RIIO-2 Energy Licence Modification Appeals

Summary of final determination

Issued: 28 October 2021

Introduction

1. This summary outlines our final 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 determination has been issued to the parties to the appeals.

2. A summary of our provisional determination was published on 11 August 2021, and we have considered the consequent detailed responses from the parties and interveners, as well as additional evidence gathered since the provisional determination, before arriving at our final determination. For details of how we have addressed the arguments made in the responses to our provisional determination, please see the published final determination.

3. This document is published on issuance of the final determination, providing transparency with a summary of the appeals and our findings whether GEMA was wrong, in whole or in part. A non-sensitive version of the final determination will be published on the CMA case page as soon as practicable.

The appeals

4. 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**).

5. 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 (**ESO**) (**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).

6. 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 (**OE**); 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.

   (d) Northern Gas Networks Limited (**NGN**): 1: Cost of equity; 2: Outperformance wedge; 3: OE; 4A: Business Plan Incentive (**BPI**) Stage 4; 4B: Efficient costs benchmark.

   (e) Southern Gas Networks plc and Scotland Gas Networks plc (together, **SGN**) (joint application): 1: Cost of equity; 2: Outperformance wedge; 3: OE; 4: Efficiency benchmark.

   (f) Scottish Hydro Electric Transmission plc (trading as SSEN Transmission) (**SSEN-T**): 1: Cost of equity; 2: Outperformance wedge; 3: Licence modification process; 4: Transmission Network Use of System Charges (**TNUoS**).

   (g) SP Transmission plc (**SPT**): 1: Cost of equity; 2: Outperformance wedge; 3: OE; 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: OE F: Tax clawback.

7. 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

[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.

common grounds of appeal would be joined across appellants that pleaded the ground, in addition to the individual grounds of appeal considered. The CMA also agreed to join the appeals of NGET and NGG, as requested by those two companies.

8. 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.

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 objective[3] 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 in a redetermination (such as the recent PR19 water redeterminations by the CMA), we are limited to finding whether GEMA was wrong on any of the specific grounds raised by the appellants and the appeal is not a re-run of the original investigation or a de novo re-hearing of all the evidence.

11. If the CMA allows to any extent an appeal in relation to a price control decision,[6] it must do one or more of the following:

[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).
[6] 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

(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.[7]

Our determination

12. We have 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.
- **OE**: We have partially found in favour of Cadent, NGN, SPT and WWU, and found in favour of SGN[8] that GEMA was wrong to impose the innovation uplift.
- **Licence modification process**: We have partially found in favour of SPT and SSEN-T 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, to the extent that GEMA has conceded an error.
- **BPI Stage 4**: We have partially found in favour of NGN, to the extent that GEMA has conceded an error. NGN subsequently withdrew the rest of the ground.

13. On all other grounds and sub-grounds, we have determined that GEMA was not wrong in its Decision and have dismissed those grounds and sub-grounds of appeal.

14. The rest of this summary provides more detail on the grounds of appeal, our determination and the relief we have ordered where we have determined that GEMA was wrong.

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.

[7] Section 11F(2) of EA89 and section 23E(2) of GA86.

[8] SGN appealed only the innovation uplift in this ground.

The grounds of appeal

Cost of equity – joined ground

15. 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.

16. We have concluded that GEMA's methodology for estimating the RFR, specifically its reliance on UK index linked gilts, was not wrong. In coming to this determination we consider that the appellants failed to demonstrate that other proxies are required to be included in GEMA's estimate, that GEMA's approach to cross checks was wrong, that GEMA's approach to indexing was wrong or that GEMA's choice of inflation metric was wrong.

17. We have concluded that the appellants failed to demonstrate that GEMA erred in estimating the TMR, which it used in coming to a view on the cost of equity, and have found that GEMA's point estimate and range for TMR were not wrong. In particular, we found that GEMA was not wrong either in its choice of data set from which to estimate historical returns, or in its choice of inflation series, or in its approach to averaging historical returns.

18. We have 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, was an exercise of regulatory judgement that fell within its margin of appreciation. With regard to methodological decisions, we have 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 manifest errors in GEMA's approach and have concluded that GEMA was not wrong in determining the beta estimates as part of the RIIO-2 price controls.

19. We have concluded that GEMA was not wrong in setting its cost of equity allowance in the round. We have found there to be no sufficiently persuasive evidence that GEMA 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.

20. We have concluded that the appellants offered no sufficiently persuasive evidence that regulators are required to aim up. In our view, therefore, the decision whether to aim up (or not), was an exercise of regulatory judgement

that fell within GEMA's margin of appreciation. Based on our assessment on the circumstances faced by GEMA in respect of the RIIO-2 price controls, we did not find that these implied that GEMA needed to aim up.

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

22. In responding to our provisional determination, the appellants submitted that we had not properly assessed their appeals according to a merits standard, but had instead applied a 'rationality' review rather than considering the merits of the appeals. They submitted that we had failed to grapple properly with the evidence and had deferred too much to GEMA's judgement rather than considering the merits of the appeals. We disagree. We have carefully scrutinised the evidence as well as the substance of GEMA's decision-making in line with the grounds of the appeal advanced before us and are satisfied that we have correctly applied the standard of review in our assessment of this joined ground.

23. 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 determined that GEMA's allowed cost of equity of 4.55%[9] was not wrong.

Outperformance wedge – joined ground

24. 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.

25. 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.

26. We have 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

[9] At 60% notional gearing.

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.

27. 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 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.

28. However, our view is that GEMA has not demonstrated sufficiently why the extensive set of tools it used for RIIO-2 should be regarded as providing insufficient protection for customers. Based on the evidence provided to us, we have found that:

    (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) Even if GEMA's concerns about the likelihood of operational outperformance had been substantiated, the outperformance wedge would be a poorly designed mechanism to address these concerns; 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.

29. We have therefore determined that GEMA was wrong and have upheld this ground of appeal. We have ordered that the decision to introduce the outperformance wedge should be quashed and substituted with our decision to remove the outperformance wedge and associated backstop.

Ongoing efficiency– joined ground

30. 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.

31. 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.

32. Cadent, NGN, SGN, SPT and WWU appealed parts of the OE challenge. 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.

33. We have concluded that GEMA was not wrong in setting the core OE challenge at 0.95% for 'capex' (capital expenditure) and repex (replacement expenditure) and 1.05% for opex (operating expenditure). GEMA carried out an 'in the round' assessment and relied on a range of factors when setting the core OE challenge. In our view, the many factors where we found GEMA did not err are sufficient to support GEMA's decisions to apply a core OE challenge of 0.95%/1.05%. Although GEMA used an incorrect SGN business plan figure and an incorrect NGN historical figure, this did not undermine the other factors that supported the level of the core OE challenge set by GEMA. In making this assessment, we took into account various reasons that made it appropriate for GEMA to set a stretching, but achievable OE challenge.

34. In relation to the innovation uplift, we have 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%.

35. Although we recognise that some past innovation funding is likely to have resulted in cost reductions, we nevertheless have concluded that the appellants have shown that GEMA's choice of 0.2% was a material error. Cadent, NGN, SGN, SPT and WWU alleged an error in the innovation uplift, and we therefore have upheld their appeals to that extent.

36. Following our provisional determination, we considered whether there was a more appropriate level of innovation uplift, or whether the innovation uplift should be quashed in its entirety. We have determined that GEMA should be directed to amend the OE challenge to remove the innovation uplift of 0.2% and set the innovation uplift at zero.

37. In the application of the OE challenge we had provisionally concluded that GEMA was wrong when it used the figure of 0.5% as the embedded OE challenge figure for Cadent. However, after considering the parties' responses to the provisional determination and additional evidence provided, we focused on the ex-ante assumption included in the business plan and have now determined that GEMA was not wrong in this matter.

38. In determining the appropriate relief for the error we have identified, we have quashed GEMA's decision to introduce the innovation uplift and have substituted our own decision to remove the uplift (except for Cadent, where we have remitted it to GEMA to consider with another error – see paragraph 53).

Licence modification process – joined ground

39. 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.

40. 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.

41. 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.

42. We have concluded that a licence condition may contain a mechanism for its later modification provided that the condition specifies the manner, 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.

43. 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 conclusions on the correct interpretation of the statute. We have concluded that certain of the Special Conditions were not sufficiently specified to meet the requirements of section 7(5) of EA89 and were thus were wrong in law. After considering the responses to the provisional determination, we added to the list of Special Conditions in which we determined that GEMA was wrong. We have therefore partially upheld SPT's and SSEN-T's appeals to that extent.

44. 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.

45. We have concluded that WWU has not demonstrated that GEMA should not have used Associated Documents in the way that it did. Accordingly, we have determined that GEMA was not wrong in its use of subsidiary documents and in providing that those documents could be modified by issuing directions and did not fail to have regard, or give appropriate weight, to its statutory duties.

46. In determining the appropriate relief for the error we have identified, we have quashed the decision of certain licence conditions for SPT and SSEN-T (as outlined in our final determination) to the extent that they provide for modification of the condition itself and have directed GEMA to use the standard licence modification process by which any modifications to the relevant licence conditions can be appealed to the CMA, pending any revisions to the licence conditions which are consistent with our determination. We anticipate that GEMA will reconsider and determine the wording of the Special Conditions in issue in the light of this determination.

Other baseline totex errors – Cadent

47. 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

48. 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).

49. 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.

50. 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.

51. 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 concluded that GEMA was wrong in including these projects and upheld the appeal to that extent.

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

53. In determining the appropriate relief for the error we have identified, we have quashed GEMA's decision in respect of this ground, and have remitted it to GEMA with directions to remove certain projects (considered to be large and atypical LTS diversion projects) and their costs from the econometric model which is used to determine Cadent's cost allowances.

London regional factors

54. 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.

55. 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.

56. We have concluded that the evidence submitted by Cadent does not persuade us that GEMA has erred. 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 determined that GEMA's approach was not wrong.

Business Plan Incentive Stage 4 – NGN

57. 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.

58. 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.

59. On the basis of GEMA's acceptance of the alleged error, we have determined that GEMA was wrong in its calculation of NGN's BPI Stage 4 reward. We have therefore quashed GEMA's decision and will implement our decision by substitution, with clear directions to GEMA to correct the identified error and increase NGN's BPI Stage 4 award to the correct figure.

TNUoS – SSEN-T

60. 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 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.

61. 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.

62. We have 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 not upheld the appeal on this ground.

Efficiency benchmark – SGN

63. 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.

64. 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.

65. SGN has failed to persuade us that GEMA was wrong to adopt the more challenging approach that it did in setting the efficiency benchmark at the 85th percentile, rather than the 75th percentile. The choice of benchmark involves an element of regulatory judgement, and therefore there is a margin of appreciation for GEMA. In that context, SGN has failed to persuade us that GEMA was wrong:

    (a) on the one hand, SGN has shown that the upper quartile is a target which has frequently been used by regulators for efficiency benchmarking; it has also shown that GEMA had only limited evidence for setting a target which was more onerous than that approach;

    (b) on the other hand, previous regulatory practice represents an indication of what has been found appropriate in the specific circumstances of those earlier cases; it does not provide a hard and fast forward-looking rule from which regulators must not depart; and GEMA's preferred approach, of using a glide path to the 85th percentile, is in practice in this case only marginally tougher than the upper quartile;

    (c) weighing these matters up, we consider that GEMA's decision to use the data it had to support a marginally tougher target in the circumstances of this case was justifiable. SGN has not persuaded us that its preferred

approach was clearly superior to that of GEMA in the circumstances of this case and so it cannot be said that GEMA stepped outside its margin of appreciation.

66. Therefore, we have dismissed this ground of appeal.

67. Our decision should not be seen as indicating any preferred starting point for efficiency benchmarks beyond this appeal as regulators must always consider the case-specific circumstances and set the benchmark at a level appropriate for the case.

68. 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 therefore determined that GEMA was not wrong in this sub-ground.

Cost of debt – WWU

69. 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.

70. We have received insufficient evidence to demonstrate, and are not persuaded, that GEMA has failed correctly to interpret or to give effect to its financing duty, that GEMA was irrationally reliant on a cost of debt index or that GEMA irrationally failed to take account of derivatives in its cost of debt allowance. We have therefore determined that GEMA was not wrong in its approach to or estimate of its cost of debt allowance.

Repex – WWU

71. 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.

72. 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.

73. We have concluded that GEMA did not act inconsistently or irrationally in its treatment of sparsity. We have also concluded that GEMA did not fail to have regard, or give appropriate weight, to the relevant considerations outlined by WWU explaining why its situation differed from that faced by other networks and why its outperformance in GD1 could not be replicated in GD2.

74. The fact that there was a gap between WWU's allowance for repex work and WWU's estimate of the cost of conducting this work is not evidence that GEMA wrongly set WWU's repex allowance too low. Our conclusions on the issues set out in the paragraph above mean that the repex allowance which GEMA set was sufficient for an efficient firm to undertake the repex work in WWU's network. Since WWU has not demonstrated that GEMA underfunded repex work in its network, its policy arguments that the allowance would negatively impact consumer safety and the efficiency of the gas network must also fail.

75. We therefore determine that GEMA was not wrong in its decision on the repex allowance for WWU, and dismiss this ground of appeal.

Tax clawback – WWU

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

77. 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 calculate the level of tax clawback.

78. We have 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 to be used for tax clawback purposes.

Relief

79. We have issued an Order that implements the relief outlined in the sections above. The Order substitutes our decision for GEMA's where appropriate and remits back to GEMA those matters for which the substitution approach does

not work. In both cases, we have included further directions to GEMA as needed.