RIIO-2 Energy Licence Modification Appeals

Summary of provisional determination

Issued: 11 August 2021

Introduction

1. This summary outlines our provisional determination of the appeals that the CMA received in respect of GEMA's decisions on the RIIO-2 price controls for electricity transmission, gas transmission and gas distribution. In accordance with the legal framework for these appeals, a full version of the provisional determination is provided to the parties to the appeals, who have the opportunity to make submissions in response to our provisional assessment of the grounds of appeal.

2. This document provides additional transparency about the process followed in these appeals, together with a summary of the appeals and where we have provisionally found that GEMA was wrong, in whole or in part. We will publish a non-sensitive version of our final determination in full following our final determination, which must be made before the end of October 2021.

The appeals

3. The Office of Gas and Electricity Markets (Ofgem) regulates the companies that run the gas and electricity networks. Ofgem is governed by the Gas and Electricity Markets Authority (GEMA).

4. On 3 February 2021, GEMA published its decisions for the RIIO-2 price control for the electricity transmission, gas transmission and gas distribution network (GDN) companies and the Electricity System Operator (Decision). The Decision modified the conditions of their respective licences to give effect to the RIIO-2 price control Final Determinations, which were published on 8 December 2020 (and revised on 3 February 2021). GEMA’s Decision set the revenue that the companies will be entitled to collect from their customers in
respect of their regulated activities over the period 1 April 2021 to 31 March 2026 (the price control period).

5. On 3 March 2021 the following companies sought permission from the CMA to appeal GEMA’s Decision on various grounds as listed below:\(^1\)

(a) Cadent Gas Limited (Cadent): 1A: LTS rechargeable diversions; 1B: London regional factors; 1C: Ongoing efficiency; 2: Cost of equity; 3: Outperformance wedge.

(b) National Grid Electricity Transmission plc (NGET): 1: Cost of equity; 2: Outperformance wedge.

(c) National Grid Gas plc (NGG): 1: Cost of equity; 2: Outperformance wedge.


(g) SP Transmission plc (SPT): 1: Cost of equity; 2: Outperformance wedge; 3: Ongoing efficiency; 4: Licence modification process.

(h) Wales & West Utilities Limited (WWU): A: Cost of debt; B: Cost of equity; C: Repex; D: Licence modification process; E: Ongoing efficiency; F: Tax clawback.

6. On 31 March 2021, the CMA granted permission to appeal to all appellants, on all grounds. Permission was granted subject to the condition that four common grounds of appeal would be joined across appellants that pleaded the ground, in addition to the individual grounds of appeal considered. The

\(^1\) Specifically, Cadent, NGN, SGN and WWU appealed GEMA’s RIIO-GD2 price control pursuant to section 23B of the Gas Act 1986 (GA86). NGET, SSEN-T and SPT appealed GEMA’s RIIO-T2 price control pursuant to section 11C of the Electricity Act 1989 (EA89). NGG appealed GEMA’s RIIO-GT2 price control pursuant to section 23B of GA86. Terms used in the grounds are explained later in this summary.
CMA also agreed to join the appeals of NGET and NGG, as requested by those two companies.

7. On 6 May 2021, the CMA granted permission to British Gas Trading and Citizens Advice to intervene in the cost of equity and outperformance wedge grounds of appeal.

8. The parties to the appeal and the interveners have been provided with the full provisional determination on the grounds of appeal and have been given a three week period in which to make submissions in response to the provisional determination. This summary of the provisional determination is published for transparency only and we are not inviting comments from other parties.

**Legal framework**

9. Having granted permission, the CMA may allow an appeal only where it is satisfied that the decision appealed was wrong on one or more of the following specified grounds:²

   (a) GEMA failed properly to have regard to the matters to which GEMA must have regard in carrying out its principal objective³ and its duties.⁴

   (b) GEMA failed to give the appropriate weight to any of those matters.

   (c) The decision was based, wholly or partly, on an error of fact.

   (d) The modifications fail to achieve, in whole or in part, the effect stated by GEMA in the decision.⁵

   (e) The decision was wrong in law.

10. The CMA’s role is not limited to reviewing the decision on judicial review grounds and the CMA is not only able, but required by GA86 and EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statutes. Unlike a redetermination (such as the recent PR19 water redeterminations by the CMA), our role in these appeals is limited to finding whether GEMA was wrong on any of the specific grounds raised by the appellants and is not a re-run of the original investigation or a de novo re-hearing of all the evidence.

² Under section 11E(4) of EA89 and section 23D(4) of GA86.
³ Under section 3A of EA89 or section 4AA of GA86.
⁴ Under section 3A or sections 3B and 3C of EA89 or sections 4AA, 4AB and 4A of GA86.
⁵ As required by section 11A(7)(b) of EA89 and section 23(7)(b) of GA86.
Our provisional determination

11. We have provisionally upheld, fully or partially, the following grounds and sub-grounds:

- **Outperformance wedge**: We have found in favour of all appellants that GEMA was wrong to impose the outperformance wedge.

- **Ongoing efficiency (OE)**: We have partially found in favour of Cadent, NGN, SPT and WWU and found in favour of SGN\(^6\) that GEMA was wrong to impose the innovation uplift and in favour of Cadent that GEMA was wrong to employ the figure of 0.5% as Cadent's embedded OE assumption.

- **Licence modification process**: We have partially found in favour of SPT and SSEN-T in that GEMA was wrong in law in that it had acted ultra vires in the manner in which it sought to use a directions process to modify certain licence conditions.

- **LTS Rechargeable diversions**: We have partially found in favour of Cadent, where GEMA has conceded an error.

- **BPI Stage 4**: We have partially found in favour of NGN, where GEMA has conceded an error. NGN subsequently withdrew the rest of the ground.

12. On all other grounds and sub-grounds, we have provisionally determined that GEMA was not wrong in its Decision.

13. The rest of this summary provides more detail on the grounds of appeal, our provisional determination and the process to determine the appropriate relief.

The grounds of appeal

Cost of equity – joined ground

14. All appellants submitted that GEMA had set the cost of equity too low, and submitted evidence that GEMA had erred in its decisions on the Risk Free Rate (RFR), Total Market Return (TMR), beta, its approach to assessment ‘in the round’, its decision not to ‘aim up’, and its assessment of the finance duty.

15. We have provisionally concluded that GEMA’s methodology for estimating the RFR, specifically its reliance on UK index linked gilts, was not wrong. In

\(^6\) SGN appealed only the innovation uplift in this ground.
coming to this provisional determination, we have provisionally concluded that the appellants failed to provide sufficient evidence that other proxies were required to be included in GEMA’s estimate, that GEMA’s approach to cross checks was wrong, that GEMA’s approach to averaging was wrong or that GEMA’s choice of inflation metric was wrong.

16. We have provisionally concluded that the appellants had not demonstrated that GEMA erred in estimating the TMR, which it used in coming to a view on the cost of equity, and have provisionally found that GEMA’s point estimate and range for TMR were not wrong.

17. We have provisionally concluded that GEMA’s approach to estimating beta, specifically to include water company data and to exclude SSE, European comparators and ‘decomposed’ National Grid plc data, were within its regulatory margin of appreciation. With regard to methodological decisions, we have provisionally concluded that there are different means by which to calculate a beta estimate which may each be considered appropriate in the relevant context. We have found no errors in GEMA’s approach and have provisionally concluded that GEMA was not wrong in determining the beta estimates as part of the RIIO-2 price controls.

18. We have provisionally concluded that GEMA was not wrong in setting its cost of equity allowance in the round. We have found there to be no compelling evidence that GEMA had combined Capital Asset Pricing Model (CAPM) metrics to deliver a cost of equity that is too low in the round, nor that there were errors in GEMA’s cross-checks of its estimate nor that evidence from the CMA’s PR19 Redetermination suggests that GEMA’s cost of equity allowance is too low.

19. We have provisionally concluded that the appellants offered no compelling evidence that regulators are required to aim up. In our view, therefore, the decision whether to aim up (or not) was an exercise of GEMA’s regulatory judgement that lay within its margin of appreciation, and we have provisionally concluded that GEMA’s decision not to aim up on the cost of equity was not wrong.

20. We have provisionally concluded that GEMA was not wrong in its assessment of financeability or its application of the finance duty.

21. On the basis of the evidence presented on this ground during the course of this appeal, we are not persuaded that GEMA has erred in its approach to, or
estimate of, the cost of equity. As a result, we have provisionally determined that GEMA’s allowed cost of equity of 4.55%\(^7\) was not wrong.

**Outperformance wedge – joined ground**

22. GEMA considered there to be an expectation of outperformance in RIIO-2 and took this into account by making a downward adjustment of 25 bps to its CAPM-based cost of equity estimate. This adjustment is referred to as the ‘outperformance wedge’. Alongside this, GEMA implemented a ‘backstop’ adjustment mechanism such that each licensee would receive a top-up equity return allowance (up to 25 bps) if its outperformance was less than 25 bps.

23. All appellants said that GEMA’s decision to introduce the outperformance wedge was wrong. Individual appellants alleged a number of errors by GEMA, including that the outperformance wedge was unnecessary, was poorly targeted, had been applied in an arbitrary and discriminatory way, and would undermine performance improvements and investment incentives, including by increasing regulatory risk.

24. We have provisionally concluded that the overall extent of operational outperformance in RIIO-1, and evidence on totex outperformance in previous energy price control periods, provided strong support for GEMA treating the scope for operational outperformance as an important risk area for RIIO-2. We recognised that regulators inevitably face information asymmetries, and that those asymmetries can make the setting of appropriately stringent and robust price controls challenging. We considered that this may be particularly so in relation to some areas of totex assessment, for example, where projects are more bespoke, and/or where the associated deliverables provide long-term benefits and are difficult to specify.

25. GEMA had introduced a range of significant changes in RIIO-2 aimed at addressing its concerns over information asymmetry related to these and other areas of totex assessment, and to Output Delivery Incentives (ODI). We have provisionally concluded that it was appropriate for GEMA, having defined and calibrated the totex and ODI arrangements, to take a step back and consider whether those arrangements overall could be expected to provide for an appropriately stringent and robust price control, and if not, to identify whether additional (and potentially novel) responses were appropriate. However, based on the evidence provided to us, we have provisionally found that:

\(^7\) At 60% notional gearing.
(a) There were a number of errors in GEMA’s analysis of the extent to which operational outperformance in RIIO-2 should be viewed as probable;

(b) The outperformance wedge would be a poorly targeted way of addressing GEMA’s concerns, even if those concerns had been robustly substantiated; and

(c) Given the problems identified in (a) and (b), there was a realistic possibility that the outperformance wedge, if introduced, might also undermine broader regulatory certainty which could result in increased costs to consumers over time.

26. We have therefore provisionally determined that GEMA was wrong and have upheld this ground of appeal.

Ongoing efficiency—joined ground

27. OE is a cost reduction applied by GEMA to account for expected productivity improvements in the sector. OE represents the ability of even the most productive companies in the sector to increase their productivity over time through, for example, adopting new technologies. OE differs from catch-up efficiency gains, where companies lagging in efficiency catch up with the performance of the industry leaders.

28. The OE challenge includes a core OE challenge for all network companies (0.95% per year for capex and repex, and 1.05% per year for opex) and an innovation uplift of 0.2%. The innovation uplift increases the OE challenge to reflect the extra innovation funding companies received from consumers.

29. Cadent, NGN, SGN, SPT and WWU appealed parts of the OE challenge. Together, they alleged errors in the core OE challenge, the innovation uplift and the application of the OE challenge to the appellants’ costs bases. SGN appealed only the innovation uplift.

30. We have provisionally concluded that GEMA was not wrong in setting the core OE challenge at 0.95% for capex and repex and 1.05% for opex. GEMA relied on a range of factors when setting the core OE challenge. Although we found some errors in the evidence that GEMA considered, overall we found that the majority of GEMA’s data sources were consistent with its core OE assumption, and that its decision could be supported on the basis of the remaining data sources.

31. In relation to the innovation uplift, we have provisionally concluded that GEMA made errors in aspects of its decision to set the innovation uplift at 0.2%. We found that the errors which we have identified related to important aspects of
GEMA’s evidence base, and that without this evidence GEMA could not have supported an innovation uplift of 0.2%.

32. Although we recognise that the benefits from past innovation funding are likely to be above zero, as some innovation projects do result in cost reductions, we nevertheless have provisionally concluded that the appellants have shown that GEMA’s approach materially over-estimated those cost reductions. We therefore have provisionally concluded that the figure of 0.2% was wrong. Cadent, NGN, SGN, SPT and WWU alleged an error in the innovation uplift, and we therefore have provisionally upheld their appeals to that extent.

33. In the application of the OE challenge we have provisionally concluded that GEMA was wrong when it used the figure of 0.5% as the embedded OE challenge figure for Cadent. This error is a result of the error we have provisionally found in Local Transmission System (LTS) rechargeable diversions (see paragraphs 40 to 44). Updating the analysis to reflect the LTS rechargeable error would impact the Cadent GDNs’ efficiency scores, which would influence whether 0.5% is the correct figure.

**Licence modification process – joined ground**

34. This ground of appeal concerns GEMA’s decision regarding the procedure to be used to manage uncertainty and contingent allowances during the RIIO-2 price control period. GEMA introduced Special Conditions to the licences which included the power for GEMA to modify those licence conditions during the RIIO-2 price control period by issuing directions. GEMA referred to this as ‘self-modification’. SPT and SSEN-T argued that in doing so GEMA had erred in law, in that it had acted ultra vires. WWU separately argued that GEMA’s decision to include licence obligations in subsidiary documents which could be changed by issuing directions was wrong because GEMA had failed to have regard to its statutory duties and had created regulatory and revenue uncertainty.

35. All three appellants submitted that the use of the directions procedure denied them their statutory rights, specifically the right to appeal licence modifications to the CMA.

36. In relation to SPT and SSEN-T’s appeals, we considered whether GEMA acted ultra vires, and was thus wrong, in providing for self-modification in the Special Conditions at issue.

37. We have provisionally concluded that a licence condition may contain a mechanism for its later modification provided that the condition specifies the manner, time and circumstances in or under which such a modification may
be made. If such criteria are properly set out in the condition, the licensee in question should be able to understand the potential impact on it of a future modification and be in a position meaningfully to appeal the condition to the CMA at the outset of the price control.

38. The Special Conditions at issue in SSEN-T’s and SPT’s appeals fall into seven categories, and we considered each in turn on the basis of our provisional conclusions on the correct interpretation of the statute. We have provisionally concluded that certain of the special conditions were not sufficiently specified to meet the requirements of section 7(5) EA89 and were thus were wrong in law. We have therefore provisionally partially upheld SPT’s and SSEN-T’s appeals to that extent.

39. WWU did not appeal on the basis that GEMA had acted ultra vires, but contended that GEMA had acted in breach of its statutory duties in placing obligations on WWU via a series of subsidiary documents referred to as ‘Associated Documents’ rather than under the licence conditions and in providing for those documents to be modified by GEMA by direction at any time in the period of the price control. The two duties invoked by WWU in its appeal are duties ‘to have regard’ to certain matters.

40. We have provisionally concluded that, provided that there is evidence that the decision-maker did not wholly disregard its ‘have regard to’ duties, then a challenge will only succeed if it can be shown that the decision was irrational. We consider that WWU has failed to demonstrate that GEMA paid no regard to the statutory duties which WWU has invoked. WWU did not allege irrationality. Accordingly, we have provisionally determined that GEMA was not wrong to include obligations in subsidiary documents and provide that those documents could be modified by issuing directions and did not fail to have regard to its statutory duties.

Other baseline totex errors – Cadent

41. As well as appealing the OE challenge, Cadent also appealed two other aspects of baseline totex: LTS rechargeable diversions and London regional factors.

LTS rechargeable diversions

42. An LTS diversion is work undertaken by a GDN to decommission and replace existing LTS pipelines with new LTS pipelines in different locations. LTS diversions costs are either recovered from third parties requesting the diversions works (rechargeable costs) or from all consumers through network charges (non-rechargeable costs).
43. Cadent submitted that GEMA was wrong to include any of these LTS rechargeable diversions costs in its econometric assessment as this had materially distorted GEMA’s efficiency benchmarking exercise and unfairly penalised (and discriminated against) Cadent for its uniquely high share of such costs.

44. Following Cadent’s appeal, GEMA said that it had reconsidered its approach to LTS rechargeable diversions and to rechargeable capex projects more widely, and agreed to exclude large (gross costs of over £5 million) atypical projects from the econometric model for consistency.

45. We agree with GEMA and Cadent that the large atypical projects should be removed from the econometric model and consequently from the benchmarking, and we have provisionally concluded that GEMA was wrong in including these projects and upheld the appeal to that extent.

46. However, we have provisionally concluded that GEMA was not wrong to include other LTS rechargeable diversion costs in the econometric model and we have therefore provisionally rejected this element of the ground of appeal.

**London regional factors**

47. GEMA used pre-modelling adjustments for regional factors to account for the variations in GDNs’ costs due to operating in different regions of Great Britain. These adjustments were applied to GDNs’ submitted costs before the efficiency benchmark analysis and were used to improve the comparability of GDNs’ costs.

48. Cadent submitted in its appeal that GEMA had erred because the pre-modelling adjustments for regional factors and GEMA’s cost assessment failed to account adequately for the substantially higher costs involved in serving the very densely populated London area.

49. We have provisionally concluded that the evidence submitted by Cadent does not demonstrate that GEMA was outside its margin of appreciation. GEMA applied substantial pre-modelling adjustments. The arguments in relation to the size of the efficiency gap, the unidentified and unquantified factors, the subjectivity of pre-modelling adjustments and the density driver analysis do not provide adequate evidence for us to find that GEMA failed to adequately control for the higher costs of operating in London. Accordingly, we have provisionally determined that GEMA’s approach was not wrong.
**Business Plan Incentive Stage 4 – NGN**

50. NGN submitted that GEMA had made errors when calculating the level of reward it awarded NGN under Stage 4 of its Business Plan Incentive (BPI) mechanism, which aimed to incentivise the submission of high quality business plans.

51. After considering NGN’s Notice of Appeal, GEMA accepted that it had made an error when calculating NGN’s BPI Stage 4 reward at the time of its Final Determination and invited the CMA to correct this error. Subsequently, NGN withdrew the remainder of this ground of appeal.

52. On the basis of GEMA’s acceptance of the alleged error, we have provisionally determined that GEMA was wrong in its calculation of NGN’s BPI Stage 4 reward.

**TNUoS – SSEN-T**

53. TNUoS charges recover the cost of installing and maintaining the transmission system in England, Wales, Scotland and offshore. Under the current arrangements for setting and recovering TNUoS charges, the Electricity System Operator (ESO) is responsible for setting TNUoS tariffs for the whole of GB and recovers the revenue from these charges on behalf of all Transmission Owners (TOs). The ESO sets TNUoS charges for each year to recover the notified amounts in aggregate for that year, adjusted for any under-/over-recovery from the previous year’s charges, and these charges are paid to the ESO by suppliers and generators.

54. For RIIO-2, GEMA decided to move the cash flow timing risk from the ESO to the onshore TOs. SSEN-T appealed this decision, alleging that it would result in a fundamental disconnect between risk and responsibility, and that there was insufficient compensation for SSEN-T for the additional costs arising from the cash flow timing risk.

55. We have provisionally concluded that GEMA was not wrong to transfer the cash flow timing risk in relation to TO revenues from the ESO to the respective onshore TOs and to provide the compensation package it did to SSEN-T for bearing the TNUoS cash flow timing risk. We have therefore provisionally not upheld the appeal on this ground.

**Efficiency benchmark – SGN**

56. GEMA applied an efficiency benchmark to reflect the efficiency improvements that GEMA expects less efficient companies to make to catch up to the more
efficient GDNs. GEMA set the efficiency benchmark on a glide path from the 75th to the 85th percentile.

57. SGN submitted that GEMA had erred in its approach to setting and applying the efficiency benchmark at its Final Determination in two respects:

(a) GEMA’s decision to set the efficiency benchmark at a level higher than the upper quartile was not supported by the evidence.

(b) GEMA had wrongly applied the efficiency benchmark to costs that had been removed from the regression model to account for regional differences.

58. Setting the efficiency benchmark is an exercise of regulatory judgement. We have provisionally found that GEMA’s decision was within its margin of appreciation, taking into account some improvements in data quality, the ambitions in business plans and the limited impact in absolute terms. Furthermore, while SGN did provide evidence on the limitations of the model, it did not identify specific errors that would substantially undermine the confidence that GEMA could have in its modelling. Therefore, we have provisionally rejected this ground of appeal. Our provisional decision should not be seen as indicating any preferred starting point for efficiency benchmarks as regulators must always consider the case-specific circumstances and set the benchmark at a level appropriate for the case.

59. We also consider that SGN has not shown that costs due to regional differences are wholly outside its control and has failed to show that GEMA did not adopt a coherent and consistent approach when applying the efficiency benchmark to these costs. We have provisionally determined that GEMA was not wrong.

Cost of debt – WWU

60. WWU submitted that GEMA had failed to provide an adequate cost of debt allowance for WWU, as it had determined an allowance for all GDNs based on an average of the actual cost of debt of a group of companies. WWU submitted that the effect of this approach was to over-remunerate some companies while penalising others. WWU submitted that GEMA’s approach discriminated against WWU. In addition, WWU submitted that GEMA had adopted an irrational and inconsistent policy of not taking account of derivatives in assessing the cost of debt.

61. We have provisionally determined that GEMA was not wrong in its approach to or estimate of its cost of debt allowance. We do not agree with WWU that
GEMA had failed to correctly interpret or to give effect to its financing duty and we have not received compelling evidence that GEMA had discriminated against WWU or that GEMA had failed to provide an adequate cost of debt allowance for WWU.

Repex – WWU

62. Repex is expenditure to replace existing iron and steel pipes with new polyethylene pipes. A substantial part of this activity is a health and safety requirement.

63. WWU claimed that GEMA had failed to provide it with sufficient remuneration over the course of GD2 to undertake the mains replacement work to be completed. WWU submitted that GEMA had acted inconsistently and irrationally in its treatment of sparsity and had failed to consider, or give appropriate weight to, relevant considerations including that its situation differed from that faced by other networks and that its outperformance in GD1 could not be replicated in GD2. WWU also submitted that GEMA had failed to have regard or give appropriate weight to its principal objective and general duties.

64. We have provisionally concluded that WWU has not provided sufficient evidence that sparsity is leading to materially higher costs for it compared to other GDNs or compared to previous price controls, nor that its situation differs from that faced by other networks. Our assessment also indicates that GEMA was not wrong in its consideration of whether WWU’s outperformance in GD1 could not be replicated in GD2. We also agree with GEMA that, in any case, WWU’s ability to meet its repex allowance in GD2 should be considered as part of the wider totex assessment. We therefore have provisionally determined that GEMA was not wrong in determining WWU’s repex allowance.

Tax clawback – WWU

65. The tax clawback policy is designed to pass through to customers any tax benefits from higher gearing.

66. WWU said that GEMA was wrong in respect of whether, and to what extent, reported movements on WWU’s derivatives should be included within the measure of interest used to measure tax clawback.

67. We have provisionally determined that GEMA was, for the purposes of the RIIO-2 price control, not wrong to set the policy it did in respect of the measure of interest for tax clawback purposes.
Relief and process to final determination

68. If the CMA allows to any extent an appeal in relation to a price control decision, it must do one or more of the following:

(i) quash the decision (to the extent that the appeal is allowed);

(ii) remit the matter back to GEMA for reconsideration and determination in accordance with any direction given by the CMA;

(iii) substitute the CMA’s decision for that of GEMA (to the extent that the appeal is allowed) and give any directions to GEMA or any other party to the appeal.

69. Having found provisionally that GEMA was wrong, or partially wrong, in five grounds, the CMA is now consulting with the parties affected by the errors on the appropriate relief, should the provisional determination be maintained.

70. The CMA has also given the parties to the appeal and interveners the opportunity to make submissions in response to the CMA’s provisional determination on the grounds of appeal. We will take responses to the provisional determination into account before final decisions are made.

71. The final determination with directions for any relief required will be issued before the statutory deadline of 30 October 2021. A non-sensitive version of the full report will be published on the CMA website shortly thereafter.

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8 Section 11F(7) of EA89 and section 23E(7) of GA86 provide that for the purposes of section 11F of EA89 and section 23E of GA86, a decision is a price control decision, in relation to the modification of a condition of a licence, if the purpose of the condition is, in the CMA’s opinion, to limit or control the charges on, or the revenue of, the holder of the licence.

9 Section 11F(2) of EA89 and section 23E(2) of GA86.