgem Response	**WWU Reply**
Ofgem considers that hypothetical discussion of various possible interlinkages would, at this stage, be unmanageable and disproportionate[9]	WWU disagrees. Ofgem's position on interlinkages should have been fully set out in its Response as the CMA has previously set out.
Ofgem considers that the RIIO-2 package as a system made up of closely linked but distinct pillars and the intrinsic links between these pillars means that each of them potentially affects and could be affected by decisions taken in relation to other pillars[10]	WWU considers the concept of pillars is too wide and generic to satisfy the CMA's test that there is a ***sufficient*** link between parts of the settlement which are appealed and parts which are not.

[8] CMA response to Ofgem's open letter dated 30 October 2019.

[9] Paragraph 6, Submissions on Totex Modelling, Efficiency and Licensing

[10] First Witness Statement of Akshay Kaul paragraph 103-107

Ofgem states that the outcome of a successful appeal could have knock on effects and included a statement of policy on the possibility of carrying out a post appeals review.[11]	WWU considers that a post appeal review would be inconsistent with the statutory framework, which provides for a licence modification decision and an appeal to the CMA. A post appeal review would be an attempt by Ofgem to circumvent the appeals process which should give finality and certainty to the price control. It is not open to Ofgem to seek to undermine any redress granted by the CMA by a post appeal review.
Ofgem stated that a post appeal review would not target a non-appealing licensee, which Akshay Kaul has retrospectively clarified to define as a non-appealing licensee (i.e. a licensee who is not a main party appellant).[12]	WWU believes that this statement was originally intended to disincentivise companies from appealing. As the CMA has made clear in its response to WWU's letter, if Ofgem were to bring forward a further post appeal review and propose further licence modifications this would be the subject of a further licence modification appeal.
Ofgem claim that they have built a coherent modelling suite for totex, where the majority of GDNs' submitted costs were assessed using regression-based benchmarking in order to compare GDN performance. Ofgem further argue that any change in the treatment of costs within the model would change the modelling outcome for ***all*** GDNs, and thus their allowances (emphasis added[13]).	WWU dispute this. If one appellant has appealed part of the modelling suite and another has not, there is no concept of a read-across to another appellant's settlement for the reasons given above. Each appeal is separate. A modelling change in one appeal cannot impact another GDN who has not appealed that element of the licence modification. There is no cross-appeal right to claim interlinkages between different appeals. As WWU has already established in correspondence with the CMA each appeal is a separate and distinct appeal in its own right. Appeals may be considered with others but not joined under the Gas Act 1989. This was confirmed by the CMA in its response to WWU's letter. Ofgem's suggestion is wrong in law.
Ofgem states that there are interlinkages between totex allowances, incentives and allowed returns and described these as '*in the round'* interlinkages as there is not a mechanistic link between these components. Ofgem does not make any mechanistic or quantitative link between the expected outperformance of 25bps, and the individual decisions on totex, incentives and efficiency but states there is a common-sense relationship.[14]	WWU would point out that this is too generic and non-specific to satisfy the CMA's requirement that there is a ***sufficient*** link between the relevant limbs of the appeal. The CMA therefore should reject this
Ofgem considered two "in-the-round" questions to satisfy itself that the RIIO-2 settlement was balanced as a whole: (i) the notional efficient licence question; and (ii) the equity and debt financeability question. The different aspects that Ofgem considered while making its final determinations and these 'in the round' tests are described in paragraphs 117-121 of Akshay Kaul's witness statement.	WWU considers that this fundamentally fails to understand the statutory appeal mechanism. The CMA is not making a determination in the round. It is considering the specific grounds of appeal which WWU has brought. This is not a water redetermination where the CMA is required to make a decision on the RIIO-2 settlement in the round. There is no concept in the statutory appeals mechanism for the CMA to adjust one part of the settlement and to make a corresponding adjustment elsewhere to balance the overall settlement back to the same overall revenue allowance.

[11] First Witness Statement of Akshay Kaul paragraph 106

[12] First Witness Statement of Akshay Kaul paragraph 106

[13] First Witness Statement of Akshay Kaul Interlinkages within Totex (GD only) (Paragraph 110)

[14] First Witness Statement of Akshay Kaul paragraph 111

Ofgem contends that there are also interlinkages between certain financial and operational aspects of the price control, for example, between setting Totex levels and expected outperformance as set out above.[15]	WWU's case on outperformance is that there should not be any interlinkage between the totex, outperformance and financial aspects of the settlement. WWU considers that it is an error for Ofgem to have reduced the cost of equity to deal with what Ofgem terms "expected outperformance". Outperformance should be dealt with in the totex incentive regimes and not deducted from the cost of equity.
Ofgem also argues any assessment of whether to increase one company's debt allowance for actual costs would require an assessment of whether every other company in the GD&T sector's debt allowance should be adjusted to their actual cost of debt. An upwards adjustment for one company would be likely to trigger a downwards adjustment for others.[16]	WWU does not agree with this. Ofgem is quite capable of setting a company specific adjustment to the cost of debt as it has for SHET and for the smaller GDNs without having to apply those adjustments to the wider sector. It is also perfectly clear that there is no cross appeal interlinkage, so to the extent that WWU is successful in its appeal and there is an adjustment to the cost of debt it would and could only apply to WWU as no other party has challenged the cost of debt appeal. The CMA therefore could not apply an adjustment to any other party, and Ofgem could only do so if it made a further licence modification adjustment.
Ofgem also asserts that the interlinkage with gearing would need to be considered as it would not be rational to provide an actual cost of debt allowance without also considering whether the cost of capital allowance ought to be based on actual gearing for each company, to prevent the risk of the consumer paying for the same costs twice.[17]	WWU is not requesting a change to the notional gearing set by Ofgem. It is requesting a cost of debt allowance which is based on the efficiency of the debt at the date on which it was issued.
Ofgem also argues that any change in the treatment of costs within the model would change the modelling outcome for all GDNs, and thus their allowances. For example, amending any of the regional factor indices would result in a change in the adjusted costs used for the regression analysis. This would in turn change the regression results and thus the GDNs' relative efficiency (i.e. their efficiency scores). Also, if some projects (e.g. Local Transmission System diversions) were to be excluded from the benchmarking exercise, the view of efficient costs would change for all the GDNs, even if the excluded projects only related to one GDN.[18]	WWU challenges the legality of this approach. As set out above each of the appeals is a separate and distinct appeal. As WWU set out in its letter to the CMA it is not correct that there can be a cross appeal remedy. WWU has not challenged the LTS or the regional factors. These form part of Cadent's appeal and not WWU's. Furthermore, WWU is not challenging the regression model. WWU does not consider it is within the legal structure of the appeal for the CMA to reach a decision in Cadent's appeal which has an impact on WWU's appeal in the manner suggested by Ofgem. It is not open to the CMA to change the efficiency ranking of any of the appellants who have not raised the LTS, although it is possible for the CMA to recommend a remedy in respect of Cadent's appeal. WWU specifically raised this issue in correspondence with the CMA and chose not to intervene in Cadent's appeal based on the very clear response from the CMA.
Ofgem argues that all modelling decisions should be viewed 'in the round' with Ofgem's other decisions in relation to outputs, allowed revenues and uncertainty and other risk mitigating	WWU does not agree with this. WWU is not contesting the modelling in its appeal. Modelling decisions in other appeals cannot apply to WWU as this is a statutory appeals process and not a redetermination. WWU is concerned that Ofgem is seeking to turn this appeal into a redetermination in a similar

[15] First Witness Statement of Simon Wilde paragraphs 204 – 211

[16] First Witness statement of Jessica Friend paragraph 102-104

[17] First witness statement of Jessica Friend paragraph 102-104

[18] First Witness statement of Michael Wagner paragraphs 70-74

mechanisms as this is the basis on which it has constructed the RIIO-2 package[19]	manner as that which applies to the water sector although this is not the case.

5 OFGEM'S FAILURE TO ADDRESS SIGNIFICANT PARTS OF THE NOA

5.1 Ofgem has included a statement in paragraph 2 of its Finance Response that where Ofgem does not expressly respond to a particular paragraph of any notice of appeal, it should not be taken to be accepting the relevant submission.

5.2 In general, WWU understands the need for this. No response can address a notice of appeal on a line-by-line basis, or should be expected to do so. However, Ofgem has failed to address large swathes of WWU's Notice of Appeal and accompanying evidence, and that is not what would have been expected. The whole purpose of pleadings in the CMA appeals is to narrow down and focus the issues between the parties.

5.3 Sometimes, Ofgem's failure to respond appears to be consistent with its approach to treating the appeal as if it could be advanced on legal grounds only, so that no policy justification is required for anything in respect of which it has 'discretion'. In that sense, this issue may to some extent be an outworking of the point identified in section 3 above.

5.4 In any event, in the circumstances, WWU is entitled to treat any points which have been made as being unopposed if Ofgem has not made a substantive response to them.

6 OFGEM'S MISCHARACTERISATION OF WWU'S CASE

6.1 In numerous places in the Response, Ofgem has mischaracterised the WWU case. This is a regrettable way of pleading a defence, and very unhelpful for the CMA as it does not contribute effectively to narrowing down or identifying the key issues in dispute.

6.2 Throughout this Reply WWU has sought to indicate to the CMA where we do not agree with these mischaracterisations.

7 OFGEM'S USE OF PREVIOUS CMA DECISIONS

7.1 WWU has taken a consistent and principled approach to the relevance of previous CMA decisions in price control appeals or re-determinations, in line with the submissions it made to the CMA on 23 April in respect of PR19.

[19] First Witness statement of Michael Wagner paragraphs 70-74

7.2 However, WWU notes that Ofgem's approach is to quote previous CMA determinations as if they were binding and conclusive precedent on any issue where it thinks a previous decision to be in its favour, while at the same time dismissing or simply choosing to ignore any previous determination with which it has acted inconsistently.

7.3 Again, this is a regrettable and inconsistent mode of pleading a defence, and does nothing to achieve clarity on the issues in dispute or facilitate an efficient and effective process.

8 OFGEM'S INTERPRETATION OF ITS STATUTORY DUTIES

8.1 WWU draws the CMA's attention to the discussion relating to the interpretation of Ofgem's statutory duties (and in particular its financing duty) in section A of this document.

8.2 While WWU's claim that Ofgem has misdirected itself in law arises first under the cost of debt head of appeal, and has therefore been treated in some detail there, it should be noted that its relevance is not limited to that head of appeal alone, and in particular that it forms an integral part of WWU's case in relation to the cost of equity and outperformance heads of appeal. If Ofgem has misdirected itself in law on a matter of such significance, it infects a wide range of decisions to which this appeal relates.

PART II. REPLY TO OFGEM'S RESPONSE ON EACH HEAD OF APPEAL

A. COST OF DEBT

A1 INTRODUCTION

A1.1 This section addresses Ofgem's response to WWU's cost of debt head of appeal, as set out in section G of its document entitled RIIO-2 Price Control: Response to Appeals on Finance Issues and TNUoS and dated 23 April 2021 (the **Response**).

A1.2 In this section: paragraph references in the form §xxx (where xxx is a number) are references to the Response; and paragraph references in the form JF1 §xx are to paragraphs in the first witness statement of Jessica Friend.

A2 OFGEM'S MISINTERPRETATION OF ITS STATUTORY DUTIES

A2.1 In the Notice of Appeal, WWU noted that Ofgem had previously had very little to say about how it interprets its financing duty[20]. Indeed Ofgem's Response is the first time it has set out its legal reasoning in any detail.

A2.2 However, the more Ofgem writes on this subject, the more its mistakes become manifest. The Response is littered with errors and misstatements. So far from undermining WWU's case on misinterpretation, it demonstrates why that case should be upheld.

A2.3 Before turning to the main errors of law, it is useful to summarise, in terms stripped of legal technicalities, what Ofgem says about its financing duty. Put simply, Ofgem says that the duty is not very important. It is a duty of process, not outcome – so long as Ofgem has thought about financeability, there is no obligation to attach any special weight to it, still less to achieve a particular result (§§386-389). The duty used to be more important, but was downgraded by Parliament in 2000 (§410). Now it is subsidiary to Ofgem's principal objective (§412) and can be overridden by Ofgem's interpretation of the consumer interest (§390). Moreover, decisions by Ofgem do not need to be based on companies' actual circumstances (§393), and indeed should not be (§399). Ofgem is free to make decisions which mean that companies are unable to finance their activities, so long as it gives its reasons for doing so (§388). In the end, there is always the insolvency regime (§416).

A2.4 WWU says that this is not an academic debate. Ofgem's interpretation of its financing duty – advanced fully for the first time in this appeal – should be of concern to all energy companies,

[20] What Ofgem had previously said was set out in full at NOA para A4.15, with a critique at paras A4.16 - A4.37.

their investors, credit rating agencies and the government. If this were a correct interpretation of the financing duty, it would have a chilling effect on investment in the GB energy sector.

A2.5 But it is not the correct interpretation. The primary reasons for this are set out in WWU's Notice of Appeal, and need not be repeated here. The following paragraphs focus on providing a brief reply to the main elements of the defence advanced by Ofgem. That defence is unsustainable, but it is necessary to draw attention only to certain features of it in order to demonstrate why.

'Have Regard to'

A2.6 **First**, in the Notice of Appeal WWU showed that Ofgem had: (i) seized upon these words in the financing duty; (ii) stripped them of the wider context in which they must be interpreted; (iii) failed to understand that the immediately following words, '*the need to secure*', are a statutory expression of the weight to be given to the objective of securing financeability; and therefore (iv) failed to appreciate that this objective was an outcome required to be achieved.[21]

A2.7 In its Response, Ofgem demonstrates the validity of this argument (§§385-389). It has nothing to say about the words '*need to secure*' or about the weight of the obligation that they impose[22], and offers no alternative interpretation of them. It simply treats the words 'have regard to' as a get-out-of-jail-free card, which allows it to think about financeability but not have to attach any particular weight to it, still less ensure that it is achieved. It is wrong for the reasons already given.

'Subsidiary'

A2.8 **Second**, in the Notice of Appeal WWU showed that the financing duty was an intrinsic part of Ofgem's primary duty to further its principal objective.[23] Ofgem now argues that it is instead '*subsidiary*' to the primary duty (§404)[24], one of a suite of subsidiary duties (§412), all of which exist at the same level as a range of considerations '*to which GEMA's attention is directed in the course of furthering that objective*' (§390).

A2.9 As to this –

[21] NOA para A4.16 - A4.18

[22] Further, as to this question of weight, see the penultimate paragraph of the Hansard extract quoted at para A2.19 of this Reply.

[23] NOA para A4.11

[24] Ofgem states in §404 that WWU '*acknowledges*' the subsidiary nature of the duty. The statement is untrue.

(a) When the Gas Act 1986 wants to make certain duties subsidiary to other duties (these are commonly referred to as **secondary duties**), it uses express language to achieve that effect – 'subject to…' (see the opening words of section 4AA(5)).

(b) The financing duty is not one of those secondary duties. On the contrary, it is a duty to which other duties are made secondary. Section 4AA(5) begins: '*Subject to subsections (1B) and (2)…*'. This means that the duties listed in that section are made subsidiary to the primary duty and the financing duty taken together. In contrast, the financing duty is subsidiary to nothing.

(c) In service of its argument, Ofgem makes a number of statements which are designed to collapse this important distinction or at least deflect the CMA from considering it –

(i) It lists a set of duties (§390.1-§390.6) in such a way as to give the impression that they are all at the same level of significance – all equal part of the '*several considerations*' to which Ofgem must have regard. In doing so it presents the financing duty as equivalent to a number of duties which are expressly made secondary to it.

(ii) It suggests that the financing duty exists '*in tension*' with the duty on efficiency and economy (§392), when the latter has been expressly made secondary to the financing duty so that any potential tension has been resolved in advance by Parliament.

(iii) It claims that WWU seeks to '*elevate*' the financing duty above other duties (§406), when in fact this is what Parliament has done using express language.

A2.10 Ofgem's presentation of this argument is therefore (whether deliberately or not) misleading. It ignores the clear statutory language.

The Utilities Act 2000

A2.11 **Third**, however, Ofgem says that a '*close analysis of the legislative history*' (§407) supports its case. It accepts that the financing duty was a primary duty of the regulator in the original Gas Act 1986 (§409), but claims that this changed when the Utilities Act 2000 amended the duty to put it into substantially its current form (§410). According to Ofgem, this change had the effect of downgrading the '*status of the duty*' so that it became '*subsidiary to the principal objective*' (§410). This is said to be '*confirmed*' and supported by extra-statutory materials, including the Explanatory Notes to the Utilities Act and the Hansard record (§§411-421).

A2.12 In passing, it should be noted that, in spite of this allegedly major legislative development, Ofgem says that it has not changed its approach to company financeability since privatisation

(§417), a statement that could only be true if: (i) Ofgem does not set its policies in accordance with its statutory duties; (ii) there was in fact no major change in 2000; or (iii) both.

A2.13 To be clear, WWU's case is that the status and meaning of the financing duty is unambiguous and does not require reference to materials outside the Gas Act 1986[25]. But since Ofgem has chosen to introduce those materials into the dispute, WWU has no difficulty in both addressing and relying on them.

A2.14 Ofgem primarily relies on two extra-statutory sources. First, it cites the Explanatory Notes to the Utilities Act 2000 (§411). However, its quotations are selective. Notably, it fails to draw the CMA's attention to the paragraph in which the Explanatory Notes address the financing duty itself. This reads as follows –

> 'This duty to further the principal objective **incorporates** the matters which form the regulators' existing primary duties. The Authority must have regard to the need to secure that all reasonable demands for the relevant utility are met. In the case of gas, this duty applies to the extent that it is economically feasible for demand to be met. Likewise, the Authority must recognise that, to the extent that the utilities legislation places obligations on utility companies (whether directly, through licence conditions or otherwise), such companies **must be able** to finance those obligations.'[26]

A2.15 WWU's case as advanced in the Notice of Appeal is that: (i) the financing duty is intrinsic to, and a sub-set of, the principal objective[27]; and (ii) the words '*need to secure*' indicate a result that must be achieved[28]. The Explanatory Notes to the Utilities Act 2000 are plainly consistent with this interpretation, just as they are wholly inconsistent with Ofgem's argument.

A2.16 Second, Ofgem draws attention to the Civil Aviation Act 2012, to the explanatory notes to that Act, and to things said in Parliament while it was being debated (§§418-420). It seeks to argue that these are relevant to the interpretation of the financing duty because of a similarity in the wording.

A2.17 WWU could explain why the context of those provisions is fundamentally different, but it is not necessary to do so. There are strictly limited circumstances in which Parliamentary materials may be used to interpret legislation (the rule in *Pepper v Hart*)[29], and they do not extend to the interpretation of one statute (Act A) by reference to the record of what was said in relation

[25] NOA para A4.12

[26] Utilities Act 2000 – Explanatory Notes, para 22 (emphasis added). Ofgem cites the previous two paragraphs, but neglects to reference this.

[27] NOA para A4.11

[28] NOA para A4.20

[29] [1993] AC 593. As to the strict application of the *Pepper v Hart* rule, see *R v Secretary of State for the Environment, Transport and the Regions ex p Spath Holme* [2001] 2 AC 349 at 392D-E, 408C-D and 413G-H.

to a different statute (Act B) applying to a different sector by a later and differently-constituted Parliament[30]. As the material cited by Ofgem is inadmissible as an aid to interpretation, we do not address it in substance.

A2.18 In any event, it is plainly extraordinary to be reaching for extra-statutory materials relating to airports when Parliament's intention in relation to the financing duty in the Gas Act 1986 is so clear. To the extent that there is any residual ambiguity surrounding that duty, the relevant passages in Hansard are those relating to the passage of the Utilities Act 2000 through Parliament. Since Ofgem's own case is that this was the decisive amending statute, we address these below.

A2.19 At House of Lords Committee stage in relation to the Utilities Bill, the question of interpretation which is the subject of this appeal was raised. Lord Kingsland expressed the concern that the amendment to the financing duty would render it '*subordinate*' to the principal objective.[31] The Minister, Lord McIntosh of Haringey, provided a comprehensive rebuttal of that concern which merits being quoted in full –

> 'Apart from the duty in respect of competition, the directors-general of gas and electricity supply have two primary duties. The first is the duty concerned with securing that all reasonable demands for gas and electricity are met—the demand duty. The second is the duty concerned with securing that utility companies are able to finance their licensed activities—**the finance duty**.
>
> Under existing legislation, both the demand duty and the finance duty are stand-alone duties; they are ends in their own right. Under this Bill, those duties are positioned where they more naturally belong, as **aspects of the duty to consumers**. That helps to explain what we mean by the "interests of consumers" as that phrase is used for the principal objective. It **incorporates** not simply the narrow consumer interest in a high quality service at low cost, but also the broader requirements of a sustainable industry.
>
> Of course, consumers have an interest in ensuring that all reasonable demands for gas and electricity are met. Ensuring that they receive a supply is the gas and electricity consumers most fundamental interest. That is why the demand duty is restated as an aspect of the primary consumer duty.
>
> Who could doubt that consumers have an interest in ensuring that utility companies operate in a viable market with a long-term outlook? **It is no good to them if the return**

[30] The reason is obvious – materials in relation to Act B did not serve as part of the context in which the earlier Act A was passed, and therefore can offer no insight into the understanding and intention of Parliament when enacting that Act A. See *R(H) v Inland Revenue Commissioners* [2002] EWHC 2164 (Admin) at [27], and *Williams v Central Bank of Nigeria* [2014] UKSC 10 at [53] (per Lord Neuberger).

[31] Utilities Bill, Committee Stage, HL Deb 13 June 2000, Series 5, Vol 613, col. 1572

> **to shareholders is so low that utility companies are unable to attract the capital needed to maintain their infrastructure.**
>
> On the other hand, it is certainly not in the interests of consumers that utility companies are able to make excessive profits, or pay excessive remuneration to certain people. The right balance must he struck between the interests of consumers and the interests of shareholders. That is why the finance duty has been incorporated as an aspect of ensuring the interests of consumers.
>
> The words "**have regard to the need**" to secure that reasonable demands are satisfied, and that licence holders are able to finance their activities, **reflect the weight** that should be given to those aspects of the interests of consumers. **They represent confirmation in statute**—these are the words that the noble Lord, Lord Kingsland, would take out—**that the consumer interest expects reasonable demands to be satisfied and licence holders to be able to finance their activities**. It is difficult to see how the authority could comply with its primary duty (to further the protection of the interests of consumers) without carrying out its functions in a manner best calculated to secure those ends.
>
> The amendments proposed would reinstate the demand duty and the finance duty as ends in their own right and make them independent of, and subject to, the duty to further the principal objective. They deny that **the interests of consumers necessarily incorporate those matters that form the demand and finance duties**. We resist them because they would render the general duties as a whole incoherent and leave the authority in doubt as to how it should interpret the "interests of consumers" for the purpose of the principal objective.'[32]

A2.20 This statement makes three points with absolute clarity –

(a) The financing duty, in the form introduced by the Utilities Act 2000, is part of Ofgem's primary duty – it must be viewed as an '*aspect*' of the principal objective which Ofgem is required to fulfil, because the interests of consumers '*necessarily incorporate*' it. The consumer interest '*expects*' that companies should be able to finance their activities; it is '*no good*' for consumers if they cannot.

(b) By using the phrase 'have regard to the need to secure' Parliament is encoding within statute the '*weight*' to be given to the ability of companies to finance their activities, in the conscious expectation that it would then be '*difficult to see*' how Ofgem could fulfil its duties without securing the financeability of licence holders.

[32] Utilities Bill, Committee Stage, HL Deb 13 June 2000, Series 5, Vol 613, cols. 1572-1574 (emphasis added)

(c) The suggestion that the financing duty is '*subject to*' to the principal objective is explicitly rejected. It is precisely because the proposed Kingsland amendment would have had this effect in relation to the financing duty that the government resisted it.

A2.21 The CMA will note that this conceptualisation of the financing duty is consistent with (indeed employs the same language as) the provision of the Explanatory Notes to the Act cited above, but wholly incompatible with Ofgem's submissions that the financing duty is a duty of process not of outcome and is merely 'subsidiary' to the principal objective.

A2.22 Ofgem has no excuse for having institutional amnesia about this part of the Hansard record, since two senior members of its then Management Board were present at, spoke in and voted on the Utilities Bill in the House of Lords Committee on that day[33]. Moreover, its lawyers have clearly undertaken an extensive trawl of statutory and extra-statutory materials (including a great deal of irrelevant material – §421 and footnote 244) in an attempt to support its case. So Ofgem either knew or ought to have known of the detailed explanation given in Parliament about the meaning and status of the financing duty, just as it must have known of the position set out in the Explanatory Notes.

A2.23 Ofgem has neglected to draw these matters to the CMA's attention, and the reason for this is clear. There is **nothing** at all in the extra-statutory materials relating to the Act which supports Ofgem's case that Parliament understood itself to be downgrading the financing duty (and therefore a key legislative protection for investors and consumers) from primary to secondary status.

A2.24 On the contrary, those materials make it clear that there was no intention to diminish the primary status of the financing duty. They are consistent in every respect with the case that is advanced by WWU in its Notice of Appeal. They are therefore fatal to Ofgem's defence of this head of appeal.

Water

A2.25 **Fourth**, it is unnecessary to respond in detail to Ofgem's attempt to rely upon previous CMA determinations, notably in the water sector (§§395-402). WWU has set out more fully, in its Supplemental Submission on PR19[34], why a direct read-across from redeterminations by the CMA in that sector is not possible.

[33] Lord Gordon Borrie and Lord David Currie – respectively a distinguished lawyer and economist, and the latter subsequently chairman of the CMA. Both voted in favour of the government position on the financing duty as expounded by Lord McIntosh of Haringey.

[34] WWU – Supplemental Submission to the Notice of Appeal – PR19, 23 April 2021

A2.26 For the record, we note that the financing duty in the Gas Act 1986, as an integral part of the primary duty to further the principal objective, must (if anything) be stronger than its equivalent in the water sector – where it is one of five main duties, all with equal status[35] – and not weaker as Ofgem asserts (§400). But nothing really turns on the point.

A2.27 Ofgem's submissions in any event miss the mark. WWU has made it clear that it is seeking to recover only its efficiently-incurred cost of debt[36], and not to pass through inefficiency. Any arguments about the irrecoverability of inefficient costs are therefore irrelevant to the case.

Notional Company

A2.28 **Fifth**, Ofgem introduces into the argument the '*notional*' (§417) or '*reasonably efficient*' (§393) or '*notional efficient*' (§394) company. In relation to these (which seem to be interchangeable) it makes a significant claim about its financing duty: '*It will be sufficient to discharge the duty in s.4AA(2)(b) if GEMA's approach allows a reasonably efficient operator in the sector to finance its activities*' (§393).

A2.29 But these are constructs of Ofgem's own devising, imported into the argument without any grounding in the statute. Ofgem neither identifies where they are located in the statutory duties nor explains how they can be derived as an outworking of the statutory duties (whether on its own interpretation or otherwise). The statement quoted above does not follow as a matter of logic from the sentence that precedes it. Its suggested validation is in past behaviour, not law (§394) – a surprising approach in an argument directed to the legal interpretation of statute, and plainly invalid as a guide to how the legislation should be read or applied. The concepts that Ofgem seeks to introduce into the statute are present neither expressly nor by implication.

A2.30 Moreover, nowhere in its Response does Ofgem address WWU's submissions on its public law duty to take into account the actual circumstances of each company it regulates[37], or the relationship between that and the financing duty[38]. WWU must assume that Ofgem raises no dispute as to the law in this area. But in that case it has entirely failed to consider what effect that law should have on its policy.

A2.31 In short, this argument reveals Ofgem imposing its own policy on the statutory duties, rather than letting the duties shape its policy. A course of previously unchallenged decisions does not provide any validation for an erroneous and unsustainable interpretation of the law.

[35] Section 2(2A) of the Water Industry Act 1991

[36] NOA para A3.1 and section A7

[37] NOA para A4.26. WWU notes that these are therefore not disputed.

[38] NOA paras A4.25 - 4.37

Actual Company

A2.32 **Finally**, we note that there are circumstances in which Ofgem accepts, to an extent, that it is both entitled to and should act on the basis of the position of the actual company.

A2.33 For instance, based on the equivalent statutory duty in the Electricity Act 1989, Ofgem has recently used the actual cost of debt in licence conditions for project financed interconnectors. It also allows the actual cost of debt, including derivatives, for OFTOs. Why are these different cases?

A2.34 Jessica Friend seeks to distinguish OFTOs on the basis that they involve 'contracted' revenues, but this attempted distinction is invalid. The OFTO revenue allowance is set out in the company's licence complete with standard and special conditions; therefore its revenues are regulated in the same way. The only difference is that the efficient cost of debt is set in the case of OFTOs by reference to an auction mechanism and not by the regulator. The regulatory revenue is therefore determined by reference to the efficient cost of debt at the time of issuance – essentially the same basis for which WWU contends in this appeal.

A2.35 Similarly, in RIIO-2 Ofgem has made company specific adjustments to the index-led approach one for SHE-T (a RAV adjustment) and for NGN, SGN and WWU to reflect less frequent issuance. Again this impliedly acknowledges that a solely notional efficient company approach will not discharge Ofgem's statutory financing duty.

A2.36 It is difficult to locate any coherence or consistency of policy approach in these cases, to see how they fit with the statutory interpretation for which Ofgem contends, or to identify a rational basis on which they can be distinguished from the cases in which Ofgem insists on the idea of regulating the notional company as a legitimate means of discharging its statutory duties.

Conclusion

A2.37 Consistent with the strategy that it has deployed generally in this appeal (see the Introduction to this Reply) Ofgem has sought to reduce the cost of debt dispute to a narrow legal issue. It says that the whole of WWU's argument turns on statutory interpretation, and that if WWU is wrong on this then the CMA need not consider its other arguments (§366).

A2.38 The contention is absurd. WWU advanced three main arguments, and each one stands on its own[39]. Even if Ofgem were correct on statutory interpretation, that would not immunise it against irrationality.

[39] Even within these arguments, there is a series of discrete points, any one of which is sufficient to render Ofgem's decision 'wrong' for the purposes of this appeal – see NOA para A5.2 which makes this clear.

A2.39 **However**, the obverse of Ofgem's argument is certainly true. If Ofgem was wrong on statutory interpretation, then it has misdirected itself in law and its decision on the WWU cost of debt must inevitably be unlawful, whether or not it was also wrong on other grounds[40]. In addition, if it was wrong on statutory interpretation, then it is unsurprising that it has fallen into other and related types of error.

A2.40 **Moreover**, while these arguments have been developed under the heading of cost of debt, it should be noted that they were also incorporated by reference in the cost of equity head of appeal and apply equally to Ofgem's decision on that issue[41]. If Ofgem has misdirected itself as to the status and meaning of its financing duty, that must infect its decision on the cost of capital as a whole and not merely on one aspect of it.

A2.41 And it is plain that Ofgem **is** wrong on the matter of statutory interpretation. WWU says that the only thing needed to reach this conclusion is the language of the statutory duties in the Gas Act 1986, given their ordinary and natural meaning. But if it is necessary to look further – in particular in the context in which Ofgem has sought to rely upon amendments made by the Utilities Act 2000 as a significant change in the status and effect of the financing duty – the Explanatory Notes and Hansard record relating to that Act are dispositive of the point.

A2.42 And, again, these errors are not academic – they have significant consequences for the way in which Ofgem thinks about its role and obligations. Ofgem's stark conclusion, flowing directly from its flawed interpretation of the financing duty, is that it may decide: '*to adopt an approach which does or may have the result that one or more licensees is not able to finance their activities*' (§388). In particular –

(a) [✂];

(b) [✂] Ofgem's price control decisions are going to significantly impair WWU's equity financeability and contribute to a weakening of its debt financeability[42];

(c) on Ofgem's interpretation of the financing duty this is a lawful and tolerable outcome, and not one with which it need be unduly concerned, since the '*statutory words do not impose an obligation of result*' (§388).

A2.43 Ofgem is wrong on this issue. That was sufficiently clear even on the basis of the very shallow explanation of its legal approach that it had provided prior to this appeal. It is even more clear

[40] See NOA para A4.3 - A4.4

[41] NOA para B1.8(a)

[42] [✂]

now that, in its Response, Ofgem has been obliged to more fully reveal its position, which has therefore served more clearly to demonstrate the nature of its errors.

A2.44 WWU invites the CMA to conclude that for these reasons alone, taken as discrete from the other arguments considered below, Ofgem's decisions on the cost of debt are unlawful and should be quashed.

A3 OFGEM'S IRRATIONAL DESIGN OF A COST OF DEBT INDEX

A3.1 There were several facets to WWU's case under this heading, and as noted in the Notice of Appeal they are cumulative and overlapping[43]. But, to reduce the case to its most fundamental level, what lies at its heart is the matter of unlawful discrimination on the part of Ofgem.

A3.2 WWU set out the various provisions of law which preclude Ofgem from adopting policies that have discriminatory effect.[44] This summary of relevant legal obligations has not been disputed by Ofgem in its Response.

A3.3 However, Ofgem now says that: '*Decisions taken by WWU's management and shareholders as to its capital structure and risk management are not an appropriate ground on which to base differential treatment*' (§450), as if to imply that its policy is to treat everyone equally and that to recognise the different circumstances of companies would be a form of inequality.

A3.4 It would be difficult to overstate the extent to which this both misses the point and disregards the requirements of law. Indeed the statement is almost the diametric opposite of the situation to which Ofgem's policy actually gives rise.

A3.5 The application of a one-size-fits-all approach to companies with very different characteristics and circumstances – through the determination for the whole cohort of a single cost of debt – **is** differential treatment, and Ofgem **does** indeed seek to justify that treatment on the basis of decisions made by the companies about the timing and nature of debt issuance.

A3.6 The question this raises is why some of those decisions are presumed to be good (or efficient, or prudent – to use terms favoured by Ofgem) so that they should be rewarded with an allowance greater than a company's actual cost of debt, and why some are presumed to be bad (or inefficient, or imprudent) so as to be penalised with an allowance lower than the company's actual cost of debt.[45]

[43] NOA para A5.2

[44] NOA para A5.25

[45] Since Ofgem frequently refers to the incentive effect of its policy (e.g. §443), the over- or under-remuneration of the actual cost of debt can only be understood as a deliberate form of reward or penalty.

A3.7 To put this same question in legal terms, what is the objective justification for the differential treatment of companies which provides the rational basis on which Ofgem avoids engaging in unlawful discrimination?

A3.8 This was the challenge effectively posed by the Notice of Appeal, and in spite of the length of Ofgem's Response – including a long witness statement from Jessica Friend – WWU's case is that it is impossible to discern within these materials a rational or coherent justification. The detail of the Response deflects attention from the question, but does not answer it.

A3.9 Mindful of the CMA's request that the opportunity to reply to Ofgem is used by appellants in a short and focused way, WWU does not here provide a line-by-line rebuttal of the content of the Response (in particular the witness statement), still less to submit a further and responsive witness statement of its own. But the absence of a reply to Ofgem's submissions on any particular point does not mean that they are either accepted or not disputed. WWU will be happy to address any matters that the CMA considers important either in the hearings or in response to written questions for further information.

A3.10 For the purpose of this Reply, we focus on providing a succinct response to certain key themes which emerge from the Ofgem materials.

The Use of a Sector Average[46]

A3.11 In the Notice of Appeal WWU questioned why the sector average cost of debt should happen to correspond to the 'appropriate' cost of debt allowance for any individual company, and what inherent qualities the average possessed which meant that it represented the 'right' or 'reasonable' normative cost of debt for all companies in the sector.[47]

A3.12 Nothing in the Ofgem Response either directly addresses these questions or comes close to providing an answer to them.

A3.13 In the first place, Ofgem mischaracterises its own policy when it says that it sets the allowed return by reference to an external index cross-checked against the sector average cost of debt (§428). Describing the average as a mere cross-check is inaccurate and misleading. In fact Ofgem, in its own language, '*decided to apply a bottom-up approach first and then to use a properly adjusted conceptual approach as a cross-check*'.[48] It does this by 'calibrating' an

[46] As in the Notice of Appeal, references to the 'sector' average in this document are intended solely as a convenient shorthand. Ofgem's average is based on companies operating across three sectors (electricity transmission, gas transmission, gas distribution) each of which has its own distinct characteristics. WWU says that this creates an unsuitable foundation for the calculation of an average, and that is one of the pleaded bases of the appeal – NOA paras A5.14 and A5.18.

[47] NOA paras A5.5 - A5.9

[48] Tab A5.9: Ofgem – RIIO-2 Final Determinations – Finance Annex (Revised) para 2.29

index to the sector average, so as to: '*broadly match the debt allowance to expected GD&T sector average efficient debt costs*'.[49] Consequently, '*Our allowance reflects what networks have done on average…*'[50]

A3.14 As to why the average constitutes an appropriate allowance, Jessica Friend says this (JF1 §119) –

> 'Our rationale for using external benchmarks and broadly matching the calibration of the benchmark to average costs is that in determining a reasonable structure and allowances for the notional efficient operator we look at evidence from across the sectors (and more broadly) to consider whether on balance the strategies they have employed, in aggregate, represent a reasonable balance of risk and return for businesses that have long life assets but revenues that periodically reset.'

A3.15 The strong implication of this statement is that Ofgem critically engages with the evidence that is provided by the range of corporate debt management strategies ('*we look at evidence…to consider whether on balance…*') in order to form a reasoned view as to whether the average of all of those corporate positions has a representative value corresponding to the appropriate allowance for an efficient operator ('*represent a reasonable balance of risk and return*').

A3.16 We invite the CMA to ask Ofgem where the evidence of this critical engagement can be found, what considerations derived from it, how and where these were consulted on, and where the concluding rationale can be found in the RIIO-2 Final Determination.

A3.17 WWU has seen no such evidence. Nor is it credible that any analysis of the type implied would lead to the conclusion that the average of the approaches taken by very different companies raising debt at different times and in accordance with different strategies (each of which may well be an *ex ante* reasonable choice from the range of options available to it) would generate a single benchmark figure which happened to correspond to the 'appropriate' cost of debt for all companies. No logically coherent explanation can be (or has been attempted to be) given which demonstrates why a sector average should have this inherent quality.

A3.18 WWU's case is that Ofgem instead treats the sector average as a self-validating construct – i.e. Ofgem considers that it corresponds to the appropriate cost of debt because the average, *ipso facto*, possesses that quality. If so, this appears to be connected to Ofgem's view that its financing duty applies to '*notional rather than actual companies*' (JF1 §107). Ofgem appears to regard the notional and the average company as equivalent constructs for this purpose.[51]

[49] Tab A5.9: Ofgem – RIIO-2 Final Determinations – Finance Annex (Revised) para 2.44

[50] Tab A5.9: Ofgem – RIIO-2 Final Determinations – Finance Annex (Revised) para 2.43

[51] For an example of this logic, see Tab A4.3: Ofgem – RIIO-2 Draft Determinations – Finance Annex, para 2.47

A3.19 Whether or not Ofgem's error flows from its misinterpretation of its statutory duties (considered above) this position remains irrational on its own terms.

A3.20 To deal briefly with two other points that Ofgem appears to make in defence of its use of the sector average –

(a) It claims that its policy of using a sector average has '*brought down the allowed return on debt and removed a significant source of risk for consumers*' (§369). But this is just adventitious, a matter of pure luck. The allowed return on debt has reduced because market interest rates have fallen. If interest rates had risen, the allowed return on debt would have gone up. There is nothing intrinsic within the design of Ofgem's index which brings down costs to consumers.

(b) It claims that setting allowances by reference to the debt costs of individual companies would: '*expose each network's customers to that network's decisions on debt type, tenor, timing and risk management*' (§438). But Ofgem's approach exposes customers in the aggregate to those decisions made by the companies as a whole. It is unclear why this is said to be better. If, as Ofgem asserts (JF1 §71) the risks of these decisions should lie with shareholders, its policy does not achieve that outcome.

(c) It claims that an individual company approach '*would expose consumers in different locations to paying different charges*' (§452). But this provides no explanation why debt costs should be treated differently by Ofgem from all other categories of cost – such as totex and pension costs – for which allowances are set on an individual company basis, with the inevitable consequence of geographically differential charges?

A3.21 Finally, it should be noted that Ofgem accepts two features of WWU's case: (i) that the effect of its policy is to generate skewed results across different companies[52]; and (ii) that the policy does so by design and inevitable outcome[53] – '*this is inevitable in any sector, and with any average*' (§443).

A3.22 Ofgem's only defence to this skewing is that the alternative, which it chooses to call '*pass-through*', would '*eliminate any incentive to manage debt efficiently*' (§443). Therefore we turn next to this question of incentives.

[52] NOA paras A5.13 - A5.23

[53] NOA para A5.27

Incentives

A3.23 In its Response, Ofgem repeatedly seeks to emphasise the supposed incentive properties of its use of a sector average as if this were a conclusive point in its favour (e.g. §§ 372-375, 437). But the argument has no merit, for the following reasons.

A3.24 **First**, an incentive is only as valid as the benchmark used to set it. If the benchmark represents a position of reasonable efficiency, then actual costs above or below that line can be regarded as giving rise to a fair reward or penalty. But if the benchmark lacks that quality, the effects of using it will be randomly distributed, and will not correspond to any fair outcome – they will be the discriminatory consequences of which WWU complains.

A3.25 Since the sector average does not (for reasons explained in the Notice of Appeal and above) have the qualities of a valid benchmark for any actual licensee, its supposed incentivisation properties also lack any validity. If Ofgem's purpose is to design a valid incentive structure, it has failed.

A3.26 **Second**, Ofgem conflates two concepts, efficiency and prudence, which are distinct. On its case, company-specific allowances '*would remove the strong incentives to manage company debt prudently and efficiently*' (§375; see also JF1 §89), which implies that Ofgem's approach provides precisely such incentives. The two issues need to be considered separately.

A3.27 As to the **efficiency** of debt *costs*, this can be meaningfully assessed – and indeed can only be meaningfully assessed[54] – on an *ex ante* basis by reference to market benchmarks at the time of debt issuance. WWU in this appeal is not seeking pass-through, but only the recovery of its efficiently incurred cost of embedded debt and an indexed benchmark allowance for new debt.[55]

A3.28 Contrary to Ofgem's case, this approach provides a much stronger efficiency incentive than Ofgem's own policy. Under Ofgem's sector average approach, an individual network operator could raise every single debt instrument inefficiently during a control period and still receive an allowance that fully recovered, or over-recovered, its actual (inefficient) cost of debt. It is unclear how Ofgem considers this a suitable incentive structure, still less a strong one.

A3.29 With regard to the suggestion that the assessment of efficiency at issuance is an inappropriate use of a regulator's time and resources (§434), it is difficult to see any merit in this argument. We are not able to comment on the characteristics of the water sector which led a CMA group

[54] Tab D1: Oxera – RIIO-2 Cost of Debt Report, para 2.15

[55] NOA section A7

to reach a similar conclusion in the PR19 redeterminations. However, with regard to the GD sector –

(a) there are only four companies to be assessed, and their debt issuance is not so frequent as to make efficiency assessments unduly burdensome;

(b) Ofgem has already assessed the efficiency of debt (including derivative) instruments for the purposes of RIIO-2, so it is difficult to understand why this should be considered to be outside the scope of its reasonable regulatory activity in the future[56];

(c) Ofgem has been gathering significant quantities of data on derivatives since 2018/19, and could ask licence holders to provide that information supported by an independent audit of efficiency if it wished to reduce its own workload;

(d) Ofgem, and other regulators, characteristically devote considerable time and resource to assessing the efficiency of much smaller categories of cost.

A3.30 In WWU's submission, the process is plainly feasible and entirely proportionate to the benefit to be achieved.

A3.31 As to the question of a **prudential** debt financing strategy, this is a different matter entirely to the issue of cost efficiency measured against a market benchmark. Put simply, there is no basis at all for the implication that there is one benchmark strategy from which any deviation amounts to either an insufficiency or excess of prudence to be penalised or rewarded via an incentive mechanism. At a basic conceptual level, this would make no sense.

A3.32 Ofgem's published position in relation to prudence, in its RIIO-2 Final Determination, was –

> 'There is a licence obligation in place relating to rating and it is **this** that could be expected to protect consumers against imprudent or risky choices from networks. In any case, we do not necessarily consider 10-15yr debt to be particularly more risky than 15-30yr debt for regulated networks and it is up to networks to determine their own capital structure and treasury strategy.'[57]

A3.33 WWU substantially agrees with this statement. Specifically –

(a) In addition to regulatory ring-fence protections, WWU is subject to a licence condition requiring it to use its reasonable endeavours to maintain an investment grade credit

[56] Tab A4.3: Ofgem – RIIO-2 Draft Determinations – Finance Annex, para 2.50

[57] Tab A5.9: Ofgem – RIIO-2 Final Determinations – Finance Annex (Revised) para 2.43 (emphasis added)

rating.[58] That is the primary vehicle by which Ofgem has chosen to protect consumers against imprudent debt financing decisions. It is a suitable vehicle for that purpose. If Ofgem considered that it was insufficient, it could seek to strengthen the condition by amendment. If Ofgem considered that it was not being complied with, it has a range of statutory enforcement powers available to it to ensure compliance.

(b) Ofgem has, indeed, recently strengthened that condition by introducing a new Part C requiring financial resilience reporting under certain circumstances – it will have effect in relation to WWU given its current rating position.

(c) Within the scope of the protection provided for consumers by that licence condition, there is no single *ex ante* prudent debt financing strategy. GDNs, like all other network companies, have a range of options open to them falling within the scope of a 'prudent' strategy in an investment grade credit environment.

(d) WWU has maintained investment grade credit status since 2005, with most of its debt – Class A debt – rated a very strong A- since March 2010. No issue has been taken by the credit rating agencies to suggest that WWU has followed an imprudent strategy.

A3.34 As against this position, which makes clear that treasury strategy is for networks to determine, it is now suggested by Ofgem for the purposes of this appeal that there is such a thing as a '*normative treasury strategy*', that it involves tracking the medium-term sector average (and so is determined in part by an alignment with other companies' treasury strategies) and that to depart from it is a matter of '*inefficiency in corporate funding*' (JF1 §123).

A3.35 This is the foundation on which Ofgem's supposed 'incentive' in relation to prudent financing, with its consequent rewards and penalties, is said to rely. But it is incoherent in its own terms, inconsistent with Ofgem's published position, and (therefore) unsustainable as an argument in favour of Ofgem's sector average approach. It does nothing to offer an objective justification for the discriminatory consequences of that approach.

'Consistency' of Policy

A3.36 A further repeated theme in Ofgem's Response is that its policy has been consistent over time (§368) and specifically that: '*It has been GEMA's consistent practice over more than 20 years to set allowed return on debt based on medium term estimates of market rates, as distinct from individual company costs*' (§429).

[58] Tab M28: WWU – Gas Transporters Licence – Standard Special Condition A38 (Credit Rating of the Licensee)

A3.37 If one implication of this is intended to be that Ofgem's policy is self-validating by virtue of its longevity ('*the fair and reasonable decision of a stable and predictable regulator*' – JF1 §137) it should be rejected on the basis that the persistence of a mistake does not validate it, and continuity over time does not amount to an objective justification.

A3.38 In addition however, Ofgem appears to be implying that it has provided such a stable policy platform that WWU should have acted in accordance with it, and that a failure to do so was a decision made at the company's own risk, which must now be borne by shareholders. As to this, WWU makes two broad responses –

(a) **First**, Ofgem has substantially overstated the historic consistency of its policy over time. The evidence provided by Jessica Friend (JF1 §§13.1-13.12) does not support the assertion that it has been Ofgem's practice for over 20 years to set the allowed return on debt on the basis of medium term market rates. On the contrary –

(i) In the price control period immediately prior to RIIO-GD1 (the 2008-13 control known as GDPCR1, which was the first full price control set after the hive-down of WWU from National Grid) Ofgem used an '*appropriate balance*' of short, medium- and long-term rates (JF1 §13.10), with a separate assessment of risk free rates and corporate credit spreads. Debt indexation was referenced by Ofgem in consulting on its options for that control period, but not adopted.

(ii) The adoption of a market trailing average index as the sole mechanism for setting the cost of debt was not first indicated until 2010 and did not take effect until the RIIO-GD1 price control came into force in 2013.

(iii) It follows that the policy context in which WWU made its key debt financing decisions in 2007 was significantly different from the one that now exists.

(b) **Second**, Ofgem has substantially overstated the extent to which its policy at any given point in time can be assumed likely to continue beyond the next control period. In its Framework Consultation for RIIO-GD2 it consulted on three options, including a move to 'partial indexation' and a 'pass-through' allowance for debt. Unless that consultation was a sham and those options were never seriously on the table – WWU assumes that this is unlikely to be Ofgem's position – then there must have been a realistic possibility that the medium-term trailing average approach to indexation adopted for RIIO-GD1 did not continue beyond the end of that price control.

A3.39 In short, regulatory policy has not been stable – it has changed, changes, and is likely to continue to change in the future. The only absolutely consistent feature of Ofgem's policy to

date is that it sets a single sector-wide cost of debt allowance for each control. But the basis on which that allowance is calculated has changed over time, and the principle of setting a single allowance is not immutable as Ofgem itself concedes by its RIIO-GD2 adjustments (albeit limited and inadequate) in relation to certain company-specific factors (§444).

A3.40 Regulatory policy therefore does not provide a stable platform, as implied by Ofgem, against which debt financing decisions can be judged for the purposes of disallowing companies their efficiently-incurred actual costs of debt (§442).

A3.41 Moreover, even if it were reasonable to take into account the policy context applicable at the time the relevant debt financing decisions were entered into, it cannot be appropriate to judge those decisions by reference to a policy adopted and/or communicated only after the event.

A3.42 Yet this is precisely what Ofgem now seeks to do. In its Notice of Appeal, WWU identified that Ofgem was in effect seeking to impose on a retrospective basis an interest rate profile policy that judges WWU's past decisions with the benefit of hindsight.[59] Ofgem's Response only serves to clarify and enhance this point, notable in Jessica Friend's statement that there is a normative treasury strategy against which WWU's decisions should be judged – JF1 §123 (quoted at para A3.34 above), and also JF1 §§109 and 132 which effectively state the same point.

A3.43 To the best of WWU's knowledge, it had been Ofgem's longstanding policy (since at least October 2006) that networks are best placed to manage financing risk. So it is both inconsistent and plainly retrospective for Ofgem to say in April 2021 that there is a normative treasury strategy in relation to interest rate risk and against which WWU's past decisions can be judged for the purpose of setting price control allowances.

A3.44 Nowhere is this more clearly disclosed than in JF1 §114 (emphasis added) –

> 'In my view, WWU is able to finance its activities and could maintain an investment grade rating if it takes certain actions. This will depend on decisions taken by WWU and its shareholders including decisions relating to financial structure and financial policy **in the past**…'

A3.45 The shift in tense from present and future-facing to backwards-looking is highly revealing. This is the definition of a retrospective policy, applied with hindsight in relation to decisions already taken that cannot be undone. It provides no rational or lawful basis to justify the discriminatory effect of Ofgem's policy.

[59] NOA paras A5.36 - A5.45

The Alleged 'Bet'

A3.46 Finally, Ofgem seeks to justify its approach by alleging that WWU's debt financing involved a '*bet*' (a point it repeats – §§442, 447) – '*WWU benefitted from that arrangement for the first six years when interest rates were high…[but] the risk which WWU bet against…has now materialised*' (§442). At the same time, it states that '*licence holders have the freedom to distribute to shareholders as they choose*' (§416) and alleges that WWU paid excessive dividends prior to GD2 (JF1 §§134-135).

A3.47 WWU will be happy to provide the CMA with any further information on these points that the CMA wishes to see. But the short position is –

(a) WWU's financing arrangements – implemented within an investment grade rated platform maintained since 2005 – were not a 'bet', any more than Ofgem's implicit financing strategy in its trailing average index amounts to a 'bet' on customer bill levels for GD2, or the financing strategies of other investment grade rated GDNs constitute a 'bet'. Both debt and derivative elements of WWU's debt portfolio have been assessed by Oxera as *ex ante* efficient, and undertaken in an investment grade context.

(b) It is Ofgem, not WWU, which now wants to judge this arrangement with the benefit of hindsight.

(c) There was no 'six year' benefit from the arrangements. WWU's regulatory allowed cost of debt has been insufficient to cover its financing cost from the beginning of GDPCR1 (i.e. in 2008) and continuing throughout the period to date.

(d) WWU does not have 'freedom to distribute to shareholders' as it chooses. WWU's secured capital structure places a range of restrictions on its ability to distribute which go beyond, and in effect enhance, the regulatory ring fence. These protective features have been acknowledged by all three major credit rating agencies. The rating agencies monitor distribution levels in their ongoing surveillance for the purposes of WWU's investment grade ratings.

(e) WWU's dividend levels were not excessive – they reflected its outperformance, and average levels since 2005 were below both the allowed cost of equity and achieved RORE.

(f) In 2007, WWU's gearing was within the sector range as noted by Ofgem in the Initial Proposals for GDPCR1. In particular, as Ofgem noted in those proposals (at paras 9.16 and 9.17) –

(i) The Transco price control in 2002 used 62.5% gearing. Since this date, the IDNs have been funded with gearing levels of 70-80% of RAV.

(ii) It is clear that a 70% gearing level can be consistent with a rating comfortably within investment grade. This can be observed from the ratings for NGN and WWU, and guidance from the agencies. The agencies also commented that these ratings were restricted by the lack of experience from the management teams and the relatively new sector. All other things being equal, such risks would reduce over time and the credit quality of the GDNs would strengthen.

(g) WWU had in fact reduced its gearing to the GD1 notional level by March 2021.

A4 OFGEM'S IRRATIONAL FAILURE TO TAKE INTO ACCOUNT DERIVATIVES

A4.1 There is nothing in Ofgem's Response on the subject of its irrational failure to take into account derivatives (§§455-463) which comes close to engaging adequately with the arguments raised by WWU in its Notice of Appeal[60] and the supporting expert evidence.

A4.2 Within the parameters set down for this Reply, WWU does not repeat those arguments here. But it invites the CMA to revisit the Notice of Appeal and take note of the extent to which the points clearly set out in it have not been addressed in the Response.

A4.3 WWU rejects Ofgem's implication that derivatives are too difficult or complex or variable to be subject to appropriate regulatory assessment (§§457-458), or that differences in the way they are used across different companies makes them unsuitable for regulatory consideration. The first is a simple error of fact, and the second impossible to understand in a context in which networks adopt widely different approaches to financing strategies as a whole and Ofgem has said that these are matters they are best placed to manage.

A4.4 WWU was also surprised to read – in circumstances in which Ofgem was aware of Oxera's assessment for a considerable time prior to this appeal and has never before raised a concern with it – the assertion that Oxera's work is not a '*rigorous assessment*' of the efficiency of the company's derivative portfolio (§459).

A4.5 That allegation is answered in the short additional Oxera expert report submitted together with this Reply and entitled '*Robustness of Oxera's Swaps Efficiency Assessment*'.

[60] NOA section A6

B. COST OF EQUITY

B1 EXECUTIVE SUMMARY

B1.1 Ofgem has predominantly sought to characterise WWU's legitimate concerns with Ofgem's methodology for assessing the cost of equity as merely attempts to question decisions which are within the Ofgem's regulatory discretion. WWU does not agree that this is the effect of its case or the evidence provided in the Oxera reports and we refer back to our general reply to this point set out in the Introduction section above.

B1.2 WWU also notes that Ofgem's setting of the allowance for the Cost of Equity must discharge its financing duty, which WWU does not consider it has done. WWU does not agree with Ofgem's characterisation of the financing duty as a subordinate duty to the consumer objective. On the contrary, as we have set out above in section A2 above, it is our view that the financing duty is an intrinsic part of the consumer objective. Ofgem's duties are to existing and future consumers, and their interests are specifically stated to include the reduction of greenhouse gases. These consumer interests can only be discharged if there is substantial investment. In turn that means, Ofgem should have set a cost of capital to secure future investment. It has long been understood that there is the potential for a significant impact on the consumer interest if the cost of capital does not encourage investment. This is particularly true in the context of Net Zero Carbon. Ofgem cannot discharge the consumer objective if investors are disincentivised from investing in future projects because the cost of capital has been set too low. Please refer to our wider commentary on the financing duty set out in Section A above.

B1.3 Ofgem has also sought to rely on mischaracterisations of the evidence WWU and its advisor Oxera have presented. In many instances, Ofgem has neither acknowledged or responded to the evidence presented by WWU and Oxera on the parameters of Cost of Equity, and notwithstanding the general catch all in paragraph 2 of the Response, WWU should be entitled to treat these arguments as undisputed by Ofgem.

B1.4 Furthermore, Ofgem has been highly selective in its use of precedents throughout its Response. In particular, notwithstanding that Ofgem argued in PR19 that there should be no read across to these Energy Licence Modification Appeals because energy was a different sector, with different duties and a different appeals process, it has sought to cherry pick where it prays PR19 in aid (see particularly in respect of the Cost of Debt Head of Appeal) but chosen to down play the precedent nature of PR19 in the Cost of Equity Head of Appeal. As we have set out in our response on PR19, we do not consider it has a significant relevance to our Appeal for the reasons set out in our previous submission.

B1.5 Ofgem in its approach appear to have misunderstood the function of incentive based regulation, which is to drive the companies to achieve outperformance in one period so that the efficiencies driven by that outperformance can be captured in the next price review. It is not, as Ofgem asserts, to set a price control such that expected out- or under-performance is zero.[61]

B1.6 To ensure brevity and for the CMA's ease of reference, this reply on Ofgem's Response mirrors the structure and headings used by Ofgem in its Response to Appeals.

B1.7 WWU has also asked Oxera to provide a table of comments on specific detailed points in the Cost of Equity part of Ofgem's Response. This table is at Tab Q1.

B2 RISK FREE RATE

B2.1 Ofgem argues that it did not find convincing evidence of a convenience premium to warrant adjustment of ILGs[62] as a proxy for the RFR. While appellants have submitted evidence to support the existence of a convenience premium, this was dismissed in Ofgem's submission as it largely related to US Treasuries and was allegedly not clear that the analysis would hold for UK gilts[63].

B2.2 However, this argument does not address the Oxera report on Cost of Equity, which demonstrates evidence of a UK-centric convenience yield. Oxera finds that the correlation between government bond return and equity return is consistently and significantly negative, using daily return data. This finding is similar to the Federal Reserve's finding for US Treasuries[64]. These findings are consistent with Oxera's emphasis on the convenience premium attached to government bonds, in both the US and UK, and supports the conclusion that government bonds are not the 'zero-asset beta' that the CAPM requires for the RFR. Since UK government bonds are the only GBP instruments capable of delivering the utility (e.g. can be used as high-quality collateral), this gives rise to a convenience premium for US Treasuries. Therefore, there should also be a convenience premium that pushes the yield on UK Gilts below that of a zero-beta asset.

B2.3 Ofgem also claims that there is a long regulatory precedent for using ILGs to estimate the RFR, and that it is the appellants who seek to move away from the 'standard' form of CAPM to suggest a distinction should be drawn between lending and borrowing rates[65]. However,

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61 Kaul WS, para 32.

62 Ofgem Finance Response, para. 74, Jessica Friend Second WS, para.51.

63 Jessica Friend Second WS, para. 55.

64 Oxera Cost of Equity Report, section 5B.2.

65 Ofgem Finance Response, para. 79.

the existence of a regulatory precedent for using ILGs does not preclude Ofgem's decision being erroneous, particularly as in past regulatory practice, the RFR has always been set higher than the spot yield. While not explicitly done in order to compensate for the discrepancy between the risk-free financing rates available to sovereigns and investors, it did mitigate the effects of the convenience yield, and therefore masked the error of using the ILGs as a proxy for the RFR. [66] It is the UKRN report (on which Ofgem relies) that diverges from regulatory precedent, as acknowledged in the report itself.[67]

B2.4 Further detail on the other points raised in Ofgem's response are contained in the Oxera report set out at Tab N1.

B3 TMR

Use of CPI data

B3.1 Ofgem continues to be in error by deriving the real TMR estimate entirely from unreliable back-cast of CPI rather than giving weight to the historically reported and documented RPI series (which is the contemporaneous data against which investors could make their decisions). In arguing that the CPI back-cast series is more reliable than the RPI series, Ofgem seeks to rely on a mischaracterisation of the Appellant's arguments by selectively displaying part of a graph presented by Oxera which appears to support Ofgem's TMR decision.[68] However, the full graph demonstrates that Ofgem relied on a subset of evidence to support its TMR estimate, illustrating that the investment managers' forecast appears to be out of line with the rest of the evidence (see figure below).[69]

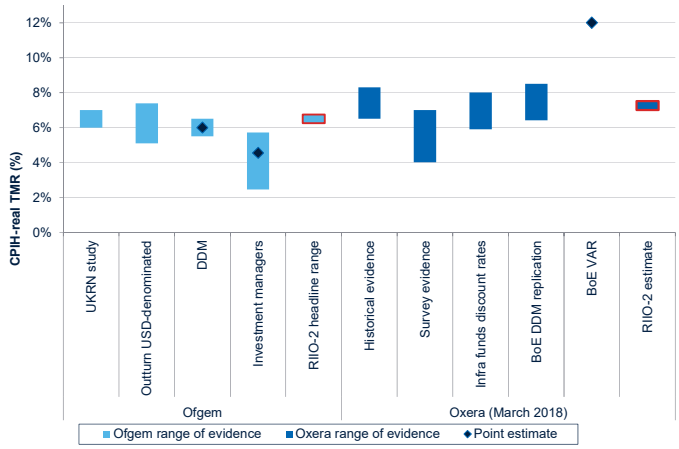
66 Oxera Cost of Equity Report, Section 5E.

67 UKRN Cost of Capital Report (2018), p.8.

68 Ofgem Finance Response, para 118, McCloskey WS, para.116-117.

69 Oxera (2019) – Review of RIIO-2 finance issues, rates of return used by investment managers, Figure 1.1

Figure 1: Oxera (2019) – Review of RIIO-2 finance issues, Rates of return used by investment managers, Figure 1.1



Source: Oxera

B3.2 Contrary to Ofgem's claim that it considered more than one approach to setting the TMR range and ultimately made a cautious choice to set it at the upper end, in actual fact Ofgem has made errors in calculating the TMR, by using incorrect and statistically biased averaging techniques, incorrect assumptions of the historical inflation rate, and a selective set of cross-checks and assumptions that would support its range. Further evidence for this is discussed at Tab N1.

B3.3 Contrary to Ofgem's assertions[70], the Appellant does not ignore the criticisms of the RPI series. Oxera explains how to adjust the RPI series to render it consistent with today's RPI methodology[71]. Ofgem (and Mr McCloskey) have not engaged with this evidence.

B3.4 Ofgem argues that there is no perfect series but that Ofgem's judgement is that CED/CPI series is more reliable than the CED/RPI series[72]. However, the CPI back-cast is an experimental series developed by the ONS for research purposes, and has, since Ofgem's use of it, been corrected for errors and is being replaced by a newly-modelled series.[73] As explained in the Oxera Cost of Equity Report, the CPI back-cast is likely to be upward biased, whereas the published RPI series is not subject to the same kind of estimation errors.[74]

70 Ofgem Finance Response, para. 118

71 Oxera (2020) 'The cost of equity for RIIO-2 – Q3 2020 update', p.16

72 Ofgem Finance Response, para 118.

73 Minutes of the 7 April 2020 meeting of the Advisory Panel on Consumer Prices—technical, https://uksa.statisticsauthority.gov.uk/wp-content/uploads/2020/07/APCP-T-Minutes-April_meeting_v4.pdf, accessed 20 October 2020.

74 Oxera Cost of Equity Report, para. 6.8.

Geometric average

B3.5 Ofgem continues to estimate the TMR using geometric average, plus a subjective uplift, arguing that investors tend to look at geometric returns and that the arithmetic average is an upward-biased estimate of the TMR if the holding period is more than a year.[75] However, Ofgem does not provide evidence demonstrating that the arithmetic average is biased and does not appear to engage with the evidence produced by Oxera demonstrating that the arithmetic average is the unbiased approach for estimating a TMR. Ofgem therefore provides no basis for departing from regulatory precedent of the use of the arithmetic average.

B3.6 Ofgem claims that the use of geometric average is supported by academic literature and practitioners referring to DMS, Wright and Mason and Barclays.[76] However, it is necessary to understand the context in which the basis is recommended by each academic / practitioner. In fact, the authors Ofgem cite each agree that the unbiased estimate of the TMR is the arithmetic mean:

(a) DMS make the following statement: "*This [the arithmetic mean risk premium] is our estimate of the expected long-run equity risk premium for use in asset allocation, stock valuation, and corporate budgeting applications*." [77]

(b) A similar conclusion is arrived at by Barclays in their annual Equity Gilt Study: "*Although geometric returns are appropriate to analyse the past, arithmetic returns should be used to provide forecasts*." [78]

(c) Further, Wright and Mason appear to agree that the unbiased approach to estimating a TMR from historical equity returns is to adopt the arithmetic average. "*These are simply alternative estimates of the arithmetic return; and it is notable that these are always lower (albeit not much lower) than the arithmetic mean annual return calculated directly (and, incidentally, at a 10-year horizon, almost identical to the JKM estimate)*."[79]

B3.7 Contrary to Ofgem's assertions[80], the Appellant does provide evidence demonstrating that uplift to the geometric average is too low. Ofgem has failed to engage with the following evidence:

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75 Ofgem Finance Response, para 128.

76 Ofgem Finance Response, para 128.

77 Dimson, E., Marsh, P. and Staunton, M. (2015), 'Credit Suisse Investment Returns Sourcebook 2015', p. 34.

78 Barclays (2020), 'Equity Gilt Study', 8 July, p. 163.

79 Wright and Mason (2020), 'Comments on ENA/Oxera', 5 November, paragraph 2.8.

80 Ofgem Finance Response, para 128-129, 132

(a) To avoid introducing a downward biased to the TMR estimate, one should either adopt the arithmetic mean or include the Cooper estimators alongside those of Blume and JKM, which Ofgem did not do.[81]

(b) The difference between the arithmetic and geometric mean can be approximated by one half of the variance. Hence, the appropriate upward adjustment to the geometric mean would be half the variance of annualised returns.[82]

(c) Furthermore, we note that Figure 25 of the McCloskey witness statement shows that the 1.5% uplift is the minimum difference between the arithmetic average and the geometric average. The justification for adopting an estimate below the arithmetic average based on the claim that equity returns are predictable over horizons longer than one year is not supported by robust evidence.

B4 BETA

B4.1 Ofgem is in error to place weight on the asset betas of water companies. Ofgem seeks to characterise the issue as a misapprehension on the part of the Appellants that Ofgem has attributed equal weights to its comparator sample, but this is incorrect. The error arises in the event that Ofgem places *any* weight on the beta of water companies to determine the appropriate notional equity beta for energy networks due to the heightened risk for energy networks compared to water networks, as seen in the empirical asset beta evidence. Ofgem has explicitly admitted that it "*[p]laced some weight on the observed equity betas of each of National Grid, Pennon, Severn Trent Water and United Utilities – placing greater weight on National Grid's observed betas than on those of the water companies*".[83] This means that 75% of Ofgem's comparator sample is based on the water industry despite the existence of cross-industry risk differences that has been highlighted in previous submissions[84]. While Ofgem seeks to characterise its choice as "*making a judgment*" as opposed to a mathematical weighting, such a decision suffers from a lack of transparency and does not resolve the underlying issues with making such a weighting as flagged in previous submissions[85].

B4.2 Ofgem argues that its unlevered beta point estimate lies above numerous beta estimates for United Utilities and Severn Trent, which implies that Ofgem did place greater weight on the unlevered beta observations for National Grid[86]. However, this argument neglects the fact that

81 Oxera Cost of Equity Report, para 6.13.

82 Oxera Cost of Equity Report, para 6.19 – 20.

83 Ofgem Finance response, para. 152.

84 Oxera Cost of Equity, section 7A.1

85 WWU Notice of Appeal, B4.5 – B4.9.

86 Ofgem Finance Response, para. 158.

the unlevered beta estimates of these companies are the lowest in the comparator sample. Conversely, National Grid's asset beta is consistently higher than the average asset beta of the two pure-play water companies across all estimation windows, including the ten-year window preferred by Ofgem[87]. The CMA also did not include National Grid in its sample for estimating the beta for water companies in the PR19 redetermination. This demonstrates that National Grid is in a different (higher-risk) category to water companies, including in the CMA's view.

B4.3 Further detail on the other points raised in Ofgem's response are contained in the Oxera report set out at Tab N1.

B5 AIMING UP

B5.1 Ofgem errs in claiming that its cross-checks reduce the uncertainty of its estimated CAPM range, and thereby the necessity of aiming up. The unreliability of these cross-checks mean that Ofgem errs in claiming that its cost of equity estimate is already 'aimed up'.

B5.2 Ofgem insists that the rationale for aiming up will depend on confidence in CoE estimate and assessment of risk of under-investment, and that in this case Ofgem considered these and made a judgment.[88] However, this simplification ignores the unavoidable truth that market parameters in the CAPM are always estimated with error. Such uncertainty is the fundamental basis for aiming up. Further, referring to previous evidence on this point, Ofgem's estimation of the CoE has reduced significantly since RIIO-1, largely due to changes in methodology. 207bps of the 305bps reduction in Ofgem's estimate of the cost of equity allowance between RIIO-1 and RIIO-2 is attributable to Ofgem's methodology changes. This uncertainty is not removed by the inappropriate cross-checks applied by Ofgem, or by cross-checks that are appropriate. Aiming up is therefore essential, particularly to secure investment for reducing greenhouse gases.

B5.3 Ofgem argues that if there was a strong link between under-investing and an under-estimated CoE, it would expect a similarly strong link between over-investing and a CoE which is too high, whereas in RIIO-1, there was no evidence of over-investment.[89] Ofgem incorrectly assumes that over- and under-estimating the CoE will have symmetric effects on investment incentives. If investors are undercompensated for risk in expectation, they will underinvest. However, if they are overcompensated for risk through an allowed return on equity that is above the cost of equity, there is no rational reason for them to reinvest these earnings into

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87 Ofgem Final Determination Finance Annex, Table 10; Oxera Cost of Equity Report, Figure 7.1 and Table 7.2.

88 Ofgem Finance Response, para 266.

89 Ofgem Finance Response, para 257.2.

new assets where the spend on these projects has not been included in the price control settlement. To do so would be a negative NPV investment. Ofgem, therefore, incorrectly assumes a symmetric effect.

B6 CROSS CHECKS

ARP-DRP

B6.1 Ofgem claims that the ARP-DRP for RIIO-2 appears to be in line with RIIO-1; according to Oxera's analysis, the ARP-DRP differential shown for RIIO-2 (~2%) is very similar to the ARP-DRP differential for RIIO-ED1 and RIIO-GD1 (~2%).[90] However, this is a mischaracterisation: the Oxera ARP-DRP report Ofgem referred to shows that the ARP-DRP differentials of energy comparators have trended upwards from the RIIO-1 period to date. It is therefore inappropriate to compare the absolute value of the ARP-DRP differential for RIIO-2 to that for RIIO-1.[91]

As discussed in the Oxera Cost of Equity report, the ARP-DRP framework shows that Ofgem's allowed return is significantly below contemporaneous market evidence.[92] In contrast to the ARP−DRP differential implied by RIIO−2, the ARP−DRP differentials implied by the RIIO-1 determinations were broadly in line with those implied by contemporaneous market evidence.[93]

*Modigliani-Miller Theory ("**MM**")*

B6.2 Ofgem misrepresents Oxera's analysis of the relationship between the WACC and gearing: Ofgem claims that Oxera's report uses alternative values for RFR, TMR and the cost of debt (namely, spot rates rather than embedded debt) but ultimately the conclusion is the same: the WACC does not remain constant across gearing levels and, furthermore, Oxera concludes that there is an increase in the WACC/AROC (of 7 bps for National Grid) between observed and notional gearing.[94]

B6.3 In actual fact, the parameters (TMR, beta, RfR, CoD) presented by Ofgem are inconsistent with the Modigliani-Miller theorem, and produce a material difference in WACC–c. 50bp for National Grid.[95] Oxera demonstrates that after correcting those parameters the WACC

90 McCloskey WS, para. 122.

91 Oxera 2020 ARP-DRP Report, p. 29

92 Oxera Cost of Equity Report, para. A.1.67

93 Oxera 2020 ARP-DRP Report, p. 18.

94 McCloskey WS, para 39; Ofgem Finance Response, para 201.

95 Oxera Cost of Equity Report, para. A1.7

difference decreases by 40bp to c. 10bp for National Grid, and concludes that the corrected parameters are a better fit to the model. We note that McCloskey omits this information from his statement, by selectively presenting the National Grid WACC out of context in support of its views. Ofgem focuses on the WACC of SVT and UU to support its Modigliani-Miller cross-check. Oxera demonstrates that Ofgem violates the Modigliani-Miller theorem by c. 20bp for those companies, whereas Oxera's preferred estimations produce a WACC difference lower than 5bp.

B6.4 Ofgem also omits to mention that Oxera has recommended estimates of the cost of equity that are conservative because Oxera forced down the re-geared equity beta to align exactly with the Modigliani-Miller relationship.

MARs

B6.5 In its previous submission Oxera provided evidence that MARs for listed water companies are explained by factors other than allowed returns.[96] Ofgem responded that Oxera's work confirms Ofwat's allowed return and that observed MARs are driven by outperformance and returns.[97] 'Dubious' assumptions would be needed for this to be true.[98] Ofgem adds that persistent MARs can only be explained by outperformance and returns.[99]

B6.6 Such statements constitute a fundamental mischaracterisation of the Appellant and Oxera's submissions. The Oxera May 2020 report concludes that Ofwat's allowed return is not supported. No recourse to the allowed return is needed to explain MARs for the listed water companies. Rather, the relevant MARs are explained using plausible assumptions on company-specific outperformance; the value of non-regulated business activities; PR14 reconciliations; accrued dividends; and an expected takeover premium. These assumptions are not 'dubious' but rather are clearly defined and evidenced in the report. Ofgem has failed to account for this evidence in its analysis. These factors are acknowledged by Ofgem's own advisors CEPA; the UKRN report; and the Oxera May 2020 report. The expected outperformance for the listed water companies was specific to those companies and not representative of the water sector as a whole.

B6.7 Further detail on the other points raised in Ofgem's response related to cross checks are contained in the Oxera report set out at Tab N1.

96 Oxera CoE, A1.14-A1.17.

97 McCloskey WS, 46-49

98 McCloskey WS, 60.1

99 Wilde WS, 60a

B7 WPD

B7.1 Ofgem makes an error in claiming that the WPD transaction provides firm evidence of the 'joint hypothesis' that either the cost of equity has been overestimated or that investors expect material sector-wide outperformance.

B7.2 Ofgem argues that National Grid's payment of a premium of 61% over asset value indicates that investors require lower returns than under the RIIO-2 settlement.[100] However, there is no read-across from this transaction to RIIO-2. The WPD transaction is specific to WPD and National Grid and neither Ofgem nor the CMA should draw any sector-wide inferences on Cost of Equity. As shown in Oxera's WPD report, a wide range of CoEs can result in reasonable valuations explaining the premium paid by National Grid. The wide range of acceptable CoEs simply highlights underlying uncertainty surrounding the 'true' CoE for the sector and therefore the need to aim up.

B7.3 Moreover, WPD was fast-tracked in RIIO-ED1 and it is widely regarded as a sector leading company, outperforming its current regulatory settlement. It is therefore rationale for an investor to expect that WPD could continue to out-perform relative to the sector over the long-term. Similarly, the combination of National Grid and WPD creates a business that is vertically integrated and with operational areas that are entirely geographically overlapping. This creates scope for synergies within both NGET and WPD that would not be available to other companies in their respective sectors on a standalone basis.

B7.4 Further detail on the other points raised in Ofgem's response are addressed in the Oxera report set out at Tab N1.

B8 OUTPERFORMANCE ADJUSTMENT

B8.1 While Ofgem has made a number of arguments suggesting that the Appellants have not provided sufficient evidence to prove there has been an error in principle,[101] it has not addressed the concern that the expected outperformance adjustment mechanism is against the principle of incentive regulation. Instead of responding to the Appellants' arguments on their merits, Ofgem prefers to appeal to regulatory discretion to implement this mechanism. The witness statement by Akshay Kaul demonstrates that the mechanism is based on the premise: "*It has always implicitly been assumed in the past that expected outperformance or underperformance is zero, and therefore no distinction between expected and allowed returns is necessary.*"[102] This premise is unfounded. Under well-functioning incentive regulation, well-

100 Ofgem Finance Response, para. 209.

101 Ofgem Finance Response, para. 342.

102 Kaul WS, para 32.

managed companies would be expected to persistently out-perform. This is a consequence of providing incentives to create improvements over time (dynamic efficiency) that are shared with consumers through lower bills and improved service.

B8.2 In seeking to justify using the outperformance adjustment, Ofgem has relied on the claim that information asymmetry cannot be completely eliminated from the RIIO-2 package despite the uncertainty mechanisms. According to Ofgem, historic sustained levels of outperformance are difficult to explain without information asymmetry advantage that companies have.

(a) "*It is no answer for the Appellants to contend that RIIO-2 will be tougher overall than previous controls. Complaints to similar effect are often made during the development of a new price control, and the evidence shows that outperformance has almost inevitably followed… As to the sources of outperformance, Ofgem accepts that information asymmetry is not the only contributing factor to sustained observed outperformance. However, the levels of outperformance which are apparent from Ofgem's extensive historical dataset support the conclusion that the sustained levels of observed outperformance are difficult to explain in the absence of information asymmetry.*""[103]

(b) "*Ofgem's view, based on its rigorous evaluation of the evidence, is that outperformance of 0-0.25% reflects information asymmetry rather than effort.*"[104]

B8.3 However, Ofgem's insistence that information asymmetry related to cost allowances and performance targets works in the favour of companies is incorrect, for the following reasons

(a) First, Ofgem already has multiple tools to address concerns with outperformance. Indeed, Oxera rejects the unevidenced claim that there will be a further "systemic imbalance" in the form of information asymmetry in RIIO-2, particularly because of mechanisms in RIIO-2 that narrow the scope for outperformance further than previous price controls in Ofgem's historical and cross-sectoral dataset. None of these arguments presented in Oxera's report 3B.1 and 3B.2 are adequately addressed in the PJ1 or the main finance response. As a further example of how the information set available to Ofgem has improved for RIIO-2, the regulator has collected a more extensive data set for the purpose of setting GD2 Repex allowance than it collected in GD1.

103 Ofgem Finance Response, para 322,332

104 Ofgem Finance Response, para 350

(b) Second, information asymmetry does not necessarily work in companies' favour. Information asymmetries related to the setting of cost allowances between companies and the regulator can be grouped into two buckets:

(i) incomplete information on costs due to the evolving technology and policy landscape, common to both the company and the regulator, at the time the price control is set – neither the regulator nor the company has any significant advantage, and Ofgem can disallow any spend if it is not satisfied with the evidence provided in company business plans;

(ii) new information that becomes available to the company within the regulatory period, that the regulator cannot act on until the end of the price control – while the company can act on this information to its advantage during the price control, this is the very purpose of incentive regulation and is why the price control is periodically reset to share benefits with consumers. Moreover, any outperformance is shared with consumers during the price control (via the annual iteration process of passing through benefits to consumers), in addition to a further reset of allowances at the end of the price control.

(c) Third, Ofgem's insistence that historic expected outperformance is materially due to information asymmetry rather than effort is incorrect. If this were the case, all the regulated companies would have sustained levels of positive outperformance across all the sectors. As shown in previous evidence, while the historical data presented by Ofgem suggests outperformance, this measure is an average, meaning there have also been a number of instances of significant underperformance that demonstrate incentive-based regulation is not a 'one-way bet' in favour of companies[105]

(d) Fourth, Mr McCloskey incorrectly implies that the increase in allowances between DD and FD shows how the information asymmetry is adverse to consumers.[106] Rather, much of the increase in allowances between DD and FD was due to costs being approved for additional workload, and the correction of modelling errors by Ofgem.

(e) Fifth, Mr McCloskey claims without showing any evidence that '*some companies have already begun to find savings for the RIIO2 period that will help them towards their outperformance goal'*.[107] Notwithstanding the lack of substantiation of this claim, this is what companies would be expected to do on a continual basis in response to pre-specified revenue allowances. It cannot be inferred that the adjustment for expected

105 Oxera Expert Report, para. 3.19, Table 3.1.

106 McCloskey WS, para 153.

107 McCloskey WS, para 154.

outperformance has had no impact on incentives to find cost savings. Companies would need to reduce costs to meet the efficiency targets factored into their business plans and to avoid over-spending against allowances. The deleterious effect on incentives relates to the incentive to reduce costs to be below the allowances.

B8.4 Ofgem also makes arguments in relation to the feedback loop on incentives in respect of the adjusted for expected outperformance, arguing it is much weaker than it is for, for example, cost targets which are licensee specific. Given that weaker feedback loop, Ofgem argues, to the extent there is any effect of incentives, it is likely to be limited.[108]. However, Ofgem has already reduced the incentives to outperform in RIIO-2, for example by reducing the sharing rate in the TOTEX incentive mechanism and by shortening the price control period. The additional explicit downward adjustment to returns based on past outperformance will act as a further sector-wide disincentive to outperform regardless of the precise mechanics of how this adjustment is determined. Ofgem has no way to separately identify and quantify the incremental impact of the expected outperformance adjustment mechanism on incentives as "likely to be limited" either now or in the future,

B8.5 Further detail on the other points raised in Ofgem's response are contained in the Oxera report set out at Tab N1.

[108] Ofgem Finance Response, para 348.

C. REPEX

C1 OVERVIEW

C1.1 Ofgem's response to WWU's appeal in relation to repex centres around the following three broad points –

(a) WWU did not submit evidence in the right format, at the right time, for Ofgem to consider it in the Final Determination, and Ofgem's decision cannot therefore be wrong for failing to do so.

(b) Somewhat inconsistently with the above, Ofgem did in fact consider the evidence provided by WWU but discounted it for a number of purportedly sound reasons.

(c) WWU did not tell Ofgem how it could accommodate what it was asking for within the parameters of Ofgem's cost model.

C1.2 In its elaboration of those points, Ofgem engages solely with some (but not all) of WWU's arguments as to whether its decision on repex was wrong in law. It seems to suggest that it is a complete answer to the case put forward by WWU to show that it had some regard to the points made by WWU throughout the price control process. It concentrates on process and fails to offer any defence of the merits of the repex allowances which that process produced.

C1.3 In doing so, it invites the CMA to view WWU's case through a much narrower lens than is required. However, the CMA has been clear that it is not only able, but required by statute, to consider the merits of the decision under appeal by reference to the statutory grounds of appeal.[109]

C1.4 It is no answer to WWU's case to state that Ofgem did consider the points it made, or that WWU did not tell Ofgem how those points could be accommodated in its model. As discussed below, those arguments do not withstand scrutiny on their own terms. But more importantly they fail to engage with the broader question – which Ofgem seeks to brush aside – of whether the allowances given to WWU are actually sufficient for it to undertake its repex work. This is a fundamental question given that WWU is legally obliged to complete the majority of that work.

C1.5 WWU's case is that Ofgem's decision is wrong – not only in law, but on the merits – as it has failed to provide WWU with adequate allowances to undertake its repex work either in-house

[109] Tab M32: CMA – Northern Powergrid v the Gas and Electricity Markets Authority – Final Determination, para 3.23; and Tab M33: CMA – British Gas Trading v the Gas and Electricity Markets Authority – Final Determination, para 3.24.

or through an external provider. Ofgem fails to engage with WWU's arguments in that regard and the expert evidence with which they are supported. It has nothing to say in defence of the merits of its decision and WWU invites the CMA to proceed accordingly.

C2 TIMING OF WWU'S EVIDENCE

C2.1 In its response to the Notice of Appeal, Ofgem places extensive reliance on the nature and timing of WWU's submission of evidence in relation to its tender process. It states that WWU had an opportunity to *'re-submit appropriately quality-assured repex forecasts when it resubmitted its BPDT [Business Plan Data Template] in October 2020. It chose not to revise its repex forecasts in that BPDT.'*[110] It also states that final bids were not submitted until 7 December 2020 suggesting that, because of this, Ofgem was not wrong to fail to use that evidence in setting the allowances for WWU's repex work in the Final Determination.[111] These points are essentially irrelevant to the task now before the CMA. However, before turning to that issue, it is worth briefly addressing Ofgem's arguments in turn.

C2.2 Firstly, as to the timing of the tender process, WWU would not have been able to conclude that process until after the Final Determination as it needed confirmation of its allowed workload for bidders to provide firm prices. For example, at Draft Determination Ofgem had disallowed a significant volume of mains replacement work that WWU had requested, including around £45m for Tier 2b work. That workload was then allowed in the Final Determination.

C2.3 Secondly, as to the timing and form of the evidence arising from that tender process, WWU received initial bid submissions on 7 August 2020. The main BPDT re-submission date was 4 September 2020 in response to the Draft Determination. This did not leave enough time for WWU to process the initial bids so as to reflect them in the BPDT submission. It did, however, present the data from the bids in a paper submitted as part of its overarching Draft Determination response on 4 September,[112] and to Ofgem at a meeting on 25 September 2020. At that meeting, WWU asked Ofgem whether there was anything else that the latter could provide and was told that Ofgem had all it needed. Following that meeting, Ofgem did in fact request that WWU provide the underlying data from the tender which WWU provided on 4 October through the Ofgem Supplementary Question process alongside its further BPDT re-submission.[113]

[110] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 483.

[111] A point made explicitly in Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 474(2).

[112] Tab B4.3: WWU – GDQ33A – Repex Cost Justification Paper.

[113] Email from Carly Evans to Ofgem, 4 October 2020, with attachment Tab H2: WWU – GD2 Outsourcing Tender Report.

C2.4 Ofgem therefore received the data as soon as possible, and in the manner which specifically reflected Ofgem's mains replacement categorisation. It was clear what WWU was seeking, and Ofgem could easily have asked it to reflect it in a BPDT format at any point during the September and October discussions. The data was obviously not provided too late or in a form that Ofgem could not deal with as it is part of Ofgem's case that it did in fact consider it.

C2.5 The points made by Ofgem as to the form and timing of data submissions by WWU are easily dismissed. In terms of legal error, Ofgem failed to give sufficient weight to the tender evidence – and the increasing costs it illustrated – even where it did consider it. However, the more fundamental issue is that the points made by Ofgem are simply irrelevant and their deployment is part of Ofgem's overarching attempt to convince the CMA that its task is much narrower than it is.

C2.6 It is true that the evidence from the final bids, and WWU's internal cost build up, were not available before the Final Determination. Indeed, the latter was a response to the final allowances set by Ofgem once it became obvious that it had failed to provide sufficient coverage for an outsourced model. However, the CMA can, and should, have regard to evidence that was not before Ofgem when it made the decision under appeal.[114]

C2.7 WWU could have simply asked the CMA to fund the costs of an external provider. Instead it has made a genuine attempt to work within the allowance given by bringing repex work in-house. The question before the CMA is whether, on the basis of the up-to-date information available to it, the allowances provided by Ofgem are wrong because they are insufficient to fund the internal delivery of repex work by WWU. In its response to the Notice of Appeal, Ofgem does not even address that question and instead tries to deflect attention from it.

C3 OFGEM'S CONSIDERATION OF THE EVIDENCE

C3.1 As discussed above, notwithstanding its statements as to the timing and format of WWU's evidence, Ofgem states that it considered both the initial tender evidence submitted by WWU, and the points made by it in relation to the other factors set out in the Notice of Appeal. However, Ofgem states that it decided not to take account of that evidence in its allowances for a variety of reasons. None of those reasons withstand scrutiny.

Treatment of tender evidence

C3.2 Ofgem states that it had a number of concerns in relation to the quality of the tender evidence submitted by WWU.

[114] Section 23D(3)(a) of the Gas Act 1986.

C3.3 Firstly, it states that, as the tender evidence was not submitted through the BPDT, it was not subject to the appropriate level of quality assurance.[115] This is incorrect. All of the evidence submitted by WWU – no matter the format – was quality assured in line with Ofgem's Data Assurance Guidance, including sign-off by multiple persons of the appropriate seniority within WWU. It was therefore quality assured to the same level as data in the BPDT.

C3.4 Secondly, Ofgem states that the tender data did not reflect final bids and was subject to change. It states that WWU *'cannot reasonably suggest'* that Ofgem should have taken the final bids submitted after the publication of the Final Determination into account.[116] WWU has made no such suggestion. Although reflecting the first round of bids, the tender data submitted in September 2020 clearly signals that the allowances provided by Ofgem in the Draft Determination were materially insufficient and that unit costs for repex work needed to be set at a much higher level. It shows that the points in relation to factors increasing repex costs made by WWU were being borne out by the market, and indeed highlighted some regional labour factors of which WWU had not been aware to which it then drew attention in its response to the Draft Determination. The tender data submitted to Ofgem therefore illustrated a trend in relation to significantly increasing repex costs that it was wrong not to reflect in its allowances.

C3.5 The CMA has the benefit of the final bids submitted in the tender process. It also has WWU's internal cost build up which, thirdly, Ofgem states that it did not have.[117] Given that the insourcing of repex work was a response by WWU to the fact that Ofgem's allowances were insufficient to allow outsourcing, and the relevant costs could only be finalised when it became clear what workloads were allowed, it would of course have been impossible to provide that data prior to Final Determination. Indeed, Ofgem seem to miss the point that by developing its in-house approach, WWU is asking the CMA for less than it would if it was seeking the costs of the outsourced model with respect to which Ofgem did have the information before Final Determination. No criticism can attach to WWU in that regard.

C3.6 As highlighted above, the CMA can and should use that up-to-date evidence to assess whether the allowances granted by Ofgem are indeed sufficient. It is WWU's case that they are not and Ofgem does not seek to counter that point.

C3.7 Fourthly, Ofgem states that tender evidence does not necessarily represent efficient costs and points to *'regulatory precedent'* from the CMA in that regard in comments made in the

[115] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 485(1).

[116] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 485(2).

[117] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 485(3).

Firmus Energy (**Firmus**) appeal.[118] Contrary to Ofgem's suggestion, the CMA's determination in that appeal is not precedent in that it does not bind the current panel in this appeal. Nor should the panel choose to follow it as the context in which the CMA's comments were made in the Firmus appeal is not comparable to the present case. In the Firmus appeal, there was evidence from a single provider in a much smaller market facing very different sparsity concerns to those in WWU's area. Certain parts of the evidence from the provider were also contradicted by other analysis presented by Firmus.

C3.8 By contrast, the evidence presented by WWU is from six bidders in a larger, more mature market. That evidence has also been quality assured by an independent expert. It is notable that in its simple dismissal of WWU's evidence, Ofgem does not respond at all to the expert report provided by Turner & Townsend which finds that evidence to be robust.[119] Those conclusions therefore stand undisputed and the CMA is invited to treat them as such.

C3.9 Indeed, in its Sector Specific Methodology, Ofgem states that cost forecasts *'arrived at via competitive process or other market testing'* should be classified as *'high-confidence baseline costs'* for the purposes of setting its totex incentives.[120] Given that it has expressed a high degree of confidence in such evidence previously, it is surprising that Ofgem now seeks to suggest it was right to disregard evidence from a robust competitive tender process.

C3.10 Notwithstanding the above, it is important to be clear as to the purpose of the tender evidence in this appeal. It is WWU's case that this evidence was a clear illustration of emerging price increases since the 2019 Business Plan submission and that Ofgem did not give sufficient weight to that evidence (either in law or in policy terms) when setting WWU's repex allowances.

C3.11 However, WWU does not seek funding for an outsourced model. WWU has shown that it can perform its repex work in-house for less than an external provider, even where WWU will take on all of the risks previously borne by its contractors. In view of that, what the tender evidence does is to provide support for the internal cost build up on the basis of which WWU requests the CMA to revise the unit costs for its repex work. The T&T Report concludes that WWU's cost build-up for an insourced solution is robust. Again, Ofgem does not refute that conclusion.

Treatment of sparsity

[118] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, paras 485(4) and 486 referencing Tab M23: CMA – Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation – Final Determination.

[119] Tab I1: Turner & Townsend – WWU Mains Replacement Appeal – Expert Report.

[120] Tab A3.1: Ofgem – RIIO-2 Sector Specific Methodology Consultation Decision – Core Document, para 11.37.

C3.12 Ofgem states that none of the other GDNs suggested that sparsity should be treated as a regional factor in relation to repex, despite some contending with sparse areas themselves.[121] However, the purpose of regional factors is to take into account the specific issues faced by a particular GDN. Whether or not another GDN requested a sparsity adjustment is irrelevant to whether or not such an adjustment was appropriate for WWU.

C3.13 For example, Ofgem cites SGN as another GDN operating in a sparse area. However, SGN has a main band of pipelines between Glasgow and Edinburgh and does not serve the extremities of its region to the same extent as WWU does. SGN asked for a sparsity adjustment in relation to emergency work only as it is required to cover call outs throughout its region, even where it has no pipeline. It is unsurprising that SGN did not ask for a sparsity adjustment in relation to repex as it does not undertake the same level of repex work at its extremities as does WWU. The differences in the regional factors requested by each therefore reflect their different circumstances. That WWU might need something in extra to other GDNs is unsurprising given that Ofgem recognises that it operates in the sparsest area.[122]

C3.14 It is also noted that Ofgem does not seek to address WWU's argument that to take account of sparsity for emergency and repair costs and not for repex is inconsistent and irrational.[123]

C3.15 Ofgem goes on to state that WWU has failed to provide any evidence in support of a link between sparsity and repex costs. However, it does not answer the evidence presented by Oxera in relation to just such a link both in response to the Draft Determination and in support of the Notice of Appeal.[124] As with the T&T Report, that evidence remains undisputed.

C3.16 Finally, Ofgem suggests that WWU would have captured the effect of sparsity in the figures submitted in its original Business Plan and that WWU received only a 3.9% reduction as against the totex allowances requested in that plan.[125] However, that point neglects the fact that WWU has consistently requested a sparsity adjustment throughout the price control process and that the costs in the Business Plan did not reflect the increasing cost pressures illustrated by the tender evidence. Indeed, the fact that WWU received no bids at all for repex work in two of its sparsest regions is a clear indication of those increased pressures.

Rising labour costs

[121] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 491.

[122] Tab A5.5: Ofgem – RIIO-2 Final Determinations – GD Sector Annex (REVISED), para 3.77.

[123] WWU – Notice of Appeal, para C9.21.

[124] Tab B4.2: WWU – Appendix GDQ26A – A Review of Ofgem's Cost Assessment Approach in the RIIO-GD2 Draft Determinations (Oxera Report) and Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region, paras 2.14, 3.24 – 3.41.

[125] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 493.

C3.17 The difference between what WWU asked for in its original Business Plan and what it requested in 2020 was driven by increased labour costs. As well as the tender evidence, WWU's assertion that labour costs are increasing in its area is supported by two reports from Oxera.[126] Ofgem makes three specific points in relation to those reports, on the basis of which it asserts that their conclusions as to WWU's increasing labour costs should be discounted.[127]

C3.18 Those points have no merit for the following reasons –

(a) Ofgem's statement that, taking Wales and the South West together, wages in WWU's area are aligned with the cross-sector average in Figure 3.1 of the Oxera 2021 Report is irrelevant. Figure 3.1 shows wage growth based on occupational wage data across a number of regions (as per Ofgem's approach), but Oxera's point is that this does not adequately reflect the specific wage pressures in the energy sector.[128]

(b) Ofgem suggests that in pointing to wage growth in the energy sector in 2020, Oxera neglects the sharp decline in wages in Wales in 2019 and the highly volatile nature of the data set. However, wage growth in Wales and the South West is higher than in London and the rest of the UK in the most recent year. Even when looking at the growth from 2018 to 2020 (i.e. accounting for the drop in 2019), the growth rate for WWU is 4.0% compared to -16.1% for London and 3.4% across the UK as a whole.[129]

(c) Ofgem's point that Oxera's analysis of three underlying indices used to set labour RPE focuses too strongly on 2020 is likewise flawed. The main focus of the analysis needs to be on the most recent evidence because the entire purpose is to highlight developments in the WWU region since the submission of its Business Plan. Moreover, while the pandemic had a substantial impact on a number of measures, including indices used by Ofgem to account for RPEs and regional labour adjustments, the labour market in the energy sector was less affected. As demonstrated by Oxera's evidence on furloughing[130] and wage developments at the sectoral level,[131] the labour market for WWU tightened despite the influence of the pandemic. Although 2020 was particularly

[126] Tab B3.3: WWU Business Plan – Appendix 9M – Regional Factors in the Cost Assessment for GD2 Oxera Report Prepared for WWU and Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region.

[127] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 504.

[128] Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region, para 3.10 – 3.11.

[129] Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region, Figure 3.2.

[130] Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region, paras 3.13 – 3.16.

[131] Tab J1: Oxera – The impacts of labour market pressures and sparsity on Repex in the Wales & West Region, Figure 3.2.

disruptive, the development of the RPE indices still reveals that they are not suitable for capturing the labour market effect experienced by WWU. Likewise, Ofgem's concerns regarding endogeneity should energy sector-specific data be used[132] are unwarranted as GDNs only account for a small proportion (6.9%) of employees out of the total number of employees in the sector.

C3.19 In relation to the use of RPEs more broadly, Ofgem refers to the CMA's comments in the Northern Powergrid appeal.[133] However, in that case the appellant had sought to argue that its own pay settlements should be used in preference to RPE data (this is entirely endogenous and thus problematic, but in no sense is this comparable to using the energy sector as a whole). WWU makes no such suggestion and the comments made by the CMA in that appeal are not sufficient to answer the specific criticisms levelled at Ofgem's use of RPEs in relation to WWU.

WWU's situation relative to other networks

C3.20 In relation to the other factors highlighted by WWU as increasing the costs of repex work in GD2, Ofgem argues that these would have been captured in its original Business Plan as they relate to known physical characteristics of the network, and that those factors do not significantly differentiate WWU from other GDNs.[134]

C3.21 WWU's Business Plan outlined a range of factors that would serve to increase repex costs in GD2. In the main, the reason why those factors serve to increase costs is because they take more time to deal with. Although that increased time was captured in the Business Plan what WWU did not know at that point – but which the tender evidence made clear – was that labour costs would increase as significantly, meaning that the same time spent would lead to a higher unit cost for completing the work.

C3.22 Ofgem acknowledges that WWU will have the highest or joint highest proportion of open-cut and ductile iron work out of all the GDNs over GD2 but states that it is not significantly out of line with other networks.[135] However, in relation to ductile iron, what may look like a relatively small difference in proportionate amounts masks the fact that ductile iron takes twice as long to deal with than cast iron and is not differentiated by Ofgem in its repex synthetic unit costs.

[132] Third Witness Statement of Michael Wagner, para 128.

[133] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 502.

[134] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, paras 498, 509 – 511.

[135] Third Witness Statement of Michael Wagner, paras 112 – 114.

C3.23 Likewise, open-cut work in the road is more expensive than other techniques, and WWU has a higher than average volume of this work to carry out in GD2. Again that work is not differentiated and remunerated at the higher rate necessary in Ofgem's unit costs.

C3.24 Ofgem states that WWU has the second lowest volume of high diameter pipes to deal with in GD2. However, that must be considered alongside the fact that WWU has 25% of the total open-cut work across all GDNs for all pipes of 180mm and over in diameter.[136] That lower volume will therefore cost more to deal with.

C3.25 Ofgem also suggests that in framing its arguments WWU has ignored factors that would serve to decrease its costs in GD2.[137] This is incorrect as those factors that would decrease costs, such as WWU's innovations, were captured in the data submitted with its Business Plan. However, whereas cost increases have become more significant since 2019, the effect of the factors serving to decrease costs has been reflected in the insourced unit cost, together with any efficiency improvement from system changes and the removal of management costs.

C3.26 In addition, the example used by Ofgem to illustrate its point – that WWU's average service density for Tier 1 workloads will fall due to moves to less populated – is incorrect. Ofgem's error seems to result from the fact that the data in relation for Tier 1 and consequential steel services were reported differently as between GD1 and the Business Plans for GD2, meaning that the data cannot be directly compared. On a like-for-like comparison – taking both Tier 1 and consequential steel services together – rather than decreasing by 15.9%, service density will increase by 1% in GD2. Indeed, across all mains types, whereas in GD1 there was on average one service every 13.5 metres, in GD2 there will be one service every 12.3 metres.

C3.27 As the discussion in the subsections above shows, the points made by Ofgem demonstrate its failure to grapple with the detail of how different factors interact to produce different costs. This broad-brush approach is reflected in unit costs which do not make different provision for different types of work or different materials – nor is the overall unit cost set at an appropriate rate to account for the increased costs arising from these factors.

C4 THE PRIMACY OF THE MODEL

C4.1 Ofgem suggests that it could not use the evidence submitted by WWU as it could not be accommodated within its modelling process[138] and that the points made by WWU *'undermine*

[136] The 180mm threshold is more relevant than the 125mm threshold in Table 7 of the Third Witness Statement of Michael Wagner as above 180mm the digger must use a larger bucket size (leading to a larger hole) and the material and technology needed to do the work changes.

[137] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 514.

[138] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 487.

the process of [cost] setting overall'.[139] The suggestion seems to be that if particular factors cannot be accommodated by the model then Ofgem can simply ignore them.

C4.2 As Ofgem states, WWU does not seek to appeal the use of a top-down model. However, the model – which does not itself appear on the face of WWU's licence conditions – is simply a means to an end, with the end being the generation of appropriate allowances. The model cannot be seen as an end in itself such that any factor that cannot be accommodated by the model must be set aside. The question is whether the allowances it has generated are appropriate.

C4.3 Notwithstanding that point, WWU did set out how many of the points it made could be accommodated within the model – through use of the current Ofgem regional factor mechanism. As Ofgem sets out, such factors are stripped out before it runs its regression, so their inclusion would in no way disrupt that analysis.[140]

C5 CONCLUSION

C5.1 Ofgem states a number of times that its decisions with respect to repex were within the bounds of its regulatory judgement or discretion.[141] However, Ofgem cannot simply invoke regulatory discretion as a shield against any scrutiny of the merits of its decisions – particularly where it has elevated process above outcome. The CMA has previously emphasised that regulatory discretion must be underpinned by robust evidential analysis.[142] As shown above, the points made by Ofgem in its response to the Notice of Appeal show that its analysis does not meet that threshold.

C5.2 More broadly, the CMA must consider whether the allowances given to WWU are wrong on the merits, applying the applicable statutory tests. The £175 blended unit cost provided by Ofgem falls far short of what WWU has asked for at any stage of the price control process. Ofgem has made no attempt to defend that allowance on its merits.

C5.3 In its response to the Notice of Appeal, Ofgem has put forward no evidence or analysis to counter WWU's evidence that the current unit costs do not appropriately cover the efficient in-house delivery of WWU's repex work, the majority of which it is legally obliged to complete.

[139] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, para 467(1).

[140] Third Witness Statement of Michael Wagner, para 21.

[141] Ofgem – Submissions on Totex Modelling, Efficiency and Licensing, paras 468, 492, 493 and 513.

[142] Tab M32: CMA - Northern Powergrid v the Gas and Electricity Markets Authority - Final Determination, paras 4.59 and 4.140.

D. LICENCE CONDITIONS AND REVENUE UNCERTAINTY

D1 OVERVIEW

D1.1 Ofgem's defence to this head of appeal is essentially that –

(a) The appeal is without merit because Ofgem has statutory powers which facilitate the "*making of Directions through the licence*"[143] and "*it has thereby committed no error of law*"[144].

(b) Ofgem has substantial discretion in choosing the regulatory framework for the GD2 price control, that this involves the exercise of regulatory judgment, and that "*its exercise of regulatory judgment in this manner is not otherwise apt to be interfered with*"[145].

(c) The duty 'to have regard' is a procedural requirement which Ofgem has satisfied because it engaged in extensive consultation before making the price control licence modifications.

(d) It is necessary and appropriate for Ofgem to be able to amend subsidiary documents on a unilateral basis by direction, for responsiveness and administrative reasons[146].

D1.2 WWU responds to each of these elements of Ofgem's defence below.

D1.3 However, a key observation to make at the outset is that Ofgem has made no attempt to engage and respond substantively to any of WWU's arguments in relation to this head of appeal.

D1.4 More specifically, Ofgem has made no attempt to provide an explanation or indeed any reasons as to:

(a) how it has had proper regard, and given appropriate weight, to the relevant statutory duties to which WWU refers;

(b) what regard it has had and what weight it has given to these statutory duties (it has failed even to acknowledge and mention that the statutory duties exist);

[143] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 172.

[144] Ibid.

[145] Ibid.

[146] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 173.

(c) how the implementation of an unprecedented number of subsidiary documents, which between them govern substantive aspects of the price control framework, provides for regulatory clarity and certainty in circumstances where they can effectively be changed at will by Ofgem; or

(d) whether, and if so how, WWU has assurance that it can recover its efficiently incurred costs in complying with the additional and/or amended requirements that will be implemented through changes to the subsidiary documents.

D1.5 Furthermore, Ofgem provides no response to:

(a) WWU's estimates of the possible costs impact of changes made within period to subsidiary documents;

(b) WWU's contentions that no consideration has been given to the regulatory principles or to regulatory best practice; or

(c) the analysis and findings set out in the KPMG Report.

D1.6 Accordingly, where Ofgem has failed to engage and respond to WWU's contentions and arguments, WWU proceeds on the basis that Ofgem does not dispute them.

D1.7 Had Ofgem given proper regard to its duties and given appropriate weight to them, it would surely have been able to explain the factors that it had taken into consideration for that purpose and its reasons for doing so. This is not a strange or new concept or scenario for Ofgem. There are certainly examples where Ofgem has made decisions and has set out its clear rationale for making those decisions.

D2 NOT WRONG IN LAW

D2.1 Ofgem has categorised[147] WWU's grounds of appeal as an objection that "*it was for some other reason **unlawful** for [Ofgem] to make provision for…*". (emphasis added)

D2.2 It then proceeds, in the first instance, to defend the appeal on the basis that it has committed no error of law.

D2.3 However, this is no answer to WWU's appeal. WWU is not appealing Ofgem's decision on the basis that it is wrong in law or that it was unlawful for Ofgem to make licence modifications which make provision for subsidiary documents to be changed by direction.

[147] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, paras 177 and 172(b).

D2.4 A statutory appeal under section 23 of the Gas Act is a qualified merits appeal. The applicable legislation does not restrict the parameters of an appeal such that it can be brought only on legal grounds.

D2.5 That the decision being appealed is 'wrong in law' is only one of the five grounds on which an appeal can be made. But it is not the ground on which WWU makes its appeal in relation to this head of appeal. WWU does not (and does not need to) contend that Ofgem's decision was unlawful.

D2.6 Section D of WWU's Notice of Appeal very clearly set out that its grounds for appeal are that Ofgem has failed:

(a) properly to have to regard to the performances of its statutory duties under sections 4AA(2)(b) and 4AA(5A) of the Gas Act[148]; and

(b) to give appropriate weight to the performance of these duties[149].

D2.7 That is, in deciding to introduce an unprecedented number of licence conditions under which WWU is required to comply with subsidiary documents (including two such documents which have the status of being a licence condition but which can also be amended other than through the statutory modification procedure) that can be modified at any time by Ofgem issuing a direction, Ofgem has:

(a) failed properly to have regard to the performance of its statutory duties to:

(i) have regard to the need to secure that WWU (as a licence holder) is able to finance the activities which are the subject of obligations imposed on it;

(ii) have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and

(b) failed to give appropriate weight to these statutory duties.

D2.8 It is not any part of WWU's appeal that Ofgem does not have the legal *vires* to make licence modifications under which it can make Directions or that it was unlawful for it to do so.

D2.9 WWU's appeal is about the matters that Ofgem took into consideration and/or failed to take into consideration in exercising its legal *vires* and making the decisions it has made on the

[148] The ground stated at section 23D(4)(a) of the Gas Act.

[149] The ground stated at section 23D(4)(b) of the Gas Act.

licence modifications which provide for subsidiary documents. That is that Ofgem has failed to give proper regard and appropriate weight to the statutory duties referred to above.

D2.10 It is very striking to note that in her witness statement, Min Zhu makes no mention whatsoever of the relevant statutory duties to which it is required to have regard and give weight to, let alone the matters to which it actually had regard and/or gave weight to and how or why it considers it has struck the right balance.

D3 REGULATORY DISCRETION AND JUDGEMENT

D3.1 Ofgem's second line of defence is that it has substantial discretion in choosing how to determine the GD2 price control and the applicable regulatory framework and that how it exercises its discretion is essentially not a matter which can be interfered with by the CMA.

D3.2 However, Ofgem is wrong in contending that there is no role for the CMA with regard to the exercise of regulatory discretion or judgement.

D3.3 As highlighted earlier, a regulatory appeal to the CMA is a qualified merits appeal. The CMA's role and remit is not the same as, and therefore cannot be compared with, the role of a court in judicial review proceedings (which is primarily considering whether the public body has met the 'public law' standard of decision making as we highlight further in section D4 below).

D3.4 The CMA can, and it is entirely right and appropriate for it to, 'interfere' (as Ofgem puts it) in matters where Ofgem has exercised its discretion for the purposes of determining whether or not in exercising its discretion Ofgem had proper regard to its duties and/or gave appropriate weight to them.

D3.5 WWU understands and acknowledges that with the appeal being a qualified merits appeal, the CMA's role is not to consider the appeal from the perspective of whether or not (acting as a reasonable regulator) it would have taken a different decision to Ofgem. But this does not assist Ofgem or its defence and does not in any way negate or weaken the need for the CMA to consider and apply the statutory test(s) in the first place, i.e. whether the regulator's decision is wrong on the relevant statutory test(s) contended for by WWU. To put it another way, the CMA's role is to consider whether any regulator (acting reasonably) could have made the decision that Ofgem has made.

D3.6 WWU's case under this head of appeal is that Ofgem has, through the sheer number of subsidiary documents and through the provision that such documents can be changed at any time by Ofgem by direction, created considerable regulatory uncertainty such that WWU is not, and cannot be, assured of being able to recover the (reasonable and efficient) costs it incurs in complying with the amended subsidiary documents.

D3.7 These are precisely the type of matters on which the CMA has jurisdiction.

D3.8 Indeed the CMA itself has previously confirmed and clarified that to be the case. For these purposes we refer the CMA to the following statements made by it in the SONI Appeal –

> "We note that for any regulated business, a clear path for recovering its efficiently incurred costs is a central aspect of the regulatory settlement. Where costs are taken outside the standard price control framework, clarity between all parties around the processes for recovering these costs is particularly important."[150]
>
> "In our view, it is important that the mechanisms through which SONI is expected to recover its efficiently incurred costs are set out clearly, in a manner that allows SONI's investors to assess the risks of investing in the company. Failing to do so is likely to introduce regulatory risk, and is likely to affect SONI's ability to finance its activities."[151]
>
> "If asymmetric risks result from a framework under which SONI faces considerable risk of not recovering its efficiently incurred costs without it being compensated for these risks, in our view this would not be consistent with UR's duty to ensure SONI's financeability."[152]

D3.9 Ofgem is certainly aware of the above statements given that WWU cited one of them in its Notice of Appeal and given that it has chosen to rely on certain aspects of the CMA's determination on the SONI appeal when addressing the arguments made by SHE-T (in its Ground 3) and SPT (in its Ground 4). It would appear therefore that Ofgem is 'cherry-picking' from the SONI determination in terms of using it where it supports its case but ignoring it where it does not.

D3.10 Simply because Ofgem has exercised the discretionary power afforded to it to make licence modifications that provide for the implementation and amendment by direction of subsidiary documents does not mean that there is no role for the CMA here.

D3.11 The question for the CMA is whether the decision is wrong on the grounds that Ofgem has not given proper regard and/or appropriate weight to the relevant statutory duties. As confirmed by the CMA, in order to do that it has to take the merits of the decision under appeal into account.[153]

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[150] Tab M17: CMA - SONI Limited v Northern Ireland Authority for Utility Regulation – Final determination, para 6.45

[151] Tab M17: CMA - SONI Limited v Northern Ireland Authority for Utility Regulation – Final determination, para 6.70.

[152] Tab M17: CMA - SONI Limited v Northern Ireland Authority for Utility Regulation – Final determination, para 6.220.

[153] Tab M17: CMA - SONI Limited v Northern Ireland Authority for Utility Regulation – Final determination, para 3.26 and footnote 91.

D3.12 In terms of considering the merits of the decision, it is of particular relevance that the subsidiary documents have the status of being legally binding documents with which WWU is required to comply and which Ofgem can enforce.

D3.13 They are not guidance documents - which seems to be the impression that Ofgem would wish the CMA to form from:

(a) the numerous times in its submissions it refers to subsidiarity documents as including or containing guidance[154]; and

(b) the response it gave to questions asked by the CMA at the Ofgem teach in session[155].

D3.14 With regard to the former, and purely to help illustrate the point, the following extracts (from the first four paragraphs listed in footnote 12) are taken from Min Zhu's first witness statement:

> 'The Associated Documents….provide information, requirements and guidance…'
>
> '…include significant levels of detail and guidance'
>
> '…[Associated Documents] can include methodologies and/or guidance…'
>
> 'The PCD Associated Document…provides guidance on the outcomes…'

D3.15 With regard to the latter, one example (at page 20 of the transcript referred to in footnote 13) is Mr Kaul's response '*We have got the guidance for most…published through the so-called associated documents…*'.

D3.16 Whether intentional or not these are misleading submissions and responses from Ofgem. All Associated Documents (bar one) are legally binding documents with which WWU is required to comply.

D3.17 Also misleading, and indeed contrary to Ofgem's Decision on principles of use for RIIO-2 Associated Documents[156], is titling the subsidiary documents as "Guidance" (which is the case for some of the documents).

[154] First Witness Statement of Min Zhu, paras 53, 54, 58, 70, 133, 149, 162, 167, 173, and 184 in particular.

[155] Page 20 of the transcript for Ofgem Teach-in Session 3.

[156] First Witness Statement of Min Zhu, Exhibit B.

D4 FOLLOWED DUE PROCESS

D4.1 The only substantive reference made by Ofgem to its statutory duties is by way of an attempt to dilute and diminish the meaning and scope of the 'to have regard' aspects of the relevant duty by:

(a) asserting that it is a procedural requirement only; and

(b) wrongly categorising WWU's appeal as a challenge to the process followed by Ofgem.[157]

D4.2 In making its assertion, Ofgem refers to and relies on a Court of Appeal case[158]. However, that case is concerned with the 'public law' standard that needs to be met by public bodies in their decision-making. But the question to be considered and determined by the CMA is not whether Ofgem met the public law standard but whether it had proper regard to/gave appropriate weight to the relevant statutory duties.

D4.3 The challenge here is to a substantive decision taken by Ofgem, i.e. the approach it has taken in respect of subsidiary documents. It is not a challenge to the decision making process and Ofgem's answer that it has met the public law standard is no answer to the question which the CMA is required to consider.

D4.4 That Ofgem has, whether inadvertently or otherwise, misunderstood and mischaracterised the nature of the regulatory appeal and the role of the CMA is also evident from paragraph 249 of Ofgem's submission where it states "*It is impossible for WWU to show that Ofgem acted irrationally...*". Again this is a public law standard and in a qualified merits appeal WWU does not need to show that Ofgem acted irrationality where the grounds of appeal is not that there was an error of law.

D4.5 Having made its mistaken assertions, Ofgem then proceeds to rely on the fact that it engaged in consultation processes as evidence that it 'has had regard' to the applicable statutory duties.

D4.6 WWU's appeal is not about procedural matters or about whether or not Ofgem has followed the correct process, including with regard to consultation.

D4.7 WWU's appeal is about the substantive decisions made by Ofgem to make licence modifications which are purporting to give effect to the GD2 price control under which there

[157] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 233.

[158] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 234.

are an unprecedented number of subsidiary documents that contain substantive obligations and requirements that can be changed on a unilateral basis by Ofgem.

D4.8 In support of its incorrect categorisation of the substance and basis of WWU's appeal, Ofgem then provides a lengthy chronology of the various consultations it has undertaken with regard to the GD2 price control.

D4.9 The lengthy submissions on the consultations undertaken by Ofgem are either a deliberate attempt by Ofgem to deflect scrutiny away from the core basis of WWU's appeal because it has no response to the arguments made by WWU or demonstrative of Ofgem's misunderstanding of the basis of WWU's appeal.

D4.10 That Ofgem has engaged in various consultation processes is not in any way determinative of the answer to the CMA's question.

D4.11 Ofgem has given no explanation as to how or why it considers it has struck the right balance between its duties; what matters it has had regard to in respect of the need for it to secure that WWU is able to finance its licence obligations relating to compliance with amended documents; the basis on which it asserts that the framework it has put in place "*makes regulation more predictable and transparent*"[159] and the evidence on which this assertion is based; the relevant weight it has given to each of the applicable duties and the reasons for doing so.

D4.12 Furthermore, Ofgem has not explained in any coherent way why it considers it necessary to change its past practice with regard to changes to the Price Control Financial Instruments; how or why its role as the independent regulator is diminished or called into question by virtue of licensees being able to demonstrate that Ofgem's proposed change would have a significant impact; and how it has taken into account licensees' comments and responses on these matters.

D4.13 Rather, Ofgem's response to WWU's appeal on licensing simply reiterates the position that Ofgem has taken and/or change that it has made without giving any reasons as to why it has taken that position or made that change and the factors it took into account, i.e. the matter to which it had regard, in doing so.

D4.14 To illustrate this point, we give the example at paragraph 191(5) of its submission[160], where Ofgem makes the following statement:

[159] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 240.

[160] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing.

> "The PCFI condition existed under RIIO-1 but it included a provision effectively enabling a licensee to 'veto' Ofgem's proposal to make modifications under the PCFI licence condition if the licensee considered the modification would have a "*significant impact*". Ofgem decided not to retain this licensee 'veto' for RIIO-2: instead, as the independent regulator, it will decide whether it must use the Statutory Modification Procedure, taking into account licensees' views."

D4.15 Firstly, this statement is not quite correct as there was no licensee 'veto' as such. Rather the licensee had to demonstrate that the change would have a significant impact. In any event the statement simply outlines the change that has Ofgem has made from the GD1 position but without giving any rationale for that change.

D4.16 Ofgem has had numerous opportunities to explain and articulate its reasons and justifications for its unprecedented increase in the number of subsidiary documents, the status of such documents, and its ability to make changes to them within-period by way of direction.

D4.17 It has failed to do so at every opportunity. It did not do so within any of the various consultations undertaken by it – effectively meaning that they were not valid consultations, nor within its reasons and effects document[161]. It has again failed to do so in its response to WWU's appeal. The scant explanation it has given – essentially that as the industry regulator it has substantial discretion and can therefore do what it likes so long as it is not acting unlawfully – is nowhere near sufficient or good enough.

D4.18 It is wholly wrong and inappropriate for Ofgem to shield behind its status as the industry regulator and fail to provide clear and reasoned justifications for its decisions, including explaining the regard it had to the applicable statutory duties and the weight given to them and why.

D5 NECESSITY

D5.1 Ofgem also contends that it is necessary and appropriate, for it to introduce such an unprecedented number of licence conditions where the detail of the obligations with which WWU is required to comply is set out in subsidiary documents, because:

(a) there are an increased number of uncertainty mechanisms;

(b) the alternative processes mean that the price control is responsive and workable;

(c) it ensures that up-to-date information is quickly reflected on the face of the licence;

[161] Tab A6.1: Ofgem - RIIO-2 Informal Licence Drafting Consultation.

(d) it avoids administrative burdens.[162]

D5.2 As to these points, WWU responds as follows:

(a) That there are an increased number of uncertainty mechanisms does not correlate with a need for the increase in the number of subsidiary documents or with the need for such subsidiary documents to be subject to unilateral change by direction by Ofgem.

(b) Furthermore, as explained by Min Zhu in her witness statement, each of the uncertainty mechanisms is either an automatic mechanism or subject to a 'reopener' process which is set out in its own licence condition[163]. WWU's appeal does not relate to the licence conditions which provide for the uncertainty mechanisms used by Ofgem in the GD2 price control.

(c) That subsidiary documents are subject to unilateral change by Ofgem direction does not make the price control responsive and workable from a licensee's perspective. Rather, as outlined in WWU's Notice of Appeal, it is less workable because it lacks clarity and transparency and creates regulatory uncertainty and risk.

(d) WWU does not understand how the making of unilateral changes to subsidiary documents by the making of Directions ensures that information is quickly reflected on the face of the licence. As Ofgem confirms most of the subsidiary documents are subordinate to the licence but even those which have the status of licence conditions are not on the face of the licence. Accordingly, changes made to the subsidiary documents are not reflected on the face of the licence.

(e) WWU does not recognise, and Ofgem has failed to explain, the administrative burdens that would be involved in Ofgem reverting to the GD1 position that applied in respect of changes to the Price Control Financial Instruments and incorporating that position for changes to all subsidiary documents. In any event, ensuring and providing regulatory clarity and certainty should not be seen as an administrative burden.

D5.3 Additionally, in her witness statement, Min Zhu states that "*Associated Documents are not able to be modified through Statutory Modification…*"[164], implying that it is legally not possible for the documents to be modified other than by Ofgem direction, but giving no explanation or reasons as to why that is said to be the case. In any event, WWU does not agree with or

[162] Ofgem's Response to Appeals on Totex Modelling, Efficiency and Licensing, para 173.

[163] First Witness Statement of Min Zhu, para 65.

[164] First Witness Statement of Min Zhu, para 187.

accept the proposition that such documents cannot be subject to modification through the statutory modification process.

D5.4 WWU accepts that it would be unwieldly and cumbersome to include all of the content of the subsidiary documents on the face of the licence and is not contending that should be the case.

D5.5 However, that takes nothing away from, and is no response, to WWU's case - which is that all subsidiary documents should have the same status as licence conditions such that, as a minimum, any significant changes to them should only be possible through the use of the section 23 modification process (and not through the unilateral issue of a Direction by Ofgem).

D5.6 Moreover, that Ofgem considers it to be an administrative burden for significant changes to Associated Documents to be subject to the statutory modification procedure serves only to highlight that Ofgem's intention is to make a large number of significant changes to these documents. It should be the exception rather than the norm for within-period changes to be made to the price control framework and parameters.

D5.7 Indeed Ofgem has confirmed that subsidiary documents 'contain detailed information'[165], include '*detailed methodology*'[166], '*detailed principles*'[167] and '*definition[s] of terms*[168]'. It has also confirmed that one reason for making changes to subsidiary documents by direction is to be able to '*expand interpretations*' [169].

D5.8 A clear example of the potential impact that changing and/or expanding interpretations (and in this particular case interpretation of a definition) in subsidiary documents can have is demonstrated by WWU's head of appeal F (tax clawback).

D5.9 WWU invites the CMA to consider this head of appeal in the light of the information set out in the pleadings and witness statements relating to head of appeal F on tax clawback – including the first witness statement of Penny Harandy and the second witness statement of Ian Weldon, which deal with the complicated history of the matter in some detail.

D5.10 Tax clawback, which relates to a matter of with material financial impact, is a policy which Ofgem purports to have set out over a number of years in subsidiary documents which sit off the face of the licence and have a complex and ill-defined relationship with each other. It is,

[165] First Witness Statement of Min Zhu, para 54.

[166] First Witness Statement of Min Zhu, para 70.

[167] First Witness Statement of Min Zhu, para 86.

[168] Ibid.

[169] First Witness Statement of Min Zhu, para 130.

moreover, a policy in relation to which Ofgem wishes to continue to do this in the future, introducing still further related documents by which the policy can be defined and given effect.

D5.11 The lack of clarity to which this has given rise is sufficiently unattractive that part of the remedy that WWU seeks in this appeal that the policy should be written onto the face of the licence for the purpose of ensuring its certainty, stability and predictability. It offers an object lesson in how the 'flexibility' which Ofgem now seeks to introduce on a wide scale across the licences regulatory risk, cost and uncertainty for network licensees.

E. ONGOING EFFICIENCY

E1 SUMMARY

E1.1 Ofgem confirms that its Ongoing Efficiency ("**OE**") target of 1.15% p.a. for REPEX/CAPEX and 1.25% p.a. for OPEX consists of a "core OE target" of 0.95% for REPEX/CAPEX and 1.05% for OPEX and a 0.2% uplift for efficiency gains from the innovation funding.

E1.2 WWU submits that Ofgem's decision making process is flawed by a lack of transparency. Furthermore, there is an inadequate rationale to justify the manner in which it has exercised its regulatory discretion. Whilst it is acknowledged that Ofgem has some regulatory discretion, that does not entitle Ofgem to act in an arbitrary way or to use its regulatory discretion to override clear evidence or to rely on flawed evidence.

E1.3 Indeed, WWU is concerned that Ofgem has applied their discretion inappropriately, and with a bias towards aiming up, imposing a high challenge on efficiency regardless of the evidence from its own experts or the data. In particular:

(a) The arguments which WWU has made about the time periods being incorrect have gone unanswered in the Response, notwithstanding that this creates an upward bias;

(b) The labour productivity date is incorrect and creates an upward bias; and

(c) The focus on VA and economy wide estimates is incorrect, also creating an upward bias.

E1.4 Ofgem's submissions and the witness statements of Mr. Gary Keane and Mr. Michael Wagner (the "**Witness Statements**") fail to clearly outline the process which it has followed, the weight given to each of the various elements or the rationale for why it has chosen to prefer its regulatory judgement to override evidence from its experts, CEPA, or to rely on flawed data.

E1.5 Ofgem has also failed to respond to WWU's conceptual arguments and empirical evidence on flaws in CEPA's quantitative analysis, the outdated and highly selective evidence used to justify stretching or "aiming-up" and the inappropriateness of the R&D uplift. WWU notes that Oxera's analysis arrived at an estimate of 0.4% which is significantly lower than Ofgem's and marginally lower than the estimate provided by WWU in its Business Plan[170]. The paragraphs below set out WWU's submissions in detail.

[170] Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 6.15.

E2 LACK OF TRANSPARENCY

E2.1 Ofgem's submissions and the Witness Statements fail to address the lack of transparency on how the OE value was derived by Ofgem. WWU submits that there must be transparent derivation of a core range or point estimate and clarity on the qualitative and quantitative overlays applied. This was the approach followed by the CMA in the PR19 Final Determination.[171]

E2.2 Ofgem confirms in its submission that OE consists of a "core OE target" of 0.95% (corresponding to the upper range of CEPA's FD recommendation) and a 0.2% uplift for efficient gains from innovation funding, however, there is no transparency on how the "core OE target" was derived.

E2.3 While Ofgem and CEPA note in their submission and Witness Statements that the "core OE target" is informed by quantitative evidence from the growth accounting methods with "qualitative arguments" taken into account and "some" weight was placed on Gross Output Total Factor Productivity ("**GO-TFP**")[172], the Witness Statements fail to outline the weight placed on the different factors, as they were assessed in the round. WWU submits that the CMA will be unable to judge if the weight placed on the different factors was appropriate due to the lack of transparency in Ofgem's / CEPA's approach. The simulation below illustrates the lack of transparency and errors committed by CEPA in deriving the OE target.

SIMULATION ILLUSTRATING THE LACK OF TRANSPARENCY

E2.4 CEPA submits that its upper range for REPEX/CAPEX OE (excluding potential consumer return on innovation funding but after including qualitative judgement) is 0.95%. In order to understand the weight that CEPA could have assigned to its various estimates for TFP (VO and GO TFP for the economy and the targeted sector using the time period from 1997-2006), Oxera ran a simulation, randomly assigning positive weights to CEPA's four TFP-measures to calculate a weighted average TFP (representing the core-target before further applying qualitative adjustments). While more weight could have been applied to the pre-financial crisis

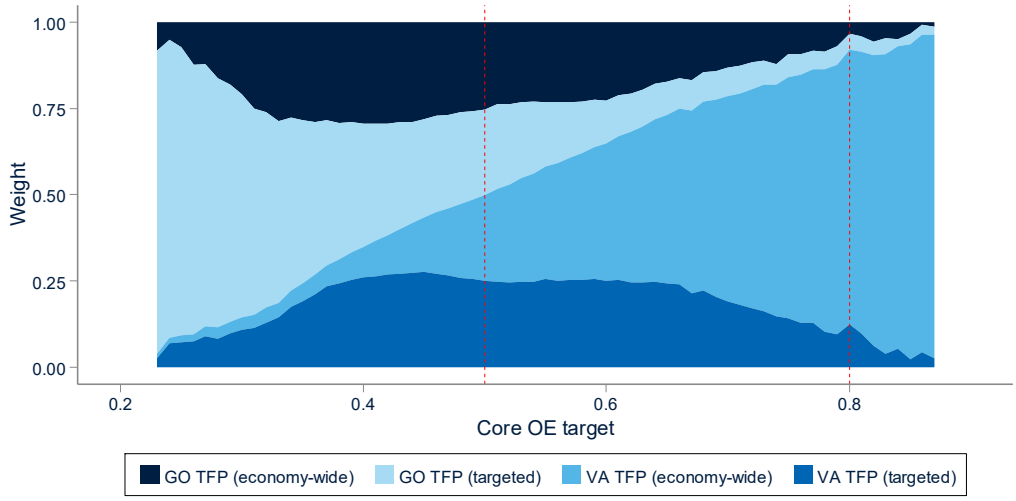
[171] CMA (2021),' Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report', March, para 4.522, 4.537, 4.545, 4.556, 4.565.

[172] Ofgem (2021), 'RIIO-2 Price Controls - Response to appeals on TOTEX modelling, efficiency and licensing', April, para 122, 128; First witness statement of Mr Gary Keane, 23. April 2021, para. 153, 163; Second witness statement of Dr Michael Wagner, 23. April 2021, para. 109, 141.

period[173] resulting in an increase in the TFP, this would be contradictory to other statements in the Ofgem response documents[174]. Oxera repeated this exercise 100,000 times. [175]

E2.5 On average, the simulation suggests a core-target before applying any qualitative judgement of 0.5% (ranging from 0.23% to 0.87%). Of these 100,000 simulations only 0.05% result in a core-target of 0.8% or higher, which is still 0.15% less than Ofgem's/CEPA's actual OE challenge.

E2.6 The following graph demonstrates that it is only possible to arrive at very high core OE targets, before applying any further qualitative adjustments, (of 0.8% and higher) if an extremely high weight is placed to Value Add ("**VA**") TFP (economy-wide), while all other estimates (particularly GO estimates or TFP estimates for targeted comparators) play only a minor role. If, in contrast, higher weight is placed on GO TFP for targeted sectors (which should represent the core target, as submitted by Oxera previously[176]), as supported by economic theory, the resulting core OE targets, before applying any qualitative adjustments, would be significantly less than 0.5%.



E2.7 Therefore, CEPA has either incorrectly placed the vast majority of weight on VA measures and only a negligible weight on GO measures and still added some aiming up for qualitative reasons to reach a figure of 0.95% or they placed a higher weight on GO and added an

173 First witness statement of Mr Gary Keane, 23. April 2021, para 109.1.

174 Ofgem (2021), 'RIIO-2 Price Controls - Response to appeals on TOTEX modelling, efficiency and licensing', April, para 116.

175 For further details, see Oxera report at Tab O1.

176 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, paras 3.22-3.33.

extremely high component of "aiming up" to reach a figure of 0.95% which is incorrect. In each case, Ofgem has adopted an incorrect approach and committed errors in deriving the OE target.

E2.8 Ofgem's non-transparent approach of mixing quantitative and qualitative evidence when deriving a core OE-target is not consistent with the CMA's approach in PR19, contrary to the CEPA witness statements[177]. In PR19, the CMA's approach starts with a transparent derivation of an OE benchmark. The CMA calculated an average estimate using the selected targeted comparators and GO-TFP as a starting point and then qualitatively adjusted this based on other factors[178]. If the CMA uses the same approach in this appeal, the core OE-target before applying qualitative adjustments would be either 0.2% (based on CEPA's FD-estimate for GO-TFP for targeted sectors) or 0.4% (based on Oxera's estimate using a more defined and weighted targeted comparator sector set). The reason for the decline in core OE-target compared with that used by the CMA in PR19 before applying qualitative adjustments is the revision of the EU KLEMS data set to the most current version and the choice of target sectors.

E2.9 Ofgem's decision making process is flawed by a lack of transparency and having greater clarity would great enable a more complete assessment of Ofgem's approach to be undertaken. Nevertheless, WWU's position does not rely on the weightings used by Ofgem, instead we have highlighted the errors committed in deriving the OE target.

E3 ERRORS IN OFGEM'S QUANTITATIVE ANALYSIS USING EU KLEMS DATA

TIME PERIOD – INCOMPLETE BUSINESS CYCLES

E3.1 WWU's contention is that the time period adopted by CEPA and Ofgem (1997-2016) is not reflective of a "full business cycle" and results is an upward bias. Ofgem refers to WWU's contention in §120, however, neither Ofgem nor CEPA have responded to the submissions made by WWU that dispute the validity of CEPA's contention that the time period selected is representative of two complete business cycles.[179] Therefore, WWU's submission and evidence remains unchallenged by Ofgem and CEPA.

E3.2 Ofgem has defended its approach in §120 by arguing that CEPA conducted an "appropriate" analysis of recent business cycles based on the OBR's estimates of the output gap. CEPA does not defend its choice of time period using actual OBR data and instead submits in Mr.

177 First witness statement of Mr Gary Keane, 23. April 2021, para. 141.

178 CMA (2021),' Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report', March, para 4.522, 4.537, 4.545, 4.556, 4.565.

179 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, paras 3.9-3.21.

Gary Keane's witness statement at §148-150 that the use of 1997-2016 as the business cycle is "consistent" with the analysis carried out on behalf of the ORR (2012) and the CAA (2013) and was based on earlier HM Treasury analysis of evidence on the economic cycle.

E3.3 WWU and Oxera have reviewed this new evidence submitted in the witness statement and note that this "consistency" identified is irrelevant because the estimation from HM Treasury was performed in 2005 and 2008, is out of date and irrelevant to the consideration raised in WWU's appeal about whether 1997-2016 represents two business cycles. We further submit that HM Treasury in its report has clearly outlined that "*uncertainties continue to surround this assessment, in particular those relating to further possible revisions to National Accounts data*."[180] The magnitude of this uncertainty can be seen while comparing the OBR data used in CEPA's ORR report[181] with the OBR data used in CEPA's FD report[182]. While the former data predicts a negative output gap from 2003 to 2005, the most recent data predicts a positive output gap for the same time period. The change in the output gap from negative to positive for the same time period explains why the most recent OBR data does not support the period 1997-2006 representing a completed business cycle.

ERRONEOUS USE OF THE "LABOUR PRODUCTIVITY" (LP) AND MIXING WITH "TOTAL FACTOR PRODUCTIVITY" (TFP) METRICS

E3.4 Ofgem's response in §132 in respect of the submissions that Ofgem is conceptually wrong or inconsistent to use LP measures for opex fails to respond to WWU's evidence and submissions[183] that no weight should apply to "LP at constant capital" for a number of reasons, including that it is not consistent with the academic literature and it yields biased results when combined with TFP estimates. While there is lack of transparency in relation to what weight was placed on LP, it is evident that a high weightage must have been given to LP as the opex OE is 0.1% higher than that for CAPEX / REPEX equivalent. Therefore, WWU's submission and evidence on this issue remain unchallenged by Ofgem / CEPA.

E3.5 Ofgem and CEPA do not defend the chosen LP measure or provide any economic reasoning explaining why a mixture between LP and TFP derives correct results and instead argue that this has been considered in previous price controls. WWU does not argue that the chosen LP measures have not been considered in previous regulatory decisions, however, WWU has demonstrated that these measures have no conceptional foundation, are not used in the

180 HM Treasury (2008), Evidence on the economic cycle, p23.

181 CEPA (2013), 'Scope for improvement in the efficiency of Network Rail's expenditure on support and operations: Supplementary analysis of productivity and unit cost change', June, page 27.

182 CEPA (2020), 'RIIO-GD2 and T2: Cost Assessment – Advice on Frontier Shift policy for Final Determinations', November, page 18.

183 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 3.34.38.

academic literature and yield inaccurate and biased results.[184] WWU submits that using academically incorrect measures in past regulatory decisions is no justification to continue to use it in the current price control.

ERRONEOUS FOCUS ON UNADJUSTED VA AND ECONOMY-WIDE ESTIMATES

E3.6 Ofgem submits in §128 that Ofgem had regard to the targeted comparator set constructed by CEPA in addition to the economy-wide comparator set in response to submissions that Ofgem had erred by placing no or insufficient weight on productivity improvements achieved by the targeted comparator set from the EU KLEMS growth accounting analysis. However, there is no explanation as to the extent to which targeted comparator sets were considered, this lack of transparency makes it impossible to unpack this argument.

E3.7 Ofgem and CEPA have reiterated their previous arguments to justify having regard to an economy-wide comparator data set as well as the targeted comparator data set and focusing on an unadjusted VA measure. WWU's submission and Oxera's evidence arguing for TFP from targeted sectors has been largely ignored by Ofgem and CEPA.

E3.8 WWU submits that GO TFP should be the core measure, as per our previous arguments, which are consistent with the views of the OECD.[185] We note that the CMA in the PR19 redeterminations also considered GO TFP as the core measure.[186] If VA TFP is to be used to set an OE challenge for TOTEX, it should be adjusted,[187] as also previously accepted by Ofgem.[188] Ofgem submits in §126 that trying to identify a subset of expenditure that corresponds to VA spending would create the risk of spurious accuracy, however, not making any adjustment is clearly spurious and if no adjustment is attempted then GO TFP should be used instead.

E3.9 WWU submits that the economy-wide target imposes the risk that sectors that are totally irrelevant are included. Being not able to perfectly match targeted sectors is no excuse to include irrelevant sectors for the sake of simplicity. Moreover, CEPA is still not able to provide

184 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 3.34-3.35.

185 Oxera (2021),' Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations', February, Section para 3.22-3.33.

186 CMA (2021),' Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report', March, para 4.545.

187 Oxera (2021),' Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations', February, Section para 3.28

188 Tab L2: Ofgem - RIIO-T1/GD1: Initial Proposals − Real price effects and ongoing efficiency appendix, July 2012.

any empirical evidence supporting their view of "spill-over" effects. The evidence provided by WWU does not suggest that such spill-over effects exist on a large scale.[189]

E4 UNBALANCED APPLICATION OF REGULATORY DISCRETION

E4.1 WWU submits Ofgem has applied regulatory discretion in a selective, inconsistent and unbalanced way as all arguments justifying aiming-up have been considered on a purely qualitative basis with little or inaccurate empirical evidence and empirical evidence has also been ignored[190]. On the contrary, any argument justifying lowering down is dismissed based on insufficient evidence. A non-exhaustive list of instances where Ofgem has adopted an unbalanced application of regulatory discretion is set out below:

(a) Ofgem's response in §145-148 in relation to the impact of COVID-19 that as a part of RIIO-2 closeout process any adjustment to the OE challenge, or conscious decision to aim-down, would have risked an arbitrary lowering of the OE challenge on the basis of insufficient evidence.

(b) CEPA and Ofgem have dismissed evidence provided by the OBR that the recent productivity slowdown is persistent and instead state in §136 of its response that Ofgem was "entitled" to conclude that energy networks are more resilient to negative shocks than the wider-economy[191], however, this is an untested assertion on Ofgem's part not supported by any empirical evidence. The higher past productivity of the wider economy is an important part of the evidence informing Ofgem's core OE target[192] but Ofgem and CEPA provide no explanation as to why the wider economy is informative during historical periods while recent evidence on its slowdown and the persistence of this can be dismissed. Ofgem has also not responded to and ignored the evidence submitted by WWU on resilience to negative shocks, which contradicts Ofgem's assertion[193].

(c) Ofgem argues that the network companies' forecasts represented one of the many evidences that Ofgem had given regard to while determining the level of the OE challenge, however, a subsequent clarification of these forecasts does not change their OE target.

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189 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 3.42-3.43.

190 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 5.20-5.22.

191 First witness statement of Mr Gary Keane, 23. April 2021, para 117, 182.

192 First witness statement of Mr Gary Keane, 23. April 2021, para 163.

193 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 5.5.

(d) Ofgem's response in §139-141 in relation to WWU's query on the validity of Ofgem's cross-checks is inadequate as Ofgem has not responded to WWU's submission[194] that estimation of this complex modelling is not a "simplistic" analysis and requires disentangling of different effects[195]. Ofgem's own commissioned research by a number of academics was unable to produce an historical productivity figure that was deemed reliable. The CMA dismissed such qualitative arguments by Ofwat in PR19[196] and even CEPA claims that analysis of the historical efficiency performance of network companies was not one of the pieces of evidence used to set the OE range in their report[197].

(e) CEPA argues that embodied technological change justifies an aiming-up of the OE-target with no analysis or assessment. We also note that Ofgem and CEPA fail to acknowledge that network companies have improved quality of service significantly over GD1 and are planning to do so over GD2 for no additional cost. This represents a further OE challenge over and above Ofgem's challenge. This also means that embodied technical change does not provide a valid reason for any additional qualitative uplift as, if there is any quality improvements in inputs that network companies use, it is highly likely that this is passed on to consumers in terms of quality improvements.

E5 UPLIFT FROM THE INNOVATION FUNDING

E5.1 The link identified by Ofgem between the innovation funding received by network companies and efficiency improvements in §154 of its response are not relevant as the dispute is not in relation to the association between R&D spending and productivity but instead on whether or not an additional uplift is required. With regards to the evidence from the companies themselves that Ofgem and the witness statement from Mr. Gary Kean refers to[198], Ofgem fails to mention WWU's submission that highlighted that WWU's business plan clearly outlined that potential cost savings due to past and ongoing innovation were *already included before applying a further 0.5% p.a. ongoing efficiency challenge* and provided examples of innovation

194 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 5.17.

195 Second witness statement of Dr Michael Wagner, 23. April 2021, para. 162.

196 CMA (2021),' Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report', March, para 4.570 with respect to the sectors historical productivity.

197 First witness statement of Mr Gary Keane, 23. April 2021, para 193.

198 First witness statement of Mr Gary Keane, 23. April 2021, para 88.

projects and how they impact costs for GD2.[199] Ofgem provides no explanation why the provided information was not sufficient and what further evidence was needed.

E5.2 Ofgem's response in §155 notes that it did not overlook the risks of double counting rather Ofgem considered that the innovation uplift was justified because innovation funding represents additional funding above any investment which the companies in the competitive sector may make. There is no support for this argument on conceptual grounds because as submitted previously, R&D spending in network industries is unlikely to be higher than comparator industries (even after taking innovation funding into account)[200]. The current RIIO-2 regulatory framework provides limited incentives to engage in risky innovation as the regulated firm cannot fully enjoy the benefits from this risky investment. This is different from the competitive sectors where a firm can fully enjoy the benefits of a risky investment. Network industries may face market failure in the absence of such funding and therefore, the innovation funding should be considered a mechanism to overcome market failure rather than as additional R&D funding in comparison to the competitive sector. Ofgem has not provided any empirical evidence to support the argument that in the absence of the innovation funding the regulated network would have the same R&D spending as competitive sectors.

E5.3 Even if the CMA accepts Ofgem's submission to add an uplift for the innovation funding, WWU submits that the full 0.2% uplift should not be applied. Ofgem's own description of the R&D funding scheme clearly shows that cost reduction was only one of several aims targeted with the innovation funding, while the majority of funding was not assigned to cost-reduction activities[201]. CEPA has estimated the uplift for innovation funding on the assumption that all funding delivers cost savings, however, this assumption is flawed as it ignores that R&D can also yield benefits through higher quality of services or different outcomes. Ofgem has ignored the evidence[202] that in GD1, 45% of the funding had been for product innovation and not for process innovation and the majority of the future funding in GD2 will not be for process innovation but on projects contributing to the achievement of net zero and the energy system transition. Failure to consider product innovation as one of the ways in which the consumer benefits is contrary to Ofgem's definition of OE: "*Ongoing efficiencies are productivity improvements expected by even the most efficient GDN. This should represent a GDN's*

199 Oxera (2021),' Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations', February, para 4.11

200 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 4.6-4.9.

201 Second witness statement of Dr Michael Wagner, 23. April 2021, para. 24.

202 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 4.15.

forecast of reductions in input volumes that can be achieved whilst delivering the same outputs".[203]

E5.4 Ofgem and CEPA have failed to substantiate its choice of a 20-year duration when the lifetime of a GDN's asset is around 45 years. As submitted previously, if a 45 year duration was considered and 4.2% return on innovation funding during RIIO-1, then the annual improvement would be around 0.1% instead[204].

E5.5 Therefore, CEPA and Ofgem: (a) wrongfully ignored that WWU had embedded innovation into its business plan and added a further ongoing efficiency challenge; (b) wrongfully assume that without innovation funding, the network industry would have the same level of R&D activity as the comparator set and provide no empirical evidence supporting this argument; (c) wrongfully assume that all R&D spending goes to process innovation (i.e. cost reductions) and ignores the evidence that the majority of spending goes into product innovation (i.e. quality improvements) and failed to acknowledge that network companies have improved quality of service significantly over GD1 and are planning to do so over GD2 for no additional cost; (d) ignores that benefits of innovations accrue over 20 years while GDN assets lives are around 45 years.

E5.6 In relation to the responses on innovation uplift, Mr. Gary Keane notes in §199 of his witness statement that CEPA's FDs report did not consider responses because Ofgem advised CEPA that that issue was outside the scope of the report and would be considered separately by Ofgem. It is notable that CEPA has not subsequently endorsed Ofgem's approach to an innovation uplift.

203 Second witness statement of Dr Michael Wagner, 23. April 2021, para. 46.

204 Tab L1: Oxera – Review of Ofgem's ongoing efficiency decision in the RIIO-2 Final Determinations, para 4.15.

F. TAX CLAWBACK

F1 INTRODUCTION

F1.1 This section addresses Ofgem's response to WWU's tax clawback head of appeal, as set out in section H of its document entitled RIIO-2 Price Control: Response to Appeals on Finance Issues and TNUoS and dated 23 April 2021 (the **Response**).

F1.2 In this section: paragraph references in the form §xxx (where xxx is a number) are references to the Response; paragraph references in the form PH1 §xx or JF1 §xx are to paragraphs in the first witness statements of Jessica Friend and Penny Harandy respectively; and [PH1/x] indicates an exhibit bearing that number to the first witness statement of Penny Harandy.

F2 WHAT THIS HEAD OF APPEAL IS ABOUT

F2.1 Ofgem's case in relation to tax clawback is exceptionally difficult to understand. If WWU finds it confusing and contradictory, that may also be true of the CMA. So, while the purpose of this reply is not to restate points already made, we begin with a short summary of what this appeal is about. In this area in particular, it is important not to lose sight of the wood for the trees.

Background

F2.2 When Ofgem sets a price control, it makes an allowance for the cost of debt and an allowance for tax liabilities. These two things are related, because interest on debt is a cost that is tax deductible. Therefore, in modelling the allowance for tax liabilities, Ofgem takes into account the assumed amount of interest that a company will pay in accordance with the cost of debt allowance. This, like the allowance itself, is based on notional gearing.

F2.3 Where a company is more highly geared than the assumption used by Ofgem for the purposes of these calculations, it is likely to pay more debt interest, and therefore have a higher interest deduction for tax purposes than Ofgem used in modelling the tax liability.

F2.4 In order to avoid the allowance for tax liabilities being overstated, and remove any '*perverse incentive to increase gearing to benefit from a greater tax shield*' (JF1 §149), Ofgem uses a mechanism designed to 'clawback' any tax deductions which, due to the higher gearing, are in excess of those assumed for modelling purposes.

The Appeal

F2.5 Ofgem **now** asserts that although derivatives are not taken into account by it when setting the cost of debt allowance – a position it seeks to defend in response to Head of Appeal A – they

are relevant to the calculation of tax clawback. As to this, WWU's appeal can be summed up in two main propositions.

F2.6 The **first proposition** is that the price control must take a consistent approach to this issue. It is inconsistent of Ofgem to say that, for the purposes of tax clawback, derivative payments '*should be treated in the same way that interest on index-linked debt is treated*' (PH1 §64), while at the same time maintaining that, for the purposes of the cost of debt, derivatives and index-linked bonds should be sharply distinguished (JF1 §145). It is inconsistent of Ofgem to make no allowance for derivative payments in setting the cost of debt, thereby requiring WWU to bear those costs in full, while demanding that any offsetting tax benefit is handed back to consumers.

F2.7 The first proposition is that the calculation of interest payments for the purposes of the cost of debt and of tax clawback must be on a like-for-like basis. Ofgem cannot have it both ways – its approach to these issues must be principled and consistent, which it is currently not. That inconsistency is irrational, and therefore unlawful, and therefore wrong under section 23D(4) of the Gas Act 1986.

F2.8 The **second proposition** is that the consistency of approach should be clearly reflected on the face of the licence conditions. The issue is one of considerable value[205]. It is not a matter that should be mired in ambiguity. WWU says that it is entitled to clarity on this issue.

History

F2.9 This matter has a long and tortuous history. In the middle of that history, in mid-2015, there was an exchange of correspondence between WWU and Ofgem designed (on both sides) to achieve some clarity on the matter (the **2015 correspondence**). The most relevant extracts are as follows –

(a) <u>WWU letter to Ofgem dated 22 June 2015</u>

> 'The inflation expense stems from derivative contracts, which are not debt instruments, and such inflation is not explicitly compensated by any revenue allowance under RIIO GD1. Accordingly, we believe that the inflation expense of RPI derivatives should be excluded from the calculation of actual interest for the purposes of tax claw-back.'[206]

(b) <u>Ofgem response to WWU dated 13 July 2015</u>

[205] NOA section F4

[206] [PH1/10]

'**Treatment of inflation expenses/income on RPI derivatives**

We have noted your concerns on the above mentioned expenses and income; however they fall outside the scope of the tax claw back calculation because they were not modelled as part of the interest allowance at final determination.'[207]

F2.10 In the end, what matters in this correspondence is its substance. WWU says that: (i) Ofgem was right to reach the conclusion it did, and for the reason it did; (ii) that conclusion and reason remain equally valid now; (iii) Ofgem is wrong to have resiled from that position.

F2.11 The question for the CMA is whether WWU is right, and Ofgem is wrong, on this substantive issue.

F2.12 By contrast, Ofgem appears to wish to make the case all about 'who said what to whom and when'. WWU is more than happy to engage on those questions – it is extremely difficult to understand in what way Ofgem believes that the history of this matter shows it in a good light or undermines the substantive WWU case. But ultimately this is largely a distraction.

F3 OFGEM'S DEFENCE

The Core Objection

F3.1 Ofgem's '*core objection*' (sub-title to §482-485) is that: '*This appeal is out of time and should be rejected. No substantive changes have been made to GEMA's approach to the treatment of interest payments on derivative instruments since 2009, and that approach was again confirmed by GEMA in 2009*' (§8.4).

F3.2 This submission is surprising, and in any event entirely without merit, both for a reason of law and a reason of fact.

F3.3 The **reason of law** is that Ofgem argued this point at permission stage, WWU was provided with the opportunity to make submissions on it, WWU did make those submissions rebutting the argument[208], and the CMA decided the question as part of its permission decision[209].

F3.4 That decision – made on behalf of the CMA by the chair of the current appeal group – was right, for the reason given. It was also conclusive and renders the matter *res judicata* for the purposes of this appeal. Ofgem is not entitled to seek to re-litigate it because it did not like the

[207] [PH1/11]

[208] Letter – WWU to CMA, 26 March 2021

[209] CMA – WWU Decision on Permission to Appeal, 31 March 2021

answer. WWU's substantive response to Ofgem's argument is the one already provided to the CMA, and we incorporate it here by reference. But the question is no longer open.

F3.5 The **reason of fact** is that the assertion that Ofgem's policy has, ever since 2009, been clear, stable and consistent with its current position is fanciful, even on the basis of Ofgem's own witness evidence in the form of PH1. Ofgem cannot credibly make that assertion when –

(a) the '*2009 Open Letter did not specifically address the tax clawback treatment of interest liabilities incurred under swap contracts*' (PH1 §16),

(b) in the 2015 correspondence (cited above) Ofgem clearly took a different position from the one it now takes (PH1 §27),

(c) in 2019, Ofgem determined it had become necessary that '*the guidance on what should and should not be included in net interest should be clarified*' (PH1 §30)

(d) on 21 October 2019, Ofgem agreed to apply a calculation of tax clawback consistently with the 2015 correspondence and therefore with WWU's position (PH §37),

(e) as recently as 12 February 2021, Stephen Henderson (the Head of Finance Policy at Ofgem) was – after internal discussions within Ofgem involving, among others, its Chief Executive, a Senior Advisor and Director (now the Director of Analysis and Assurance), and the legal team – preparing to write a letter to WWU[210] which confirmed the application of the position outlined in the 2015 correspondence for the pre-GD1 period, the GD1 period, and then 'grandfathered' for the GD2 period (PH §69),

(f) Ofgem is consulting on and proposing to introduce 'PCFM Guidance' which will set out relevant provisions affecting how tax clawback will operate in GD2 (PH1 §§50, 57-62).

F3.6 Two further observations can be made.

F3.7 **First**, Ofgem seeks to place some weight on changes it made to the 'RFPR RIGs' in 2019 (§§476-480) under which it '*clarified the definition of net interest and net debt*' (§480). It claims that this was a decision-point triggering a right for WWU to judicially review its policy, in the absence of which challenge it argues that the issue is now '*out of time*' (§489).

F3.8 This argument is hopeless. It is true that WWU noted that the proposed amendments to the RFPR RIGs were inconsistent with the 2015 correspondence and raised this as a question in

[210] [PH1/27]

its consultation response ('*appears to conflict with what we have previously been advised by Ofgem*' – PH1 §32[211]). That was the first intimation for WWU that Ofgem's policy was shifting.

F3.9 But the RFPR RIGs are merely a set of reporting requirements. The licence condition under which they are made[212] is not part of the price control licence conditions, and provides no legal basis for Ofgem to change: price control allowances, the Price Control Financial Instruments, the operation of the Annual Iteration Process, the tax clawback policy, or the definition of any terms applicable to any of the above. The RPFR RIGs were legally-inoperative as far as the price control was concerned. Legally-inoperative decisions neither can, nor need, be subject to judicial review.

F3.10 Consistently with this, as Mr Ian Weldon points out in his second witness statement, Jessica Friend in an email exchange at the time made clear that '*the intention was certainly not to change any definitions for tax clawback purposes*'.[213] It is surprising in this context to find Ofgem implying something different in its Response.

F3.11 **Second**, it should be noted that –

(a) in correspondence with Stephen Henderson about the letter that he was proposing to send on behalf of Ofgem to 'grandfather' the effect of the 2015 correspondence during the GD2 period, WWU expressed the concern – consistently with the second proposition set out at para F2.8 above – that this treatment should be made clear on the face of the licence[214],

(b) Stephen Henderson replied to the effect that this was unnecessary, and that the letter could be effective on the same basis that the 2015 correspondence was[215].

F3.12 The effect of this is that Ofgem appears to consider the price control legal framework to be sufficiently mutable that it could apply radically different policies on tax clawback – whether to one licence holder at different times, or (presumably) to different licence holders, at its own election – depending on the content of side correspondence.

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[211] And [PH1/14]

[212] Tab M28: WWU – Gas Transporters Licence – Standard Special Condition A40 (Regulatory Instructions and Guidance)

[213] Second witness statement of Ian Weldon, 10 May 2021, para 4.1(g)

[214] Contained in the bundle of correspondence at [PH1/1] – email from Ian Weldon of WWU to Stephen Henderson of Ofgem, 13 January 2021

[215] Contained in the bundle of correspondence at [PH1/1] – email from Stephen Henderson of Ofgem to Ian Weldon of WWU, 14 January 2021

F3.13 We note that this firmly gives the lie to the contention that the policy was settled and locked down by virtue of a letter written in 2009. It is also manifestly inappropriate on its own terms, and emphasises the importance of the second proposition set out above.

Legitimate Expectation

F3.14 Ofgem says that WWU's claim that a legitimate expectation exists in relation to the treatment of tax clawback is 'baseless' (§486).

F3.15 However, it correctly identifies that the test to be applied for identifying whether a legitimate expectation has arisen is whether there was a promise that is '*clear, unambiguous and devoid of any relevant qualification*' (§487).

F3.16 The 2015 correspondence falls squarely within this description. It provides an assurance to WWU as to how Ofgem will apply the tax clawback rules during GD1 and how WWU should therefore report tax clawback –

> '**Treatment of inflation expenses/income on RPI derivatives**
>
> We have noted your concerns on the above mentioned expenses and income; however they fall outside the scope of the tax claw back calculation because they were not modelled as part of the interest allowance at final determination.
>
> Although interest on index linked debt is included in tax deductible net interest paid values for tax claw-back calculations, expenses (or income) associated with derivatives are not…
>
> …
>
> For the reasons stated above, Inflation related expenses and income both accrued and actual should be excluded from the value for adjusted tax deductible net interest paid for the purposes of RIIO GD1 tax claw back adjustment calculations.'[216]

F3.17 Nothing could be clearer than this. It was designed to be relied upon by WWU. And, as Mr Henderson of Ofgem was prepared to concede when preparing his own draft letter to WWU: '*I see this letter as having the same status as the 2015 letter, which you have relied upon*'[217]. The draft letter itself made clear that Ofgem understood that it was '*WWU's expectation that the 2015 letter would continue to apply*'[218].

[216] [PH1/11]

[217] Contained in the bundle of correspondence at [PH1/1] – email from Stephen Henderson of Ofgem to Ian Weldon of WWU, 14 January 2021 (emphasis added)

[218] [PH1/27] (emphasis added)

F3.18 A legitimate expectation is capable of being frustrated only where there is a public interest sufficiently strong to override the expectation, having full regard to the duty of fairness to the person seeking to rely on it[219]. Ofgem has not come close to demonstrating that this high threshold test is met in this case. The legitimate expectation cannot possibly have been '*defeated by*' (§489) the change to the RFPR RIGs in 2019, for reasons given above about the status and effect of that document. Nor does the fact that Ofgem now seeks to dismiss the 2015 correspondence as 'inaccurate' (PH1 §64) – a claim that WWU heard for the first time on 8 December 2020[220] – have any bearing on its legal force and effect.

F3.19 Moreover, since it remains the case that Ofgem has not even engaged in a valid consultation about a change to the position promised in the 2015 letter, even the most basic requirements of procedural fairness for departing from a legitimate expectation have not been met.

Lack of Logical Coherence

F3.20 In response to WWU's arguments about Ofgem's obvious inconsistency in the treatment of derivatives for cost of debt and tax clawback purposes, Ofgem offers the argument that one is based on a *notional* company and the other on the circumstances of the *actual* company (§494).

F3.21 This is merely a description of the inconsistency, not an explanation of it, and still less a valid justification for it. The argument does not come close to validating Ofgem's approach as a rational policy position.

F3.22 As is made clear in its Notice of Appeal, WWU accepts the necessary interlinkage between the treatment of derivatives in relation to the cost of debt and tax clawback for the purpose of the remedies it seeks in this appeal.[221] It is a matter of some irony that Ofgem – which (as we have identified in the Introduction) wishes to identify interlinkages everywhere, to the point of stretching the concept beyond all reasonable limits – in this case seeks to deny the existence of an interlinkage that is both clear and obvious.

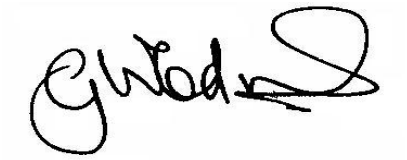
[219] *R v North and East Devon Health Authority ex p Coughlan* [2000] 3 All ER 850

[220] Second witness statement of Ian Weldon, 10 May 2021, para 4.1(g)

[221] NOA paras F3.4 and F5.2

PART III. STATEMENT OF TRUTH

The Appellant believes that the facts stated in this Reply to Ofgem's Response to the Appeal are true.



Signature of Authorised Representative

Name of Authorised Representative: **Graham Edwards**

Date: **10 May 2021**

for and on behalf of Wales & West Utilities Limited

ANNEX 1 – SUMMARY OF SUPPORTING EVIDENCE

Oxera - Second Witness Statement of Peter Hope: National Grid's acquisition of WPD from PPL and the simultaneous sale of NECO to PPL (**Tab N1**)
Oxera – Second Witness Statement of Alan Horncastle: Reply to Ofgem witness statements on ongoing efficiency (**Tab O1**)
Oxera – Third Witness Statement of Peter Hope: Robustness of Oxera's swaps efficiency assessment (**Tab P1**)
Oxera – Fourth Witness Statement of Peter Hope: Cost of equity technical table (**Tab Q1**)
Second Witness Statement of Ian Weldon (**Tab R1**)

Note: Where we refer to 'Tab XX' in this Reply this is a reference to the tab reference and document in the Bundle (and as listed in the Bundle Index) accompanying the Notice of Appeal or to the tab reference and document listed above.