NON-SENSITIVE VERSION

NOTICE OF APPEAL
ENERGY LICENCE MODIFICATION

NORTHERN POWERGRID (NORTHEAST) PLC and
NORTHERN POWERGRID (YORKSHIRE) PLC

APPELLANTS

- and -

GAS AND ELECTRICITY MARKETS AUTHORITY

RESPONDENT

RIIO-ED2 PRICE CONTROL

SLAUGHTER AND MAY

Slaughter and May
One Bunhill Row
London EC1Y 8YY

2 March 2023

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LIST OF ABBREVIATIONS

ABBREVIATION	MEANING
BPI	Business Plan Incentive.
CMA	Competition and Markets Authority.
CC	Competition Commission.
CCC	Climate Change Committee.
DDA	Demand Driven Adjustment.
DNO	Electricity distribution network operator.
EA89	Electricity Act 1989.
ENA	Energy Networks Association.
EV	Electric vehicle.
FDQ	Final Determinations Question.
FES	NGESO Future Energy Scenarios.
GEMA	Gas and Electricity Markets Authority.
HP	Heat pump.
LCT	Low carbon technology.
LPN	London Power Networks plc, a DNO.
LRE	Load related expenditure.
NGED	National Grid Electricity Distribution, a DNO.
NGESO	National Grid Electricity System Operator.
NPg	NPgN and NPgY.
NPgN	Northern Powergrid (Northeast) Plc, a DNO.
NPgY	Northern Powergrid (Yorkshire) Plc, a DNO.
RIIO-ED1	The first RIIO price control regime applying to DNOs, which operates from 1 April 2015 to 31 March 2023.
RIIO-ED2	The second RIIO price control regime applying to DNOs, which will operate from 1 April 2023 to 31 March 2028.
SPN	South Eastern Power Networks plc, a DNO.
UKPN	UK Power Networks, a DNO.
UM	Uncertainty mechanism.
WWU	Wales and West Utilities Limited.

PART I: INTRODUCTION

1. The Appellants

1.1 This Notice of Appeal ("**Notice**") is filed on behalf of Northern Powergrid (Northeast) Plc ("**NPgN**") and Northern Powergrid (Yorkshire) Plc ("**NPgY**") (together, the "**Appellants**" or "**NPg**").

1.2 NPgN and NPgY are the electricity distribution network operators ("**DNOs**") for the North East of England and for Yorkshire and Northern Lincolnshire, respectively. They each hold a distribution licence under section 6(1)(c) of the Electricity Act 1989 ("**EA89**") (each a "**Licence**" and together, the "**Licences**").

2. Request for permission to appeal

2.1 This appeal concerns the RIIO-ED2 price control for electricity distribution ("**RIIO-ED2**"), which will operate from 1 April 2023 to 31 March 2028. RIIO-ED2 will follow on from the previous price control for electricity distribution ("**RIIO-ED1**"), which operates from 1 April 2015 to 31 March 2023.

2.2 The Appellants seek permission under sections 11C(1) and (3) EA89 to bring an appeal against the decision of the Gas and Electricity Markets Authority ("**GEMA**") to proceed with modifications to the Licences published on 3 February 2023 (the "**Decision**") under section 11A EA89 in connection with the RIIO-ED2 process.[1] The Appellants rely on this Notice, the documents exhibited to it in **NOA1** and the factual and expert evidence provided in support of it in applying for permission to bring this appeal and, if permission is granted, for the appeal itself.

2.3 Section 11C(2)(a) EA89 provides that a "*relevant licence holder*" (within the meaning of section 11A EA89) may bring such an appeal under section 11A(10)(b) EA89 where the Appellants are holders of Licences, the conditions of which are to be modified by the Decision. Both Appellants were named as "*relevant licence holders*" in the Decision and accordingly have standing to bring this appeal.

2.4 The subjects of this appeal are material errors made by GEMA, which have significant impacts on the Appellants (see further paragraph 3.4 below). The Appellants therefore bring this appeal for reasons that are neither trivial nor vexatious.[2]

3. Scope of the Appellants' appeal and materiality

3.1 The Appellants have given careful consideration to the overriding objective of the energy licence modification appeals regime, i.e. to enable the Competition and Markets Authority (the "**CMA**") to dispose of appeals fairly, efficiently and at proportionate cost within the

[1] A copy of the Decision is included in this Notice in **NOA1** at Tab 1 and Tab 2. The Decision is also available online at https://www.ofgem.gov.uk/publications/decision-proposed-modifications-riio-2-electricity-distribution-licences.

[2] Section 11C(4)(d) EA89 provides that the CMA may refuse permission to appeal where: (i) an appeal is brought for reasons that are trivial or vexatious; or (ii) the appeal has no reasonable prospect of success.

time periods prescribed by the EA89, and the requirement that all parties to an appeal must assist the CMA to further this overriding objective.[3]

3.2 In accordance with the CMA's guidance:[4]

(i) on 16 February 2023, the Appellants informed GEMA by letter that they were considering bringing an appeal against the Decision;

(ii) on 17 February 2023, the Appellants provided the CMA with reasonable notice of the same by e-mail; and

(iii) before deciding to appeal, the Appellants raised the issues that are the subject of this appeal with GEMA, to seek to resolve the errors before filing this appeal.

3.3 The Appellants present a focussed appeal on two specific issues where they contend GEMA has taken decisions that are "wrong" within the meaning of section 11E(4) EA89:

(i) GEMA's misallocation of allowances between cost categories: GEMA relied on DNOs' submitted cost proportions when allocating DNOs' efficient modelled costs. GEMA's decision to do so was irrational and illogical because DNOs' submitted costs were based on decarbonisation planning scenarios that were manifestly different from the one that GEMA intended to fund.

(ii) GEMA's failure to grant NPgY a Business Plan Incentive ("**BPI**") Stage 4 reward: GEMA failed to compare costs on a rational and consistent basis when determining eligibility for a reward. As a result, NPgY was not granted a BPI Stage 4 reward when it should have been.

3.4 The errors made by GEMA in respect of these two issues are material with a significant adverse impact on the Appellants:

(i) The first issue (misallocation of allowances) has an adverse impact of £157 million for the Appellants (£53 million for NPgN and £104 million for NPgY).[5]

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[3] Energy Licence Modification Appeals: Competition and Markets Authority Rules (27 October 2022), CMA70, Rules 4.1 and 4.2.

[4] Energy Licence Modification Appeals: Competition and Markets Authority Guide (27 October 2022), CMA71, paragraphs 3.9 to 3.14.

[5] See Annex A of the Frontier Misallocation Report. The figures given here for the impact of the misallocation of allowances are the effect on final allowances, which are the cost allowances that DNOs are allowed to recover through the price controlled allowed revenue, as set up at the start of the RIIO-ED2 price control period. In some categories, these allowances may increase or decrease during the period as a result of uncertainty mechanisms. Figures in this Notice are rounded to the nearest million.

(ii) The second issue (the BPI Stage 4 reward) has an adverse impact of £15 million for NPgY.[6]

3.5 The combined adverse impact of these errors on the Appellants, if not corrected, is therefore £171 million (£53 million for NPgN and £118 million for NPgY).

3.6 While these errors are significant, they are straightforward to correct. The Appellants do not challenge the architecture of GEMA's benchmarking process or the basic features of the BPI Stage 4 reward assessment. The errors that are the subject of this appeal relate to discrete stages of GEMA's cost assessment process, which the Appellants consider could be corrected without any consequential amendments to GEMA's methodology.

3.7 The Appellants' grounds of appeal in respect of these two issues are set out further in Parts V and VI below.

4. Key documents

4.1 The following key documents contain the grounds of this appeal, reasons and supporting evidence:

(i) This Notice and Exhibit **NOA1** to this Notice. GEMA's reasoning for the Decision is contained primarily in the following documents, which are contained in **NOA1**:

(a) "RIIO-ED2 Final Determinations Core Methodology Document" (30 November 2022) (the "**Final Determinations Core Methodology**");[7] and

(b) "RIIO-ED2 Final Determinations Overview Document" (30 November 2022);[8]

(ii) The reports of Frontier Economics, exhibited to the Witness Statement of Michael Paul Huggins ("**Huggins 1**") as **FE1** at Tab 1 (the "**Frontier Misallocation Report**") and Tab 2 (the "**Frontier BPI Report**"), which identify and explain GEMA's errors in respect of each ground of appeal; and

(iii) The Witness Statements and Exhibits thereto of Alexander Patrick Jones ("**Jones 1**"), Professor Philip Charles Taylor ("**Taylor 1**") and Jonathan Mark Nicholson ("**Nicholson 1**").

4.2 Other relevant documents to which the CMA should have regard include:

[6] See section 5 of the Frontier BPI Report.

[7] **NOA1**, Tab 3.

[8] **NOA1**, Tab 4.

(i) "RIIO-ED2 Draft Determinations – Core Methodology Document" (29 June 2022);[9]

(ii) "RIIO-ED2 Statutory Licence Modification Notice – Standard Conditions" (3 February 2023);[10]

(iii) "RIIO-ED2 Statutory Licence Modification Notice – Special Conditions" (3 February 2023);[11] and

(iv) "Statutory consultation on the RIIO-ED2 licence drafting modifications – reasons and effect" (14 December 2022).[12]

4.3 The Appellants have endeavoured to provide all the facts, reasons, documentary evidence and Witness Statements that they rely on with this Notice. If permission to appeal is granted, however, it may be necessary for the Appellants to file further material, particularly following receipt of GEMA's response.

5. Contact details

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[9] **NOA1**, Tab 5.

[10] **NOA1**, Tab 1.

[11] **NOA1**, Tab 2.

[12] **NOA1**, Tab 6.

PART II: BACKGROUND AND OVERVIEW OF COST ASSESSMENT PROCESS

6. Introduction

6.1 RIIO-ED2 is the second price control conducted by GEMA under the RIIO (setting **R**evenue using **I**ncentives to deliver **I**nnovation and **O**utputs) regime for electricity distribution. It sets the "outputs"[13] that DNOs need to deliver and the associated revenues that each DNO is allowed to collect (or "allowances") for the five-year period from 1 April 2023 to 31 March 2028.[14]

6.2 As part of the price control, GEMA assessed the efficiency of each DNO's proposed expenditure in its business plan. This Part provides an overview of GEMA's cost assessment process, which is relevant background for both of the issues that are the subject of this appeal.

6.3 For the avoidance of doubt, the Appellants do not seek to challenge the architecture of GEMA's cost assessment process, GEMA's decision to fund different categories of activity through different mechanisms, the design of those mechanisms, or the majority of the steps described below. The discrete issues that are the subject of this appeal are set out in Parts III, V and VI of this Notice.

7. The context: decarbonisation uncertainty

7.1 As explained in Jones 1, from the outset of the RIIO-ED2 price control process in 2019, it was clear that two key features of the process would be: (i) the need to support investment in decarbonisation and achieving Net Zero[15]; and (ii) the inherent uncertainty surrounding the demands that decarbonisation will place on DNOs' networks and therefore the extent (and timing) of such investment.[16]

7.2 To address the unprecedented level of uncertainty over the network investment that will be required to support decarbonisation during the RIIO-ED2 price control period, GEMA decided to make greater use (both in terms of scope and financial significance) of uncertainty mechanisms ("**UMs**") than has been the case in other price controls. UMs allow changes to DNOs' final allowances during the price control period to reflect significant cost changes that are expected to be outside their control.

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[13] "Outputs" specify what DNOs need to deliver in return for the revenue they are permitted to recover from consumers.

[14] See: https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/network-price-controls-2021-2028-riio-2/network-price-controls-2021-2028-riio-2-electricity-distribution-price-control-2023-2028-riio-ed2.

[15] Net Zero is the UK Government's target to negate completely the amount of manmade greenhouse gases produced in the UK by 2050.

[16] Jones 1, paragraphs 11 to 12.

7.3 The use of these UMs means that in this price control there are, in effect, two types of allowances:

(i) those where funding is subject to UMs, i.e. funding is (wholly or partly) contingent on a DNO's activity during the price control period ("**Contingent Allowances**"); and

(ii) those where funding is not subject to UMs, i.e. funding is fixed at the outset of the price control and will not be adjusted over the period ("**Fixed Allowances**").

8. The starting point: DNOs' business plans

8.1 GEMA's cost assessment at RIIO-ED2 started with the costs submitted by DNOs as part of their business plans. DNOs submitted costs at a granular level, apportioned across 51 different activity-level cost categories.[17]

8.2 When inviting DNOs to submit their business plans, GEMA chose not to set a common decarbonisation scenario to be used by each of the DNOs. Instead, each DNO was asked to submit a business plan based on its own "best view" decarbonisation planning scenario, informed by the assumptions applied in the National Grid Electricity System Operator ("**NGESO**") Future Energy Scenarios ("**FES**")[18] and the Climate Change Committee's ("**CCC**") Sixth Carbon Budget.[19]

8.3 GEMA also did not specify at this stage what UMs would be used to vary final allowances and how these mechanisms would operate. DNOs therefore set out in their business plans their own proposals for the split between Fixed Allowances and Contingent Allowances, specifying how they proposed UMs should be used.[20]

8.4 A key point for the purposes of this appeal is that there were a wide range of plausible decarbonisation scenarios that DNOs could use for planning purposes, which were necessarily based on different assumptions about the nature and rate of change in patterns of energy usage. As explained in Taylor 1, the expectations of demand on a DNO's network are impacted by assumptions regarding:

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[17] The full list of activity-level cost categories is set out at Annex B of the Frontier Misallocation Report. Examples include categories of operating expenditure such as repair and maintenance, IT & telecoms and smart metering roll out as well as categories of capital expenditure such as connections, various types of reinforcement work and flood mitigation.

[18] The FES is an annual document produced by the NGESO containing a range of different decarbonisation scenarios. The NGESO also publishes data for the assumptions underlying each scenario including, for example, EV and HP uptake figures.

[19] The CCC is an independent statutory body established under the Climate Change Act 2008. Its purpose is to advise the UK and devolved governments on emissions targets and to report to Parliament on progress made in reducing greenhouse gas emissions and preparing for and adapting to the impacts of climate change. The Sixth Carbon Budget is provided at Tab 7 of **NOA1**.

[20] See further Jones 1 at paragraphs 41(C) and 45.

(i) the extent to which decarbonisation will rely on the use of electricity rather than other energy sources (e.g. hydrogen);

(ii) the extent to which there is a move away from large-scale electricity generation (through fossil fuel or nuclear power stations) to a larger number of smaller renewable energy generators;

(iii) the speed at which consumers will switch to low carbon technologies ("**LCTs**"), such as electric vehicles ("**EVs**") and heat pumps ("**HPs**"); and

(iv) the extent to which it is possible to incentivise consumers to flex up or down their demand generally and/or at peak times (which will, in turn, affect how much additional capacity is needed on the network).[21]

8.5 As explained in Jones 1, a key consideration for NPg when developing its decarbonisation planning scenario was ensuring that it was consistent with the UK Government's Ten Point Plan for a Green Industrial Revolution published in November 2020 (the "**Ten Point Plan**").[22] The Ten Point Plan set out plans to meet the CCC's Sixth Carbon Budget and Net Zero. NPg's planning scenario assumed that electricity, rather than hydrogen, would lead the drive towards decarbonisation and that, in line with the Ten Point Plan, there would be rapid uptake of EVs and HPs during the RIIO-ED2 price control period. This would impose greater demand on the NPg electricity distribution networks than would result from other (lower electrification) demand scenarios.[23]

8.6 NPg developed its planning scenario with the objective that NPg would be able to keep pace with any decarbonisation scenario that occurred and would not become a blocker to decarbonisation if rapid electrification takes place. NPg sought to plan its level of spending to strike an appropriate balance between: (i) investing sufficiently during the RIIO-ED2 period to ensure that all future pathways to Net Zero remained viable through the period (and beyond); and (ii) affordability for NPg's customers.[24]

8.7 An effect of these planning assumptions was that NPg's business plan[25] provided for a higher level of investment in the category of load related expenditure ("**LRE**") than would have been the case under a planning scenario that assumed a lower level of electrification.[26] As explained in Nicholson 1, LRE is generally expenditure related to the installation of new, or upgrade of existing, network assets and the costs of deploying

[21] Taylor 1, paragraph 21.

[22] The Ten Point Plan is provided at Tab 8 of **NOA1**.

[23] Jones 1, paragraphs 22 to 26.

[24] Further detail on the development of NPg's business plan is provided at paragraphs 20 to 28 of Jones 1.

[25] NPg's business plan is provided at Tab 9 of **NOA1**.

[26] See further Nicholson 1, paragraph 16.

innovative grid management solutions to accommodate changes in the level or pattern of electricity supply and demand.[27] It includes the costs of addressing increased demand by installing new smart and flexible technologies and/or undertaking conventional reinforcement works (such as laying new cables or installing new transformers), as well as the use of more innovative solutions to manage network capacity such as price-driven customer flexibility[28] and DNO-contracted customer flexibility.[29] In a decarbonisation scenario where there are large increases to the load that the electricity distribution network must bear, a correspondingly large amount of LRE investment will be required to accommodate that additional load.

9. GEMA's cost assessment process

9.1 Starting with the submitted costs in DNOs' business plans, GEMA carried out the following seven steps in its cost assessment process.[30]

Step 1: Pre-modelling adjustments

9.2 GEMA made some pre-modelling adjustments to DNOs' submitted costs to make them more comparable through the removal of region-specific costs and re-categorisation of certain costs.

Step 2: Benchmarking

9.3 GEMA benchmarked these adjusted submitted costs using two different approaches:

(i) **Totex benchmarking**, which compared DNOs' total costs in models that, by design, do not distinguish one cost category from another. This provided GEMA with a set of total modelled costs for each DNO; and

(ii) **Disaggregated benchmarking**, which broke down DNOs' total costs into cost categories and then assessed DNOs' costs in each category separately. GEMA used a range of different modelling approaches to identify and remove costs deemed to be inefficient. GEMA then summed the outputs of these models to give a second set of total modelled costs for each DNO.

[27] Nicholson 1, paragraphs 18 to 23. Examples of network assets include overhead power lines and underground cables.

[28] Price-driven customer flexibility is where customers flex their use of electricity or change their energy use patterns in response to price signals in their energy tariffs. This is described further at paragraph 20(A) of Nicholson 1.

[29] DNO-contracted customer flexibility is where customers contract with NPg to use more or less energy at specific times or under particular circumstances in return for payment. This is described further at paragraph 20(B) of Nicholson 1.

[30] There are some elements of the process which are not relevant to this appeal and have therefore not been included.

Step 3: Post-modelling adjustments

9.4 Given that DNOs' business plans had been premised on different decarbonisation planning scenarios, which varied according to (among other things) the assumptions outlined at paragraph 8.4 above, GEMA decided to carry out post-modelling adjustments to the output of both the totex and disaggregated modelling to align with a common decarbonisation scenario for the purposes of its cost assessment process (referred to below as "**Scenario Adjustments**") based on the 2022 "System Transformation" FES[31] (the "**Common Scenario**"). It did this by scaling down DNOs' costs and volumes of work according to how their decarbonisation planning scenario assumptions differed from the Common Scenario. Specifically:

(i) within the **totex modelling**, GEMA did this through a "Demand Driver Adjustment" ("**DDA**"); and

(ii) within the **disaggregated modelling**, GEMA did this through "workload adjustments".

9.5 The Common Scenario differs – to a greater or lesser extent – from the planning scenarios and assumptions adopted by DNOs for the purposes of their respective business plans. GEMA's use of the Common Scenario was intended to provide a common level of baseline funding, with various UMs used to increase or reduce specific allowances relative to the amounts deemed appropriate to that baseline. NPg was not aware that GEMA intended to adjust each DNO's submitted costs to a common decarbonisation scenario (and, it follows, did not know which decarbonisation scenario GEMA would choose in this regard), until a bilateral meeting between GEMA and NPg which took place shortly before the publication of the Draft Determinations on 29 June 2022.[32]

9.6 The Common Scenario assumes relatively small increases in network demand over the RIIO-ED2 price control period. GEMA describes it as "*the lowest net zero compliant scenario*" and says it "*will ensure we are only funding a level of investment we can be reasonably confident is needed in the next five years*".[33] The Common Scenario assumes a much lower level of electrification than NPg's planning scenario, with greater reliance on hydrogen for heating and lower levels of LCT uptake by consumers.[34] It should be noted that the Common Scenario was not chosen by GEMA on the basis that it was more or less likely to occur than any other scenario.

[31] The 2022 FES is provided at Tab 10 of **NOA1**.

[32] See Jones 1 at paragraph 41(B).

[33] RIIO-ED2 Draft Determinations – Core Methodology Document, paragraph 3.36, provided at Tab 5 of **NOA1**.

[34] See further Jones 1 at paragraphs 43 to 44.

Step 4: Glide path

9.7 GEMA scaled both totex and disaggregated modelled costs (following Scenario Adjustments to the Common Scenario) using a "glide path" so that all DNOs were required to meet the levels of efficiency achieved by the DNOs that GEMA identified as best performing. This is often described as a "catch-up" challenge.

Step 5: Weighting together modelled costs

9.8 Both totex and disaggregated modelled costs were then averaged together to give a weighted view of total efficient modelled costs for each DNO.

Step 6: Allocation of total efficient modelled costs

9.9 Each DNO's total efficient modelled costs were then allocated across the 51 activity-level cost categories, which are funded through a range of different mechanisms. GEMA conducted the allocation using the average (i.e. on a 50:50 basis) of the:

(i) cost proportions calculated using DNOs' submitted costs (i.e. the proportionate relationships between the various cost categories in DNOs' business plans, which were each based on decarbonisation planning scenarios that were materially different from GEMA's Common Scenario);[35] and

(ii) cost proportions calculated using the activity-level modelled costs from the disaggregated modelling.

9.10 This allocation of total efficient modelled costs determines the allocation of total allowed costs (which includes costs assessed outside the benchmarking)[36] and, in turn, the allocation of total final allowances.

9.11 If all cost categories were funded "upfront" and subject to the same terms (i.e. there was a single funding pot), there would be less need for allocation. The main purpose[37] of this allocation between cost categories at RIIO-ED2 (rather than leaving it to DNOs to spend their total final allowances as they see fit) is to support the effective operation of different funding mechanisms for different cost categories, including UMs.[38]

[35] DNOs' submitted costs are taken on a net basis, after exclusions and reclassifications.

[36] Allowed costs include ongoing efficiency (applied at **Step 7** of the cost assessment process) and separately assessed costs. Separately assessed costs are costs that were not processed through the benchmarking process. The vast majority of costs (by value) are subject to benchmarking.

[37] There is also a secondary purpose, which is to allow GEMA to compare allowances against submitted costs, for monitoring purposes.

[38] GEMA's rationale for the use of UMs is explained further in the Frontier Misallocation Report, at section 4.2.

9.12 The UMs operate in various cost categories to adjust or, in some cases, replace the final allowances deemed appropriate to the conservative Common Scenario, where specified criteria are met. GEMA describes UMs as ensuring "*spending plans can flex to meet the level of reasonably anticipated demand, rather than being fixed to a single view of the future formed at a point in time when there is uncertainty about future requirements*".[39] An important function of UMs in this price control is to permit allowances to adjust in the event that there are different levels and patterns of electricity demand from those assumed in the Common Scenario. The UMs are intended to ensure that allowances closely match the cost of network investment made by DNOs.

9.13 The effect of the allocation between Contingent Allowances (which are subject to UMs) and Fixed Allowances (which are not) has a material impact on a DNO's funding, as each cost category with Contingent Allowances effectively has its own pot of funding, which is only available to a DNO to spend on activity in that cost category, while all cost categories with Fixed Allowances, in effect, share a single funding pot, which can be spent on any activities within such categories. DNOs may therefore treat Fixed Allowances as fungible between cost categories, while Contingent Allowances are not.

Step 7: Ongoing efficiency challenge

9.14 As the final step in its cost assessment, GEMA applied a 1% per annum ongoing efficiency challenge to all costs, to reflect expected improvements in productivity.[40]

The output of GEMA's cost assessment process

9.15 Within its cost assessment process, GEMA therefore carried out two conceptually distinct operations, to:

(i) assess the efficiency of each DNO's submitted costs and make any adjustments that GEMA considered necessary ("**Efficiency Adjustments**"); and

(ii) adjust each DNO's submitted costs, which were based on that DNO's chosen planning scenario, to bring their final allowances into line with the Common Scenario (i.e. the "**Scenario Adjustments**" described at **Step 3**).

9.16 The output of this process was the total efficient modelled costs appropriate to the Common Scenario as assessed by GEMA for each DNO, split out across activity-level cost categories.

[39] RIIO-ED2 Methodology Decision: Overview, paragraph 1.10, provided at Tab 11 of **NOA1**.

[40] The ongoing efficiency challenge was also applied to costs not processed through the two benchmarking streams (see footnote 36 above).

PART III: EXECUTIVE SUMMARY

10. Issue 1: Misallocation of allowances

10.1 The first issue that this appeal concerns is GEMA's manifestly irrational and illogical decision to rely on DNOs' submitted costs proportions when allocating, post-benchmarking, DNOs' total efficient modelled costs to different cost categories.

10.2 The Appellants' challenge relates to the approach taken by GEMA to allocating total efficient modelled costs (i.e. **Step 6** of the cost assessment process described at Section 9 above) which determined, subject to certain further adjustments, the allowances that DNOs' received in each cost category.

10.3 This allocation process is not designed or intended to involve any downward adjustment to total efficient modelled costs, rather the allocation process should be neutral in its effect on a DNO's total final allowances (subject to the operation of UMs).

10.4 As explained above, GEMA allocated the total efficient modelled costs of each DNO to various cost categories using a hybrid allocation model that had regard 50:50 to: (i) the cost proportions from each DNO's own respective submitted costs; and (ii) the costs proportions resulting from GEMA's disaggregated modelling.

10.5 That approach is irrational and illogical insofar as it relies (as to 50%) on the cost proportions from a DNO's submitted costs that were based on a decarbonisation planning scenario that was manifestly different from the one that GEMA used in the cost assessment process and for setting total final allowances. GEMA's modelling (prior to **Step 6**) materially changed the structure of DNOs' costs from those in their submitted costs. Given that DNOs' submitted costs were not prepared on the same basis as the Common Scenario, their submitted cost proportions should not play any role in the allocation of allowances that were assessed to be efficient by reference to that Common Scenario.

10.6 GEMA decided to reduce the weighting given to DNOs' submitted cost proportions by 50% between the Draft Determinations stage and the Final Determinations stage; however, that does not make this any less of an error. The error is a matter of principle, not degree.

10.7 The effect of GEMA's approach is that whatever happens in the RIIO-ED2 price control period (i.e. regardless of whether the Common Scenario, the Appellants' scenario or any other scenario arises), some of the DNOs' total costs that GEMA has determined to be efficient will be irrecoverable in practice. As such, DNOs will under-recover relative to their assessed-as-efficient costs and final allowances.

10.8 This effect is particularly significant for an efficient DNO whose business plan was premised on a relatively fast pace of electrification and the accompanying relatively high network challenge, as compared to the Common Scenario. This is because such DNOs

inevitably allocated a higher proportion of their total costs to LRE (which receive Contingent Allowances) and a correspondingly lower proportion to all other cost categories (most of which receive Fixed Allowances[41]) in their business plans.

10.9 For the Appellants, GEMA's approach results in an effective total disallowance of £157 million of funding that GEMA had deemed efficient through:

(i) an over-allocation to LRE exceeding the level of expenditure appropriate to the Common Scenario, where any excess funding can in fact never be accessed and cannot be used to fund other activities (because it is funded with Contingent Allowances); and

(ii) a corresponding under-allocation to other cost categories that are funded with Fixed Allowances[42], which results in efficient costs in these cost categories being irrecoverable in all circumstances.

10.10 The overall effect of an over-allocation to LRE is that the Appellants are under-funded across the totality of its licensed activities, compared to the funding that was assessed to be efficient through GEMA's benchmarking process.

10.11 The Decision was therefore wrong in that GEMA's approach to allocation:

(i) suffers from errors of fact and/or law; and

(ii) fails to achieve GEMA's stated effect.

10.12 The Decision also involves a failure by GEMA to have regard to, and/or to give appropriate weight to, its statutory duties.

11. Issue 2: BPI Stage 4 reward

11.1 The second issue that this appeal concerns is GEMA's failure to grant one of the Appellants (NPgY) a BPI Stage 4 reward. GEMA failed to compare costs on a rational and consistent basis when determining eligibility for a reward, generating an arbitrary

[41] There are various UMs in relation to cost categories other than LRE, but these costs do not vary dramatically with decarbonisation scenario and so are largely unaffected by the misallocation.

[42] A small amount of this under-allocation (less than £6 million) is to cost categories other than LRE that are funded by Contingent Allowances. See further Jones 1 at paragraph 55.

difference in treatment between DNOs. As a result, NPgY was not granted a BPI Stage 4 reward when it should have been.

11.2 The BPI Stage 4 reward is designed to reward DNOs that provide information about their projected costs that aids GEMA in setting accurate price controls for the sector based on efficient allowances.

11.3 GEMA's assessment of eligibility for, and calculation of the size of, a BPI Stage 4 reward is based on a comparison of each DNO's submitted costs to its modelled costs (i.e. costs as adjusted through GEMA's modelling). In simple terms, if a DNO's submitted costs fell below the modelled costs resulting from the benchmarking process, the DNO received a BPI Stage 4 reward. GEMA's rationale for such award is that the DNO in question would have provided valuable information on achievable levels of performance in its submitted costs.[43] Information of this kind, in principle, assists GEMA in setting other DNOs' allowances below the level that would otherwise have been set.[44]

11.4 The modelled costs used to identify whether any BPI Stage 4 reward is required (and, if so, the amount of any such reward) were based on both the totex and disaggregated modelled costs (weighted equally), applying various adjustments.

11.5 The Appellants do not challenge the basic features of the BPI Stage 4 reward assessment.

11.6 GEMA erred, however, in its selection of the specific adjustments that it applied when assessing DNOs' eligibility for a BPI Stage 4 reward, in particular by comparing submitted costs to modelled costs after workload adjustments in the disaggregated modelling. Modelled costs before such adjustments were manifestly the appropriate input, having regard to the logic of the award.

11.7 In brief, workload adjustments strip out costs reflecting certain volumes of network reinforcement work that GEMA considers would not be required under the Common Scenario.[45]

11.8 The use of modelled costs after workload adjustments in assessing DNOs' eligibility for a BPI Stage 4 reward is irrational and illogical for the following reasons:

(i) The BPI Stage 4 reward is designed to incentivise and reward DNOs that submit efficient plans. Workload adjustments are driven overwhelmingly not by efficiency assessments, but reflect differences between GEMA's chosen Common Scenario

[43] The principal aim of the reward is to "*reflect the added value* [GEMA] *may get from information revealed in setting more accurate price controls for other companies*" (RIIO-ED2 Sector Methodology Decision, Annex 2 Keeping bills low for consumers, paragraph 10.59 provided at Tab 12 of **NOA1**).

[44] More information on the operation of the BPI Stage 4 reward is provided at section 3 of the Frontier BPI Report.

[45] See further the Frontier BPI Report, at paragraphs 3.10 to 3.12 and Annex A.

and the planning scenario that was used for the purposes of a DNO's business plan. By comparing DNOs' own submitted costs to modelled costs after workload adjustments, GEMA failed to compare like with like. This approach results in the BPI Stage 4 reward scheme penalising DNOs that assumed a different decarbonisation scenario to the Common Scenario without a coherent rationale, and its outcome does not reflect underlying efficiency or the value of the information provided by DNOs' business plans. It therefore runs contrary to GEMA's stated aim of the BPI Stage 4 reward.

(ii) The illogic of the inclusion of workload adjustments is evident even within the broader BPI Stage 4 reward calculation itself. Totex modelled costs before the DDA are used in the calculation, thereby correctly comparing like with like. The workload adjustments applied to disaggregated modelled costs are in main part functionally equivalent to the DDA. There is no rational justification for treating these equivalent adjustments differently for the purpose of one and the same process of comparison.

(iii) Using disaggregated modelled costs after workload adjustments has a particularly severe (and discriminatory) effect on DNOs, such as NPgY, that assumed a relatively higher pace of electrification than GEMA's Common Scenario. GEMA gave no notice that DNOs with more conservative decarbonisation planning scenarios would receive preferential treatment when assessing eligibility for a BPI Stage 4 reward, and such preference is in any event arbitrary in light of GEMA's stated policy aims for the reward.

(iv) GEMA also issued no guidance before the submission of DNOs' business plans that would have enabled a DNO to calibrate its planning to the Common Scenario.

(v) GEMA's approach to assessing the BPI Stage 4 reward is inconsistent with its process for calculating "efficiency scores" elsewhere in the RIIO-ED2 process. The process for the calculation of efficiency scores works in substantially the same way as the BPI Stage 4 reward. The central difference, however, is that efficiency scores are based on a comparison of modelled costs before the application of workload adjustments. Of the top-three most efficient DNOs by efficiency score, the first and third most efficient receive a BPI Stage 4 reward, whereas the second most efficient (NpgY) perversely does not receive any reward. This discrepancy is illogical and can be traced to the erroneous inclusion of workload adjustments in GEMA's BPI Stage 4 reward calculations.

11.9 GEMA's error means that NpgY wrongly does not receive any BPI Stage 4 reward.

11.10 The Decision was therefore wrong in that GEMA's approach to the calculation of the Appellants' BPI Stage 4 reward:

(i) suffers from errors of fact and/or law; and

(ii) fails to achieve GEMA's stated effect.

11.11 The Decision also involves a failure by GEMA to have regard to, and/or to give appropriate weight to, its statutory duties.

12. Relief sought

12.1 The Appellants seek permission to appeal.

12.2 The specific relief sought by the Appellants in relation to each of the issues is explained in detail in Parts V and VI.

12.3 The Appellants seek an order that GEMA pay the Appellants' costs of this appeal.

PART IV: STATUTORY FRAMEWORK TO DETERMINE THE APPEAL

13. Overview

13.1 To assist the CMA, the Appellants have summarised in this Part the legal framework that governs the CMA's substantive assessment of this appeal under the EA89:

(i) first, the Appellants identify the standard of review to be applied by the CMA in determining whether to allow this appeal; and

(ii) second, the Appellants identify the statutory grounds of appeal on which an appeal may be brought.

13.2 The Appellants do not anticipate a substantial disagreement between the parties on the applicable legal principles.

14. Standard of review

14.1 This Section sets out the standard of review that applies when the CMA is assessing one or more of the statutory appeal grounds set out in Section 15.

Merits review

14.2 There have been no relevant changes to the statutory provisions in the EA89 that govern this appeal process (i.e. sections 11C – 11H) since the CMA published its final determinations in respect of the RIIO-ED1 price control in 2015 (the "**ED1 Determinations**").[46]

14.3 At that time, the CMA described (broadly) the standard of review that applies to an appeal under section 11C EA89 as follows:

> "*the CMA should not substitute its views for GEMA's solely on the basis that it would have taken a different approach (eg on issues of the weight to be attached to particular considerations), but the standard of review goes further than the traditional heads of judicial review. The key question is whether GEMA made a decision that was wrong on one of the prescribed statutory grounds. To that extent, the merits of GEMA's decision must be taken into account.*" [47]

[46] *British Gas Trading Limited v The Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 ("**BGTL v GEMA**") and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 ("**NPg v GEMA**").

[47] *BGTL v GEMA*, paragraph 3.43; and *NPg v GEMA*, paragraph 3.42.

14.4 The CMA also confirmed that:

> "*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 EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute*."[48]

14.5 Since the ED1 Determinations, the following further appeals have been brought before the CMA under section 11C EA89 or analogous provisions, in which detailed consideration was given to the appropriate standard of review to be applied when determining such appeals:

(i) the CMA's 28 October 2021 Final Determination in respect of the RIIO-GD2/T2 price control regime appeal[49] (the "**GD2/T2 Final Determination**"); and

(ii) the recent appeals brought by Firmus Energy and SONI against the Northern Ireland Authority for Utility Regulation ("**Firmus Energy**", "**SONI**", and together the "**Firmus Energy and SONI Appeals**").[50]

14.6 The CMA's final decisions in those cases largely reflect its line of reasoning in the ED1 Determinations, i.e. that a merits review of the relevant authority's decision is required.

14.7 This is nonetheless distinct from a *de novo* consideration of the merits per *R (Wales & West Utilities Ltd) v CMA* [2022] EWHC 2940 (Admin) ("**WWU**") at paragraphs 26-33. Ultimately, the CMA must consider the merits to the extent necessary to determine whether the challenged decision is wrong under the statutory ground(s) relied on in the appeal. If, unlike in this appeal, there is a challenge to the exercise of "*an overall value judgment*", the authority is entitled to a substantial margin of appreciation.

Meaning of "wrong"

14.8 In the GD2/T2 Final Determination, the CMA explained that its starting point when considering an appeal is as set out in *SONI*. In that case, the CMA considered that the relevant standard is whether the decision was wrong and not whether the decision was unreasonable:

[48] *BGLT v GEMA*, paragraph 3.24; and *NPg v GEMA*, paragraph 3.23.

[49] GD2/T2 Final Determination, paragraphs 3.20 to 3.25.

[50] *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 26 June 2017; and *SONI Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 10 November 2017.

> "[T]*he test is not whether the decision under appeal was 'unreasonable'. The test is whether the CMA is satisfied the regulator's decision was wrong on one or more of the statutory grounds and that the error was material*."[51]

14.9 If the CMA finds that GEMA's decision "*is based on a plain error of fact or is wrong in law, there is no room for a margin of appreciation*".[52]

Materiality

14.10 An error must be material in order for the CMA to allow an appeal.[53]

14.11 The materiality of an error is to be assessed by the CMA "*on a case-by-case basis taking into account the particular circumstances of each case*".[54] In the ED1 Determinations, the CMA set out a non-exhaustive list of factors relevant to undertaking this assessment, which include:

(i) the impact of the error on the overall price control;

(ii) whether the cost of addressing the error would be disproportionate to the value of the error;

(iii) whether the error is likely to have an effect on future price controls; and

(iv) whether the error relates to a matter of economic or regulatory principle.[55]

14.12 The CMA subsequently noted in its Final Determination in the BT and TalkTalk Appeals[56], quoting the CMA's predecessor – the Competition Commission's (the "**CC**") – *Carphone Warehouse (LLU)* decision[57], that:

> "[W]*here the impact is below 0.1 per cent, the mistake is unlikely to be capable of producing a material effect on the charge control; in those circumstances it fell within an acceptable margin of error for a regulator. In our view, this is not, and was not intended to be, a bright-line test for the assessment of materiality. The*

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[51] GD2/T2 Final Determination, paragraph 3.65, referring to *SONI,* paragraph 3.35.

[52] GD2/T2 Final Determination, paragraph 3.72.

[53] *Id*, paragraph 3.89.

[54] *BGLT v GEMA*, paragraph 3.61; and *NPg v GEMA*, paragraph 3.58.

[55] *Ibid*.

[56] *BT v Ofcom* and *TalkTalk v Ofcom* (Case 1237/3/3/15), Final Determination, 13 June 2016 (together, the "**BT and TalkTalk Appeals**").

[57] *Carphone Warehouse (LLU)* (Case 1111/3/3/09), 31 August 2010.

impact of the mistake as a percentage of the charge control is but one factor in an overall assessment based on all the circumstances of the case[.]"[58]

14.13 The CMA reached the same view in *Firmus Energy*.[59] Furthermore, in its GD2/T2 Final Determination the CMA confirmed that certain circumstances may necessitate assessing "*whether the cumulative effect of immaterial errors could have a highly significant impact on the price control*"[60] and therefore an overall material impact.

14.14 In bringing this appeal, the Appellants have therefore limited the errors being challenged to those that result in a material adverse impact on the Appellants specifically.

15. Statutory grounds of appeal

15.1 Section 11E(4) EA89 provides that the CMA may allow an appeal against a decision by GEMA to proceed with the modification of a licence where it is satisfied that the decision being appealed is wrong on one or more of the following grounds:

(i) GEMA failed properly to have regard to the matters to which GEMA must have regard to in carrying out its principal objective under section 3A of EA89 and its duties under sections 3A-C of EA89 (section 11E(4)(a));

(ii) GEMA failed to give appropriate weight to any of the matters referred to in (i) above (section 11E(4)(b));

(iii) GEMA's decision was based, wholly or partly, on an error of fact (section 11E(4)(c));

(iv) the modifications fail to achieve, in whole or in part, the effect stated by GEMA in its decision (section 11E(4)(d)); and/or

(v) GEMA's decision was wrong in law (section 11E(4)(e)).

15.2 Each of these statutory grounds is considered in further detail below.

[58] BT and TalkTalk Appeals, paragraph 2.35.

[59] *Firmus Energy*, paragraph 3.24.

[60] GD2/T2 Final Determination, paragraph 3.97.

Section 11E(4)(a) EA89: GEMA failed properly to have regard to the matters to which it must have regard in carrying out its objective and duties

15.3 GEMA's relevant objectives[61] for the purposes of this appeal are set out below.

The principal objective

15.4 Under section 3A(1) EA89, GEMA's principal objective in carrying out its functions under Part 1 EA89 (which includes GEMA's functions of granting licences to distribute electricity (section 6 EA89) and modifying the conditions of those licences (section 11A)) is to:

> "*protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems*."

15.5 In pursuit of its principal objective, GEMA must comply with certain duties. These include a duty to act in the manner best calculated to further the principal objective (section 3A(1B)).

The need to secure that licence holders are able to finance their regulated activities

15.6 In performing its duties, GEMA must have regard to certain specified matters. A relevant matter for the purpose of this appeal is the need to secure that licence holders are able to finance their regulated activities.

15.7 Section 3A(2) EA89 provides that, in performing its duties under sections 3A(1B) and (1C), GEMA shall have regard to (*inter alia*):

> "*the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part, the Utilities Act 2000, Part 2 or 3 of the Energy Act 2004, Part 2 or 5 of the Energy Act 2008 or section 4, Part 2, sections 26 to 29 of the Energy Act 2010 or Part 2 of the Energy Act 2013.*"

15.8 Section 3A(2)(b) is relevant to this appeal because the Decision under appeal is in relation to activities that are the subject of obligations imposed "under this Part" (i.e. Part 1 EA89). The CMA has previously referred to this obligation as GEMA's "**Financeability Duty**" or "**Finance Duty**".[62]

15.9 The Appellants submit that the Financeability Duty requires that price control decisions ensure that DNOs are able to (i) cover the reasonable costs of meeting the required outputs, (ii) make reasonable returns on capital for providing distribution services and (iii) raise any necessary debt or equity financing readily and on reasonable terms. This

[61] The use of "objectives" here includes both GEMA's principal objective and the duties with which GEMA must comply in relation to its principal objective.

[62] See, for example, *SONI*, paragraph 3.20 and the GD2/T2 Final Determination, paragraph 5.1051.

requires a consideration of both short-term and longer-term effects on the availability of finance.

Section 11E(4)(b) EA89: GEMA failed to give appropriate weight to the matters to which it must have regard in carrying out its objective and duties

15.10 GEMA will have failed to give appropriate weight to any of the matters to which it must have regard (as set out above) where it has given insufficient or excessive weight to them. The CC's interpretation of the same ground in *E.ON* was expressed in similar terms:

> "*In relation to section 175(4)(c), it is important to note the precise language of that section. Section 175(4)(c) provides that a decision may be wrong on the grounds that GEMA failed to give the appropriate weight to one or more of the matters or purposes referred to in subparagraphs (a) and (b). Subparagraph (c) is therefore concerned with the weight given by GEMA to the relevant matters and purposes*"[63]

Section 11E(4)(c) EA89: GEMA's decision was based wholly, or partly, on an error of fact

15.11 Under this ground, GEMA will have based its decision wholly, or partly, on an error of fact where GEMA has made a factual error in making its decision and that error materially affects the decision.

15.12 The CC considered this ground in *E.ON* and found that it had:

> "*a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact.*"[64]

Section 11E(4)(d) EA89: the licence modifications fail to achieve, in whole or in part, the effect stated by GEMA

15.13 Under section 11A(7) EA89 GEMA must:

(i) publish its decision to proceed with the making of licence modifications and the modifications "*in such a manner as it considers appropriate*" (section 11A(7)(a));

(ii) state the effect of the modifications (section 11A(7)(b));

(iii) state how it has taken account of representations (section 11A(7)(c); and

[63] *E.ON UK Plc v GEMA, Decision and Order of the Competition Commission, 10 July 2007* ("**E.ON**"), paragraph 7.16.

[64] *Id*, paragraph 5.16.

(iv) state the reason for any differences between the modifications and those set out in the statutory notice published under section 11A(2)(b), setting out the proposed modifications and their effect (section 11A(7)(d)).

15.14 In the Decision, GEMA states that the reasons and effects for making the modifications can be found in its consultation documents. The stated effects of the modifications relevant to this appeal are discussed further in Parts V and VI below.

Section 11E(4)(e) EA89: GEMA's decision was wrong in law

15.15 GEMA's decision will be wrong in law where, amongst other things, GEMA has misdirected itself on its objectives (including more broadly any relevant requirements of the EA89) in making its decision.

15.16 A decision is also "wrong in law" where it contravenes the principles applicable in judicial review, including that a decision is unlawful where it falls outside "*the range of responses which a reasonable decision-maker might have made in the circumstances*" (i.e. it is irrational in the public law sense).[65]

15.17 The concept of "wrong in law" also covers basic arithmetic errors.[66]

[65] The formulation used by the Privy Council in *Soomatee Gokool & Ors v Permanent Secretary of the Ministry of Health and Quality of Life & Anor* [2008] UKPC 54, at [18].

[66] *Danae Air Transport v Air Canada* [2000] 1 WLR 395, at page 406.

PART V: MISALLOCATION

16. Overview

16.1 This Part of the Notice concerns the Appellants' first challenge, which relates to the approach taken by GEMA to the allocation of total efficient modelled costs for the Appellants for the RIIO-ED2 price control period. This allocation feeds through into final allowances.

16.2 The CMA is directed by way of further background to this issue to:

(i) the Frontier Misallocation Report;

(ii) the Final Determinations Core Methodology, in particular paragraphs 7.634 to 7.647.

(iii) Jones 1, paragraphs 34 to 61; and

(iv) Nicholson 1, paragraphs 18 to 31.

16.3 In summary, the Appellants submit that using cost proportions from DNOs' submitted costs (which were each based on decarbonisation planning scenarios that were materially different from GEMA's Common Scenario) to inform the allocation of total efficient modelled costs (which were based on GEMA's Common Scenario) was illogical, irrational and wrong by reference to the statutory grounds detailed below.

16.4 The Appellants accordingly request the relief identified in Section 22 below.

17. GEMA's approach to allocating DNOs' total efficient modelled costs

17.1 The allocation of total efficient modelled costs is **Step 6** of the cost assessment process as described at paragraphs 9.9 to 9.13 above.

17.2 The key decision for GEMA in the allocation process is the choice of method used to calculate the proportion of total efficient modelled costs that will be allocated to each cost category. As noted at Part II above, this is particularly significant in the RIIO-ED2 price control, given the importance of UMs and the material impact that the allocation between Fixed Allowances and Contingent Allowances has on a DNO's funding.

17.3 At the Draft Determinations stage, allocations were based 100% on the cost proportions (by category) taken from each DNO's submitted costs. The allocation did not reflect in any part the efficient modelled costs from GEMA's benchmarking process. Allocations therefore (perversely) reflected the inputs to GEMA's modelling but not the outputs.

17.4 GEMA's approach at the Draft Determinations stage was criticised by all DNOs (including NPg), which expressed concern that the outcome of GEMA's modelling process was not

reflected in the allocations.[67] As explained in Jones 1, NPg criticised GEMA's use of DNOs' submitted cost proportions to inform their respective allocations. NPg argued that GEMA's benchmarking process alters the composition of submitted costs (principally, through the Scenario Adjustments), and that it was therefore crucial that GEMA allocated allowances in a way that was consistent with the basis for those allowances (i.e. that reflects costs deemed to be efficient and appropriate to the Common Scenario GEMA is seeking to fund).[68]

17.5 In response to this criticism, at the Final Determinations stage GEMA changed approach. GEMA adopted a hybrid, or 50:50, approach to allocation, whereby:

(i) a 50% weighting was given to the proportional split of costs by category derived from GEMA's disaggregated modelling of the relevant DNO's costs (which reflect GEMA's view of efficient costs appropriate to the Common Scenario); and

(ii) a 50% weighting was given to the cost proportions (by category) provided in the relevant DNO's submitted costs (i.e. prior to Scenario Adjustments).

18. GEMA's error in its approach to allocating total efficient modelled costs

18.1 This appeal does not challenge GEMA's decision to ask DNOs to identify their own decarbonisation planning scenarios for the purposes of their business plans, the subsequent use of a Common Scenario for the purposes of GEMA's benchmarking process, or the choice of the Common Scenario for that purpose. Nor does it challenge GEMA's assessment of the total amounts that, according to the benchmarking, it would be efficient for the Appellants to spend to deliver the outputs required under the Common Scenario. Further, the Appellants accept the principle that, for the reasons given at paragraph 9.11 above, there is a need in the context of RIIO-ED2 for there to be an allocation between different cost categories with a range of different funding mechanisms.

18.2 The Appellants contend that an error of logic was made at a late and discrete stage of GEMA's cost assessment process (i.e. **Step 6**) which creates an arbitrary disallowance of efficient funding that is inconsistent with the logic and outputs of the benchmarking process and GEMA's intent to fund the efficient costs of the Common Scenario.

18.3 In overarching terms, GEMA's benchmarking process was focussed on identifying the efficient costs of delivering the required outputs of the Common Scenario. As explained at paragraphs 9.5 to 9.6 above, the expected proportions of spend within different cost categories will be materially different under the Common Scenario as compared to NPg's submitted costs because the Common Scenario is based on a very different set of assumptions as to the nature and pace of decarbonisation (and, in particular, levels of electrification). The same will be true of any other DNO that had a business plan that was

[67] The Final Determinations Core Methodology, paragraph 7.640, provided at Tab 3 of **NOA1**.

[68] Jones 1, at paragraphs 46 to 47.

based on materially different assumptions to the Common Scenario (which NPg believes to be the case for all other DNOs, to varying degrees).

18.4 Importantly, GEMA accepts that the allocation process is not designed or intended to adjust DNOs' total efficient modelled costs or reduce final allowances. In other words, the allocation process should not result in the disallowance of funding that has already been determined to be efficient to deliver the required outputs. In the Final Determinations, GEMA expressed this position as follows:

> "*It should be noted that the approach taken to disaggregate allowances* ***does not impact the overall totex allowance*** *but does affect the proportion that is classed as variant (at-risk) and non-variant (fixed) totex*."[69] (emphasis added)

18.5 Notwithstanding GEMA's above remarks, however, a material disallowance has in fact arisen through GEMA's decision to use NPg's submitted cost proportions when allocating total efficient modelled costs between cost categories (which allocation feeds through to final allowances).

(i) As noted above, NPg's business plan assumed a much faster pace of LCT uptake and higher levels of electrification and required a correspondingly higher amount of LRE. This is reflected in the proportional relationships between the various cost categories in NPg's submitted costs, i.e. LRE accounts for a relatively higher proportion of total costs, compared to what would have been the case if the Common Scenario had been used by NPg as the basis for its business plan.

(ii) By contrast, the Appellants' total efficient modelled costs reflect (in addition to the efficiency assessment) the application of Scenario Adjustments to adjust total modelled costs to the level required in the Common Scenario. This is, of course, a scenario for which much lower LRE will be required and, therefore, in which LRE will be a much lower proportion of total costs. Scenario Adjustments stripped out a large proportion of NPg's LRE, significantly altering the proportional split of costs between different categories as compared to NPg's submitted costs. Under NPg's submitted costs LRE accounts for 17% of total costs (for NPgN) and 22% of total costs (for NPgY), whereas the equivalent proportions under the Common Scenario are each 8% (based on the disaggregated modelling).[70]

18.6 Using NPg's submitted costs to inform the allocation of total modelled costs assessed as efficient for that Common Scenario therefore results in a substantial misallocation of final allowances between cost categories.

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[69] The Final Determinations Core Methodology, paragraph 7.635, provided at Tab 3 of **NOA1**. The categories of "*variant…and non-variant…totex*" referred to by GEMA correspond broadly to Contingent Allowances and Fixed Allowances respectively.

[70] See Frontier Misallocation Report, Table 3. Percentages in this Notice have been rounded to the nearest whole number. Totex modelling does not provide outputs that differentiate between costs in different categories.

18.7 GEMA's approach also does not make sense. The proportional relationship between the different cost categories in NPg's submitted costs is inherently uninformative as to the appropriate allocation of NPg's total efficient modelled costs, as assessed by GEMA to be appropriate to the Common Scenario, because submitted costs are based on NPg's own decarbonisation scenario assumptions and not the Common Scenario. Using submitted costs proportions generates inconsistency between what GEMA decided to fund (efficient costs appropriate to the Common Scenario) and how GEMA decided to fund it (allowances allocated to costs categories in proportions appropriate to very different scenarios).

18.8 The effect of this inconsistency is to create real-world detriment for NPg because of the importance in RIIO-ED2 of the distinction between Contingent Allowances and Fixed Allowances.

18.9 Despite the fact that GEMA's intention is that allocation should not affect DNOs' total final allowances GEMA's allocation method has the effect of making some of NPg's final allowances irrecoverable in practice. This is because an over-allocation to cost categories funded by Contingent Allowances means an under-allocation to cost categories funded by Fixed Allowances, relative to the level of expenditure that has been assessed to be efficient and appropriate to the Common Scenario. This creates a shortfall in funding for categories funded by Fixed Allowances that is unaffected by any increases to Contingent Allowances.

18.10 Importantly, this aggregate under-funding arises regardless of the decarbonisation scenario that actually materialises during the RIIO-ED2 price control period. It does not depend on the extent to which NPg's scenario or the Common Scenario turn out to be accurate predictions of future network demands and required investment.

The bulk of the misallocation: secondary reinforcement

18.11 Secondary reinforcement – one of the five cost categories within LRE[71] – is subject to "volume driver" UMs. These volume drivers operate so that the funding DNOs receive for the aspects of secondary reinforcement work covered by the volume drivers will be equal to the volume of work carried out, multiplied by a unit cost set by GEMA. The allowances DNOs will receive for this work are therefore effectively set to zero at the start of the price control period. Allocations to secondary reinforcement are therefore no more than notional, and any excess allocation is effectively lost (because it cannot compensate for

[71] The five cost categories that make up LRE are: secondary reinforcement, primary reinforcement, fault level reinforcement, connections and new transmission capacity charges. These cost categories are explained further in the Frontier Misallocation Report at Annex C.

the corresponding under-allocation to other categories, where the money would have real-world value).[72]

18.12 In this case, NPg's submitted costs had allocated a much higher level of spend to secondary reinforcement. As explained in Nicholson 1, as a result of NPg's high-electrification planning scenario and in particular the demand assumed to be generated by LCT uptake, NPg assessed that a proactive approach to secondary reinforcement would be required during the RIIO-ED2 price control period to resolve capacity constraints on its network.[73]

18.13 As a result of submitted costs being used to inform the allocation of total efficient modelled costs, a higher proportion of NPg's total final allowances have been allocated to this cost category than is appropriate under the Common Scenario. It follows that:

(i) There is an over-allocation to secondary reinforcement and an under-allocation of allowances to other cost categories.

(ii) The Appellants cannot spend money over-allocated to secondary reinforcement to fill the gap in funding of other cost categories because that money is only available to the extent that it is "earned" under the mechanistic volume driver and so necessarily spent on secondary reinforcement. In the particular circumstances of this price control, the over-allocation to secondary reinforcement cannot be redistributed by NPg to make up the corresponding shortfall in other categories.

(iii) The cumulative effect of this is that a proportion of the Appellants' total final allowances – which GEMA has assessed to be efficient – is not available to NPg to spend, however efficiently it operates. Allowances that GEMA has determined to be efficient in other cost categories are effectively stranded in the wrong category (i.e. secondary reinforcement) and, pursuant to the operation of the UMs, overwritten to zero. This cannot be right or what GEMA intended.

18.14 As explained in the Frontier Misallocation Report at paragraphs 4.30 to 4.34 and illustrated at Annex D of that Report, the result is that the Appellants are inevitably under-funded overall, regardless of what decarbonisation scenario arises.

18.15 The irrationality and incoherence of this outcome is most easily illustrated by assuming that network demands develop as anticipated in the Common Scenario. On that basis:

[72] The operation of these volume drivers is explained in more detail at paragraph 4.19 and Annex C of the Frontier Misallocation Report.

[73] Nicholson 1, paragraph 25.

(i) through the disaggregated modelling, GEMA has calculated that the efficient cost for the secondary reinforcement work required of NPg to deliver the Common Scenario outputs on its networks is £110 million; [74]

(ii) despite this, £246 million of the Appellants' allowed costs have been allocated to secondary reinforcement; [75] and

(iii) assuming the Common Scenario comes to pass, the operation of the volume driver UMs applying to secondary reinforcement will result in NPg receiving much less than its notional final allowances for that cost category, but with no corresponding increase in allowances in the under-allocated cost categories. As a result, NPg will not recover the amount that GEMA has determined would reflect its efficient costs in those under-allocated categories if the Common Scenario comes to pass; nor, for that matter, will NPg recover its total final allowances or allowances commensurate with its efficient modelled costs.

Other cost categories within LRE and subject to Contingent Allowances

18.16 Secondary reinforcement is not the only cost category where this issue arises; GEMA's error also impacts other categories of LRE. While the exact way in which this effect arises is somewhat different (because of the use of UMs other than volume drivers), the final result is similar.

18.17 Allowances in the LRE cost categories not covered by the secondary reinforcement volume drivers[76] can vary as a result of two mechanisms:

(i) A "reopener" – a different type of UM – which is intended to provide a basis for additional funding for LRE when a DNO's final allowances in these categories have been spent.[77]

(ii) Ex post "claw back", which will apply if DNOs have spent less than 80% of their final allowances in these cost categories.

18.18 As a result of these mechanisms, the allowances allocated to these cost categories are at least partially Contingent Allowances. The Appellants cannot spend excess money allocated to LRE categories to fill the gap in funding of all other cost categories, because those allowances would then be subject to "claw back" of the notionally underspent amounts. In other words, the allowances are not fungible. In addition, the operation of the "reopener" means that any over-allocation in these categories raises the threshold at

[74] See Frontier Misallocation Report at paragraph 4.67(c)(i).

[75] *Id*, paragraph 4.67(c)(iii).

[76] That is, primary reinforcement, secondary reinforcement (excluding the areas covered by the volume drivers), fault level reinforcement, new transmission capacity charges, connections, and load-related strategic investment.

[77] The operation of the LRE reopener is discussed in the Frontier Misallocation Report at paragraph 4.19 and Annex C.

which additional funding can be accessed for additional work that is required in these categories. The Appellants therefore do not benefit from any over-allocation in these cost categories, but do suffer an under-allocation in other categories. As with secondary reinforcement, any over-allocation to these cost categories results in those surplus notional final allowances being stranded and the Appellants being under-funded overall.

18.19 Again, this under-funding arises regardless of the decarbonisation scenario that materialises during the RIIO-ED2 price control period. As explained in the Frontier Misallocation Report at paragraphs 4.35 to 4.37 and illustrated at Annex D of that Report, the combination of the availability of additional funds through the "reopener" and the possibility of "claw back" of allowances will ensure that allowances will match efficient costs in these LRE categories, while the under-funding in all other cost categories persists under any scenario.

GEMA's justifications for its approach do not withstand scrutiny

18.20 As explained in Jones 1, NPg raised this issue with GEMA on a number of occasions following the publication of the Draft Determinations.[78] GEMA essentially accepted NPg's argument as to 50% of its allocation approach, moving from allocating costs 100% in accordance with DNOs' submitted costs at the Draft Determinations stage, to 50% in the Final Determinations.

18.21 GEMA's justified its approach at the Final Determinations stage on the basis that:

(i) it "*reflects the recommended approach from the majority of the DNOs*";[79]

(ii) the exclusion of either the outcome of the disaggregated or totex modelling "*would lead to a worse overall outcome*" and would be "*subject to criticism from DNOs and stakeholders*";[80]

(iii) GEMA considers it appropriate "*to use the submitted business plans of each DNO to inform cost proportions, as* [GEMA's] *totex workstream does not make any assumption or give any information on how these allowances should be disaggregated*";[81]

(iv) GEMA is satisfied that its "*chosen approach offers the most balanced outcome in terms of allowance allocation*";[82]

[78] Jones 1, paragraphs 46 to 47.

[79] The Final Determinations Core Methodology, paragraph 7.642, provided at Tab 3 of **NOA1**.

[80] *Id*, paragraph 7.643.

[81] *Id*, paragraph 7.645.

[82] *Id*, paragraph 7.646.

(v) "*there are many different approaches that could be undertaken to disaggregate allowances,* […]*, but that ultimately the decision is subject to a degree of regulatory judgement*";[83] and

(vi) "*NPg's preferred approach would provide allowances to NPg on Closely Associated Indirects and Business Support Costs far in excess of its Business Plan submission. In contrast, our chosen approach provides NPg with allowances consistent with its ask for Closely Associated Indirects and Business Support Costs, and a lower LRE allowances which it can then scale up using the LRE UMs*."[84]

18.22 GEMA's explanation for taking this approach does not withstand scrutiny, for the following four reasons.

18.23 First, NPg did not recommend GEMA's approach. In fact, NPg actively opposed the use of proportions derived from submitted costs in the allocation. In its response to the Draft Determinations, NPg made clear that "[a]*pplying a method of disaggregation that uses submitted costs in any way will lead to erroneous mis-allocation of allowances*" and that GEMA "*should not attempt to remedy this by using a blend of disaggregated modelling cost shares and DNO submitted cost shares*".[85]

18.24 As regards other DNOs, it is far from clear that all DNOs understood, prior to Final Determinations, the effects of the misallocation as described above (or that DNOs have not since changed their position). In any case, GEMA cannot rely on a show of hands to excuse irrationality and unfairness in its decision-making.

18.25 Second, GEMA's own hybrid approach does not reflect the outcome of totex modelling and does not provide a "*balanced outcome*" between the totex and disaggregated modelling streams. Submitted costs are an input to both the totex and disaggregated models, but they are not an output of either stream or an appropriate proxy for the output from the totex modelling stream.[86] Moreover, as GEMA recognises in the Final Determinations,[87] totex modelling is a black box. It does not provide an output that is split across cost categories. Therefore, totex modelling does not imply cost proportions

[83] *Id*, paragraph 7.642.

[84] *Id*, paragraph 7.647.

[85] See paragraphs 647 to 648 of NPg's response to the Draft Determinations, provided at Tab 39 of **NOA1**, and extracted at paragraph 47 of Jones 1.

[86] See further the Frontier Misallocation Report, paragraphs 4.72 to 4.74.

[87] GEMA explains that "*to represent our totex workstream within the disaggregation of allowances methodology, we consider it appropriate to use the submitted business plans of each DNO to inform cost proportions, as our totex workstream does not make any assumption or give any information on how these allowances should be disaggregated*" (emphasis added). The Final Determinations Core Methodology, paragraph 7.645, provided at Tab 3 of **NOA1**.

appropriate to the Common Scenario, whereas disaggregated modelling does exactly that.

18.26 Third, GEMA appears to suggest this is a matter of overall regulatory value judgement, but it clearly is not. The question of whether or not to have regard to the proportional split of DNOs' submitted costs in the allocation process is not a matter on which a broad margin of discretion is appropriate. It is irrational and flatly wrong, in this price control, to use proportions derived from submitted costs (based on one decarbonisation scenario) to allocate total efficient modelled costs (based on a different decarbonisation scenario). The only logical approach to allocating allowances is one that reflects GEMA's view of the efficient costs appropriate to the Common Scenario. The approach GEMA has taken is irrational and illogical and produces a result that cannot possibly be what GEMA intended or be justified in light of the objectives of the price control regime.

18.27 Fourth, GEMA's apparent objection to NPg's proposed allocation method on the basis that it would result in allowed costs in respect of closely associated indirect costs[88] and business support costs[89] in excess of the costs that NPg identified for those categories in its business plan is surprising and unprincipled. Specifically:

(i) The objection is surprising because, as set out in the Frontier Misallocation Report at paragraph 4.77, it is commonplace in benchmarking exercises for DNOs to receive allowed costs higher than submitted costs in some categories, and lower in others, depending on where each DNO is assessed by GEMA to be more or less efficient. This is inherent to any fair system of benchmarking. Moreover, as explained at paragraph 9.13 above, Fixed Allowances are fungible. What matters is that the final allowances for those categories are calibrated correctly in aggregate and not the final allowance set for any individual category within the fixed pot.[90] As explained in Jones 1, NPg has been found to be highly efficient on closely associated indirect costs and business support costs in GEMA's disaggregated benchmarking.[91] Notably, even GEMA's current approach to allocation leads to allowed costs higher than DNOs' submitted costs in specific categories. For example, UK Power Networks ("**UKPN**") has received, relative to its business plan figures:

(a) £[redacted] million more for "tree cutting"; and

[88] A category of costs consisting of expenditure related to "back office" functions directly involved in construction and operation of network assets such as project management and network design.

[89] A category of costs consisting of indirect operating expenditure required to support a DNO's overall business, such as human resources and finance departments, property and IT.

[90] See further the Frontier Misallocation Report at paragraph 4.79.

[91] Jones 1, paragraph 53.

(b) £[redacted] million more for condition driven civil works.[92]

(ii) The objection is unprincipled because GEMA's reasoning would imply the application of an unheralded, unjustified and discriminatory further ratchet on final allowances.[93] GEMA has not applied any such ratchet more generally or ever indicated that it would do so in RIIO-ED2. The application of a further category-by-category ratchet would reduce the incentive on DNOs to be ambitious in cost categories where they can outperform the efficiency benchmark.

18.28 The error is a matter of principle, not degree. Having accepted that placing 100% weight on submitted cost proportions in the Draft Determinations was wrong, GEMA's decision to reduce the weighting given to the submitted cost proportions by half does not make this any less of an error. It is an error of principle to use irrelevant cost proportions derived from submitted costs, irrespective of what weighting is then applied to those proportions in the allocation method. Moreover, the impact of GEMA's error remains highly material for the Appellants (see further below).

19. Impact of GEMA's error on the Appellants

19.1 The impact of GEMA's allocation approach will vary by DNO, depending on their chosen planning scenario (and underlying assumptions) and relative efficiencies in different cost categories.

19.2 This misallocation affects the Appellants more severely than other DNOs because their submitted costs were relatively efficient and there is a greater difference between the Common Scenario, on the one hand, and the decarbonisation scenario and planning assumptions used by the Appellants for their business plan, on the other hand. Specifically:

(i) After NPgY's plan had passed through GEMA's cost assessment process, only 12% of its final allowances relate to LRE to deliver the Common Scenario (based on cost shares from the disaggregated modelling). The remaining 88% should properly be allocated to fund all other efficient activities appropriate to that scenario. However, under GEMA's methodology, all of NPgY's other cost categories receive just 81% of NPgY's final allowances.

(ii) The same is true for NPgN, with only 10% of its final allowances relating to LRE to deliver the Common Scenario (based on cost shares from the disaggregated modelling). However, as a result of GEMA's methodology, 15% of NPgN's final allowances are allocated exclusively for use on LRE.

[92] See further Frontier Misallocation Report, paragraph 4.76.

[93] GEMA has already applied a ratchet at the total cost level, setting total allowed costs at the lower of each DNO's submitted and efficient modelled costs. See further paragraph 4.80 of the Frontier Misallocation Report.

(iii) As set out in the Frontier Misallocation Report at Annex A, the ultimate result of this misallocation is that NPgY's core business is underfunded by c. £104 million and NPgN's core business is underfunded by c. £53 million. In total, the Appellants are underfunded by c. £157 million relative to the allowances that GEMA determined would be efficient and appropriate to the Common Scenario.

19.3 It is important to note that this irrational outcome persists even if GEMA's assumptions as to how network demands will develop turn out to be inaccurate. Contingent Allowances would adjust up or down in accordance with the UMs, but Fixed Allowances would of course stay the same.

19.4 On any future outcome, relying on NPg's submitted cost proportions to inform the allocation of the Appellants' total efficient modelled costs results in costs being incorrectly allocated to cost categories funded by Contingent Allowances and, therefore, effectively disallowed.

20. GEMA should have allocated DNOs' total efficient modelled costs on a basis that is consistent with its view of efficient costs appropriate to the Common Scenario

20.1 Instead of pursuing the hybrid approach adopted in the Final Determinations, GEMA should have allocated DNOs' total efficient modelled costs (and subsequently, final allowances) on a basis that is consistent with its view of efficient costs appropriate to the Common Scenario.

20.2 As the Frontier Misallocation Report explains, the logical approach is to allocate in accordance with the cost proportions resulting from GEMA's own disaggregated modelling. This is for the following key reasons:

(i) The disaggregated modelled costs reflect GEMA's view of efficient costs appropriate to the Common Scenario, at a granular cost category level.

(ii) It is consistent with the UMs, as the resulting allocation of final allowances would reflect the baseline costs under the Common Scenario, from which the UMs can flex funding up or down.

(iii) The final allowances allocated to secondary reinforcement using this method can be replicated on a bottom-up basis by using unit costs and volumes from GEMA's disaggregated modelling, which captures expenditure appropriate to the Common Scenario. This cross-check demonstrates that allocating total final allowances on the basis of the cost proportions resulting from GEMA's disaggregated modelling matches the reality of the expenditure determined to be efficient and appropriate to the Common Scenario.[94]

[94] This cross-check is set out at paragraph 4.67(c) of the Frontier Misallocation Report.

(iv) It is possible to see in the disaggregated modelling how GEMA has adjusted costs to bring them into line with the Common Scenario (via workload adjustments). There is therefore no risk of failing to capture Scenario Adjustments fully.

(v) GEMA has recognised the disaggregated modelling proportions as a valuable source of information and a valid methodology – this approach was one of three options for allocating allowances mentioned in the Draft Determinations,[95] and it makes up 50% of GEMA's hybrid approach adopted in the Final Determinations.

(vi) This approach is consistent with GEMA's approach at RIIO-ED1, where it used proportions resulting from disaggregated modelled costs to allocate the portion of allowances that had been set through its totex and disaggregated benchmarking models.

(vii) Implementing this approach would be very straightforward. GEMA has built a toggle into its cost assessment models that allows it to switch between three allocation methods: (a) using submitted cost proportions; (b) using cost proportions from the disaggregated modelling; and (c) using a 50/50 weighting of (a) and (b), i.e. GEMA's current approach. Moreover, making this change would not require changes to any prior steps of GEMA's cost assessment process.[96]

21. Legal grounds of appeal

21.1 Accordingly, the Decision was wrong in that:

(i) the Decision was based on an error of fact (section 11E(4)(c) EA89), in that GEMA used submitted cost proportions in the allocation method on the erroneous basis that such proportions are a proxy for the output of its totex modelling;

(ii) the modifications fail to achieve the effect stated by GEMA (section 11E(4)(d) EA89) in that:

(a) GEMA stated in the Final Determinations[97] that allowances for LRE under the modified price control would be calibrated to the Common

[95] See RIIO-ED2 Draft Determinations – Core Methodology Document, paragraph 7.482, provided at Tab 5 of **NOA1**.

[96] Frontier Misallocation Report, paragraph 4.67(e) and section 5.

[97] In the "Statutory consultation on the RIIO-ED2 licence drafting modifications – reasons and effect" (14 December 2022) provided at Tab 6 of **NOA1**, GEMA stated the effect of the modifications to Chapter 2 of the Special Conditions was (amongst other things) to "*bring into effect our decisions set out in the Final Determinations*".

Scenario[98] and that the approach taken to allocation would "*not impact the overall totex allowance*"[99]; whereas

(b) for the reasons set out above and because of the erroneous approach taken to allocation, the price control introduced by the modifications does not achieve either of these effects as regards the Appellants' allowances; and

(iii) GEMA erred in law (section 11E(4)(e) EA89), by acting irrationally in its use of submitted cost proportions in the allocation method.

21.2 In addition, GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties, in particular under section 3A(2)(b) EA89 (securing that licence holders are able to finance their activities) because GEMA's approach to allocation results in the Appellants being materially under-funded relative to their assessed-to-be efficient costs and the outputs the Appellants are required to produce.

22. Relief sought

22.1 The Appellants request that the CMA under section 11F(2) EA 1989:

(i) quashes GEMA's decision on allocation as regards the Appellants; and

(ii) substitutes for that decision its own decision, namely that the Appellants' total efficient modelled costs be allocated between cost categories in the proportions derived from the disaggregated modelling.

22.2 In the alternative, the Appellants request that the CMA:

(i) makes a quashing order; and

(ii) remits the matter to GEMA under section 11F(2)(b) EA89 with directions as to how to conduct the allocation as regards the Appellants. As to the content of such directions, NPg submits that the CMA should direct GEMA to allocate the Appellants' total efficient modelled costs between cost categories in the proportions derived from the disaggregated modelling.

22.3 The Appellants request that the CMA should order GEMA to pay the Appellants' costs of the present proceedings.

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[98] The Final Determinations Core Methodology, provided at Tab 3 of NOA1, paragraphs 3.9 and 3.20.

[99] *Id*, paragraph 7.635.

22.4 The detailed application of the proposed relief is set out at section 5 of the Frontier Misallocation Report.

PART VI: BPI STAGE 4 REWARD

23. Overview

23.1 This Part of the Notice concerns GEMA's calculation of the BPI Stage 4 reward.

23.2 The CMA is directed by way of further background to this issue to:

(i) the Frontier BPI Report; and

(ii) NPg's Final Determinations Question ("**FDQ**") relating to the BPI Stage 4 reward and GEMA's response.[100]

23.3 In summary, the Appellants submit that GEMA was wrong to use disaggregated modelled costs after the application of workload adjustments as the basis to calculate the BPI Stage 4 reward. This approach is at odds with the logic of the process as well as inconsistent with the approach taken elsewhere by GEMA in the cost assessment process. It also creates an arbitrary difference in treatment between DNOs to the detriment of DNOs in the position of the Appellants.

23.4 Accordingly, GEMA's Decision not to grant any BPI Stage 4 reward to NPgY was wrong by reference to the statutory grounds detailed below.

23.5 The impact of GEMA's error is that NPgY does not receive a BPI Stage 4 reward (of £15 million), which, but for GEMA's error, it would have received. GEMA assessed NPgY as the second-most efficient DNO (by efficiency score), but only the DNOs ranked first and third received BPI Stage 4 rewards.

23.6 The Appellants request the relief identified in Section 29 below.

24. GEMA's approach to calculating the BPI Stage 4 reward

24.1 The BPI is a set of incentives with four stages, with each stage operating independently to provide a financial reward or penalty depending on certain properties of DNOs' business plans. Only the BPI Stage 4 reward is relevant to this appeal.

24.2 Eligibility for a BPI Stage 4 reward is based on a comparison of each DNO's submitted costs with costs drawn from GEMA's modelling. GEMA states that DNOs will be eligible for a reward where "*their high-confidence costs meet our benchmark*".[101] The stated principal aim of the reward is to "*reflect the added value* [GEMA] *may get from information*

[100] NPg's FDQ and GEMA's response are provided at Tab 13 of **NOA1**.

[101] RIIO-ED2 Final Determinations Overview Document, paragraph 9.54, provided at Tab 4 of **NOA1**.

revealed in setting more accurate price controls for other companies"[102] – in other words, to reward DNOs for providing information that enables GEMA to set efficient allowances.

24.3 The upshot of this comparison is that a reward is given if GEMA's modelled costs are higher than the value of the modelled proportion of the relevant DNO's submitted costs. In that case, a DNO has "beaten" GEMA's benchmark and provided information of value for the price control process (in principle, allowing the identified level of efficient costs to be lower than it otherwise would have been).

24.4 For the purpose of comparing DNOs' submitted and GEMA's modelled costs in the BPI Stage 4 reward, DNOs' submitted costs were naturally prepared on the basis of each DNO's own planning scenario.[103] There is no complaint about this.

24.5 On the other side of the comparison, GEMA used modelled costs for each DNO that were a weighted average of costs taken from its totex and disaggregated modelling streams. It is in the selection of the inputs for this weighted average that GEMA made an error:

(i) For one half of the calculation of modelled costs – totex modelled costs – GEMA used the results of the totex modelling before any Scenario Adjustments (which were made in the totex modelling through the DDA). This correctly ensures that the totex modelled costs used in the BPI Stage 4 reward calculation are on a like for like basis with DNOs' submitted costs (i.e. without stripping out from modelled costs the additional costs that are attributable to the DNO's use of a higher electrification planning scenario, rather than any lack of efficiency).

(ii) However, for the other half of the calculation of modelled costs – disaggregated modelled costs – GEMA did apply Scenario Adjustments, through using modelled costs after "workload adjustments". These modelled costs are effectively premised on a different scenario from DNOs' submitted costs, such that like is not compared with like.

25. GEMA's error in its approach to calculating the BPI Stage 4 reward

25.1 By taking half of the modelled costs after Scenario Adjustments, GEMA's approach inappropriately makes it harder for a DNO to achieve an award where there is a significant difference in the decarbonisation scenario assumptions underpinning that DNO's business plan as compared to the Common Scenario. A DNO's selection of scenario assumptions has no relationship with the BPI Stage 4 reward's underlying stated rationale of incentivising efficient plans.

25.2 Submitted costs reflect each DNO's planning scenario assumptions and provide information in relation to the DNO's costs based on those assumptions. To assess

[102] RIIO-ED2 Sector Methodology Decision, Annex 2 Keeping bills low for consumers, paragraph 10.59, provided at Tab 12 of **NOA1**.

[103] The lack of consistency between DNOs' planning scenarios is discussed at Section 8 of Part II above.

whether a DNO has submitted a business plan with efficient costs (and thereby provided valuable information to GEMA), GEMA's modelled costs must be compared with submitted costs on a like for like basis, i.e. before adjustments to bring costs into line with the Common Scenario. Otherwise, GEMA contaminates its assessment of whether a plan provides information as to efficient costs; real efficiency differences are swamped by differences attributable to choice of planning scenario.

25.3 This error is particularly significant for NPg. NPg's relatively high electrification planning scenario inevitably results (all else being equal) in higher submitted costs. The disaggregated modelled costs for NPg are accordingly subject to larger workload adjustments. If the comparison to submitted costs is done after workload adjustments are applied to modelled costs, NPg's submitted costs will of course appear high by comparison to modelled costs, making it harder for NPg to achieve a BPI Stage 4 reward. But this is an artefact of scenario choices and is uninformative as to efficiency.

25.4 GEMA's approach to the BPI Stage 4 reward is also inconsistent with the approach it has taken to the efficiency ranking of DNOs. In another stage of the price control, GEMA attributes an "efficiency score" to each DNO. The efficiency scores are then used to set the "catch-up" efficiency challenge for all DNOs. These scores were, correctly, calculated before any workload adjustments to disaggregated modelled costs. In the resulting ranking, NPgY ranks as the second-most efficient DNO, between South Eastern Power Networks plc ("**SPN**") (first) and London Power Networks plc ("**LPN**") (third).

25.5 Despite this, under the BPI Stage 4 reward, SPN and LPN are granted a reward and NPgY is not, simply due to the erroneous inclusion of workload adjustments in the modelled costs used for comparison.[104] This shows that GEMA's approach is not achieving its aim, is irrational and creates an arbitrary difference in treatment. It is not rewarding NPgY for submitting efficient allowances that have been used to set the catch-up efficiency challenge but is rewarding a DNO that has a lower efficiency score than NPgY.

25.6 Inconsistently with its approach to calculating efficiency scores, GEMA has recently disputed that workload adjustments correct for scenario differences. In response to NPg's FDQ raising the error in the calculation of the BPI Stage 4 reward, GEMA wrote that workload adjustments "*do not reflect scenario adjustments in the case of most cost activities where they are present*". That is technically correct: most of the cost categories affected by workload adjustments are not categories for which costs differences are likely attributable to differences in scenario. There are several categories of cost that would not be expected to vary substantially depending on scenario differences but in relation to which relatively small workload adjustments are made. Tree cutting is an obvious example. These small adjustments appear to be efficiency-related, rather than scenario-driven.

[104] SPN and LPN are both part of UKPN. UKPN's business plan also assumed a higher electrification planning scenario than the Common Scenario, but was nonetheless much closer to the Common Scenario than NPg's planning scenario.

25.7 That is, however, largely beside the point. By value, workload adjustments are overwhelmingly scenario-driven. For NPgY, workload adjustments total £[redacted] million, of which £[redacted] million comprise a reduction to secondary reinforcement costs, which is a reduction made to bring NPgY's submitted costs in line with the Common Scenario. These Scenario Adjustments predominate in and characterise the workload adjustments as a whole.[105]

25.8 As noted above, for the purposes of efficiency scores GEMA used modelled costs before workload adjustments, apparently recognising in that context that workload adjustments (by value) are driven overwhelming by differences between scenarios, even if there are several cost categories where adjustments are likely driven by efficiency assessments, rather than scenario differences. GEMA should have taken the same approach – recognising the predominant purpose and effect of workload adjustments to be Scenario Adjustments – when it came to the BPI Stage 4 reward.

25.9 As implemented, GEMA's test for the BPI Stage 4 reward is therefore wrong.

26. GEMA should have used the disaggregated modelled costs pre-workload adjustments

26.1 In the BPI Stage 4 reward calculation, GEMA should use disaggregated modelled costs before the application of workload adjustments. This would be consistent with the use of totex modelled costs before the application of the DDA, and with GEMA's approach to calculating efficiency scores. Adopting this approach would not require any consequential changes to any other aspect of the BPI reward scheme.

27. The impact of GEMA's error

27.1 In its Final Determinations, GEMA has given a BPI Stage 4 reward only to SPN and LPN. NPg has not been given a BPI Stage 4 reward.

27.2 If the BPI Stage 4 reward is calculated before all workload adjustments (as with efficiency scores), NPgY would receive a BPI Stage 4 reward of £15 million.

27.3 If instead the BPI Stage 4 reward is calculated before workload adjustments to secondary reinforcement are applied (but after the small workload adjustments to other cost categories), NPgY would receive a BPI Stage 4 reward of £13 million.

[105] Details of the workload adjustments and the materiality of their components are discussed in detail in Annex A of the Frontier BPI Report.

28. Legal grounds of appeal

28.1 Accordingly, the Decision was wrong in that:

(i) the Decision was based on errors of fact (section 11E(4)(c) EA89), in that GEMA erroneously proceeded on the basis that workload adjustments in the disaggregated modelling are (or are predominantly) reflective of efficiency judgments, as opposed to adjusting for differences between scenarios;

(ii) the modifications fail to achieve the effect stated by GEMA (section 11E(4)(d) EA89) in that:

(a) GEMA stated[106] that a BPI Stage 4 reward would be provided to any DNO whose high confidence costs beat an independent benchmark; whereas

(b) as set out above, NPgY's high confidence costs did beat the appropriate independent benchmark (modelled costs prior to Scenario Adjustments), yet it wrongly did not receive any reward; and

(iii) GEMA erred in law (section 11E(4)(e) EA89), by acting irrationally in its calculation of the BPI Stage 4 reward.

28.2 In addition, GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties because GEMA's approach to calculating the BPI Stage 4 reward results in NPgY not receiving a material BPI Stage 4 reward, which, but for GEMA's error, it would have received.

29. Relief sought

29.1 The Appellants request that the CMA under section 11F(2) EA89:

(i) quashes GEMA's decision on BPI Stage 4 reward as regards the Appellants; and

(ii) substitutes for that decision its own decision, namely that disaggregated modelled costs be assessed before the application of workload adjustments for the purposes of the BPI Stage 4 reward calculation, or, in the alternative, before the application of any workload adjustments in respect of secondary reinforcement.

29.2 In the alternative, the Appellants request that the CMA:

[106] Specifically, in the Final Determinations Overview Document, provided at Tab 4 of **NOA1**, at paragraph 9.54 (referring implicitly back to the detail on the operation of the BPI Stage 4 reward in "RIIO-ED2 Sector Methodology Decision, Annex 2 Keeping bills low for consumers", provided at Tab 12 of **NOA1**, paragraphs 10.57 to 10.59).

(i) makes a quashing order; and

(ii) remits the matter to GEMA under section 11F(2)(b) EA89 with directions as to how to treat Scenario Adjustments in the determination of modelled costs for the purposes of the BPI Stage 4 reward calculation to ensure that appropriately comparable baseline scenarios for those costs are used. The Appellants submit that those directions should require disaggregated modelled costs to be assessed before the application of workload adjustments for the purposes of the BPI Stage 4 reward calculation. In the alternative, GEMA should be directed not to apply any workload adjustments in respect of secondary reinforcement as part of the calculation.

29.3 The Appellants request that the CMA should order GEMA to pay the Appellants' costs of the present proceedings.

PART VII: CHRONOLOGY

This chronology sets out the key events leading up to GEMA's Decision.

Date	Event
7 March 2018	GEMA released the RIIO-2 Framework Consultation (**NOA1**, Tab 14).
30 July 2018	GEMA published the RIIO-2 Framework Decision (**NOA1**, Tab 15).
18 December 2018	GEMA published the RIIO-2 Sector Specific Methodology Consultation (**NOA1**, Tab 16).
24 May 2019	GEMA published the RIIO-2 Sector Specific Methodology Decision (**NOA1**, Tab 17).
3 June 2019	GEMA published an updated version of the RIIO-2 Business Plan Guidance (**NOA1**, Tab 18).
6 August 2019	GEMA published the RIIO-ED2 Open Letter Consultation (**NOA1**, Tab 19).
9 September 2019	GEMA published a further revised version of the RIIO-2 Business Plan Guidance (**NOA1**, Tab 20).
11 October 2019	NPg submitted its response to the RIIO-ED2 Open Letter Consultation (**NOA1**, Tab 21).
17 December 2019	GEMA published its Decision on the RIIO-ED2 Framework (**NOA1**, Tab 22).
6 July 2020	The NGESO published the FES 2020 (**NOA1**, Tab 23).
30 July 2020	GEMA published the RIIO-ED2 Methodology Consultation (**NOA1**, Tab 24).
4 August 2020	GEMA published the RIIO-ED2 Draft Business Plan Guidance (**NOA1**, Tab 25).
16 September 2020	NPg published its Emerging Thinking paper (**NOA1**, Tab 26).
1 October 2020	NPg submitted its response to the RIIO-ED2 Methodology Consultation (**NOA1**, Tab 27).
17 December 2020	GEMA published the RIIO-ED2 Methodology Decision (**NOA1**, Tab 11).
22 December 2020	NPg published a first draft of its DFES 2020 (**NOA1**, Tab 28).
1 February 2021	GEMA published the RIIO-ED2 Business Plan Guidance (**NOA1**, Tab 29).
22 April 2021	GEMA published a revised version of the RIIO-ED2 Business Plan Guidance (**NOA1**, Tab 30).
1 June 2021	NPg published its final DFES 2020 (**NOA1**, Tab 31).
1 July 2021	NPg submitted a draft of the NPg business plan to GEMA (**NOA1**, Tab 32).
29 September 2021	September 2021 bilateral meeting between GEMA and NPg took place (**NOA1**, Tab 33).
30 September 2021	GEMA published the final version of the RIIO-ED2 Business Plan Guidance (**NOA1**, Tab 34).

Date	Event
1 December 2021	NPg submitted the NPg business plan to GEMA (**NOA1**, Tab 9).
17 January 2022	NPg's Customer Engagement Group published its ED2 Final Report (**NOA1**, Tab 35).
8 February 2022	The RIIO-2 Challenge Group published the RIIO-2 Challenge Group Report (**NOA1**, Tab 36).
17 March 2022	The ED2 Open Hearing conducted by GEMA regarding the NPg Business Plan took place (**NOA1**, Tab 37).
29 June 2022	GEMA published the RIIO-ED2 Draft Determinations (**NOA1**, Tab 5).
11 August 2022	August 2022 bilateral meeting between GEMA and NPg took place (**NOA1**, Tab 38).
25 August 2022	NPg submitted its response to the Draft Determinations (**NOA1**, Tab 39).
30 November 2022	GEMA published the RIIO-ED2 Final Determinations (**NOA1**, Tab 3).
14 December 2022	GEMA published the RIIO-ED2 Statutory Licence Consultation (**NOA1**, Tab 6).
December 2022 - January 2023	NPg submitted several questions to GEMA regarding the errors it had identified in the Final Determinations as part of the FDQs process (**NOA1**, Tab 13).[107]
13 January 2023	GEMA responded to NPg's FDQ on the BPI Stage 4 reward (**NOA1**, Tab 13).
3 February 2023	GEMA published the Decision (**NOA1**, Tabs 1 and 0).

[107] The document included at Tab 13 of **NOA1** is NPg's FDQ in relation to the BPI Stage 4 reward and GEMA's response, which is relevant to this appeal.

PART VIII: STATEMENT OF TRUTH

The Appellants believe that the facts stated in this Notice of Appeal are true.

SIGNED [redacted]

PHILIP JONES

DATED **2 March 2023**

for and on behalf of Northern Powergrid (Northeast) Plc

SIGNED [redacted]

PHILIP JONES

DATED **2 March 2023**

for and on behalf of Northern Powergrid (Yorkshire) Plc