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24 April 2023

**Application for Permission to Intervene in Energy Licence Modification Appeal 2023**

For the attention of the CMA Panel

**Summary of Intervention Notice**

*Introduction*

1. Citizens Advice wishes to intervene, to oppose this appeal, as part of its statutory role to represent domestic and small business energy consumers in Great Britain.

2. Allowing this appeal would grant Northern Powergrid (NPg) significant additional revenue[1], to be funded by consumers, without any related improvement in service or investment. We do not believe that this is justified. We note that in its submission, NPg has not offered any argument or evidence for why this appeal is in the best interest of their customers, or consumers more generally. We, similarly, have been unable to find any such arguments.

3. Any unjustified returns for network companies arising from RIIO-2 add unfair cost to consumers' bills (at the time of an energy and cost of living crisis). We also believe unjustified returns will erode the credibility of the regulatory regime and so damage customer trust. Trust will be vital to net zero delivery. This must mean that there is a high burden of proof to allow network companies additional money.

[1] According to Notice of Appeal, up to £171m

4. NPg claims to be underfunded but has not provided any evidence that this will occur in reality, preferring instead to compare allowances with a notional figure that it has previously raised concerns over.

5. NPg has not demonstrated that it will receive allowances at a level below what it expects to spend. It has simply demonstrated that if you calculate allocations using a different method you get a different answer (that is favourable to NPg).

6. Indeed, when comparing with NPg's business plan - which should theoretically represent NPg's view of actual required expenditure - there is evidence that NPg would be over-funded if their preferred allocation method was followed.

7. So, there does not appear to be any credible risk that NPg will be underfunded or, as a consequence, be unable to make acceptable returns on investment. This means that allowing this appeal would lead to substantial windfall gains for NPg.

8. This should be seen in the context that UK regulated networks companies have generally and consistently enjoyed high returns through regulatory settlements that have proved too generous. This is why the returns enjoyed by network companies have come under considerable scrutiny for a number of years. Allowing windfall gains, on top of an already generous settlement, is likely to bring the overall regulatory regime under further pressure. A stable regulatory regime is important for consumers, particularly with the increase in investment required for net zero.

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**Citizens Advice request to intervene**

9. This is an Application to Intervene by Citizens Advice. We make this request to intervene in this appeal as an interested third party in accordance with the provisions of the Acts and the Energy Licence Modification Appeals Rules and Guide. Citizens Advice opposes this appeal.

10. The application is necessarily based on publicly available information only. We have not had access to any appeal documents other than those available through the CMA website. Our analysis is also limited to data published.

*Material interest*

11. We are the statutory consumer voice for energy in Great Britain, and the consumers that we represent have an interest in this appeal as they may be materially affected by this decision given the additional amounts that consumers will pay if NPg is successful. We also have a material interest in the outcome of the appeal as a party that has capacity to appeal the Energy Licence Modification in its own right under the Electricity Act 1989[2].

*Unique perspective*

12. Citizens Advice provides a unique perspective that will assist the CMA in the determination of this appeal. As the statutory consumer advocate for energy, Citizens Advice have been heavily engaged in the RIIO process and so can provide informed insight. We intervened previously in the 2021 RIIO-GD2 and T2 appeals process[3]. As in RIIO-GD2 and T2, we have again represented the interests of consumers at each stage of the RIIO-2 price control process[4]. We have worked closely with energy network companies, customer engagement groups, consumers, the RIIO-2 Challenge Panel, and Ofgem.

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[2] Electricity Act 1989, 11C
[3] Citizens Advice (2021) Application for Permission to Intervene in Energy Licence Modification Appeal 2021
[4] Most recently, see Citizens Advice (2022) Response to the RIIO ED2 Draft Determinations

*Proportionate approach*

13. Our evidence is regarding Ground 1 because of the higher materiality. In particular, it will focus on our assessment of potential consumer detriment arising from providing allowances that are not justified.

14. We believe this is a proportionate approach to intervening. It should not be interpreted as support for any aspects we do not comment upon.

*Further engagement*

15. We request access to the following information that we have not been able to review. We request permission to make a later submission (as per Rule 10.4) to the CMA Panel if we wish to make further comments following our review of these documents.
    a. Witness statements and supporting documents provided to the CMA Panel by NPg.
    b. Witness statements and supporting documents provided to the CMA Panel by the Gas and Electricity Markets Authority (GEMA) or Ofgem.
    c. Any witness statements and supporting documents provided to the CMA Panel by other parties.

16. We wish to attend any hearings and would welcome the opportunity to make oral representations.

## Ground 1: allocation of total expenditure

17. Allowing this appeal would grant NPg significant additional revenue[5], to be funded by consumers, without any related improvement in service or investment. We do not believe that this is justified. We note that in its submission, NPg has not offered any argument or evidence for why this appeal is in the best interest of their customers, or consumers more generally. We, similarly, have been unable to find any such arguments.

*No evidence of underfunding*

18. We do not believe that NPg will be underfunded and, instead, allowing this appeal will simply allow NPg to make additional returns over and above the allowed cost of capital.

19. NPg chooses to define underfunding by comparing to the results of Ofgem's disaggregated benchmarking[6]. This is clearly wrong as it relies upon having confidence that the disaggregated modelling can be taken as a reliable view of efficient costs (at an activity level). NPG's appeal overall seeks to argue that the disaggregated modelling should be taken as the sole view of efficient costs[7]. This means that the NPg definition of underfunding relies upon its central argument, to which it aims to support, being accepted. We are also surprised the NPg believes this is sensible given the extensive criticism[8] it has previously made about disaggregated benchmarking, for example: '*the distorted outcomes from granular disaggregated benchmarking can be especially costly to customers'*[9].

20. From a consumer perspective, underfunding should simply be where funding is below expenditure[10]. We note that NPg does not present evidence that it will spend in excess of their total expenditure (totex) allowance or that it will be unable to complete the necessary work. We do not believe that there is any

[5] Up to £171m, based on NPg figures from the notice of appeal
[6] Notice of appeal: '*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****.'* Emphasis added.
[7] As per the proposed remedy in the notice of appeal
[8] Northern Powergrid (2021). Business plan Annex 6.3 Cost Benchmarking
[9] Ibid pg2
[10] Including cost of capital

reason to believe that NPg will spend more than their totex allowances and so be underfunded.

21. A sense-check on the outputs from NPg's preferred method of allocating the totex allowance indicates that this may result in NPg being over-funded, at the expense of consumers. Our analysis shows that the effect of using NPg's preferred method is to move allowances from Load Related Expenditure (LRE) to Closely Associated Indirects (CAI) and Business Support Costs (BSC). As the below table shows, this gives values for CAI and BSC that are higher than those included in NPg's business plan submission.

| £m | **Business Plan**[11] | **Final Determinations**[12] | **NPg allocation**[13] | **Difference (vs FD)** |
|---|---|---|---|---|
| **Load Related Expenditure**[14] | 637 | 386 | 235 | -151 |
| **Closely Associated Indirects** | 621 | 613 | 703 | 90 |
| **Business Support Costs** | 304 | 301 | 346 | 45 |
| **Remainder** | 1,724 | 1,468 | 1,484 | 16 |
| **Total**[15] | 3,286 | 2,768 | 2,768 | 0 |

22. This is despite the reduction in scope of activity, reflected in the lower LRE baseline, which would be expected to lead to a corresponding reduction in CAI and BSC. NPg's business plan, the basis on which it had conducted stakeholder and consumer engagement, proposed that for £1 of LRE around £1.45[16] of CAI and BSC would be required. Under NPg's preferred allocation method for each £1 of LRE around £4.45[17] of CAI and BSC would be required. This is a very different proposition to the one engagement activity was based upon. This does not appear to be in consumers' interests and also risks undermining the value of stakeholder engagement.

[11] From RIIO-ED2 Final Determination NPg Annex
[12] From RIIO-ED2 Final Determination NPg Annex Net before NPCA
[13] Allocation proportions from disaggregated benchmarking inferred from the business plan proportions and Final Determinations proportions, from NPg Annex. Rounding errors will occur as allowances are given in whole numbers.
[14] Sum of Connections, New Transmission Capacity Charges, Primary, Secondary and Fault Level Reinforcement
[15] 'Cost Activities sub-total'
[16] Comparing Load Related Expenditure with CAI and BSC, from 'Business Plan'
[17] Comparing Load Related Expenditure with CAI and BSC, from 'NPg allocation'

23. In summary:
    a. NPg submitted a business plan showing high levels of LRE, alongside values for the CAI and BSC required to support this. It has been provided with CAI and BSC at around these values at Final Determinations, despite the significantly reduced level of activity.
    b. As explained in the Notice of Appeal, LRE allowances can be broadly expected to move with the level of actual activity due to the uncertainty mechanisms in place[18]. Also, an 'Indirects Scalar'[19] has been included which provides additional funding for indirect costs as the level of LRE increases.
    c. Combining these high values for CAI and BSC, with the potential for additional funding through the Indirects Scalar, and a value for LRE that will move with actual activity, this is likely to lead to an overall value that is too high. This further reinforces that NPg has not been underfunded.

*Choice of allocation methodology*

24. This strange outcome, arising from using the results of disaggregated benchmarking for totex allocation, also demonstrates that Ofgem could not reasonably have been expected to have relied on this. Indeed, we believe that Ofgem would have been failing in its duty to protect consumers had it chosen to do so.

25. Given this, a different method of allocating totex is required instead of, or addition to, using disaggregated benchmarking. Using companies' business plans provides the alternative approach that is required. We are not aware of any other alternatives.

*Impact of regulatory regime on risk of underfunding*

26. In order to understand how realistic the prospect of NPg being underfunded is, it is important to consider the context of the regulatory regime that NPg operates in. Within the RIIO-1 price controls for ED, GD and ET sectors, underspending

[18] Notice of Appeal: '*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.*'
[19] Ofgem (2022): Final Determinations Core Methodology pg333

against allowances is routine with few instances of overspending, as the below table shows:

| Price control | Group | Allowance £m | Expenditure £m | Difference £m | % |
|---|---|---|---|---|---|
| ED1 | ENWL | 2,085 | 1,917 | -168 | -8.1% |
| | NPg | 3,425 | 3,435 | 10 | 0.3% |
| | NGED | 7,782 | 7,635 | -147 | -1.9% |
| | UKPN | 6,838 | 6,020 | -819 | -12.0% |
| | SPEN | 3,699 | 3,828 | 129 | 3.5% |
| | SSEN | 4,128 | 4,189 | 61 | 1.5% |
| GD1 | Cadent | 9,375 | 8,891 | -483 | -5.2% |
| | NGN | 2,266 | 1,968 | -299 | -13.2% |
| | SGN | 5,533 | 4,666 | -867 | -15.7% |
| | WWU | 2,302 | 1,867 | -435 | -18.9% |
| T1 | NGET | 13,217 | 9,914 | -3,303 | -25.0% |
| | SPT | 2,435 | 2,272 | -162 | -6.7% |
| | SHET | 3,669 | 3,361 | -307 | -8.4% |
| | **Total** | **66,754** | **59,963** | **-6,790** | **-10.2%** |

*Ofgem RIIO-1 Network Annual Reports data (rounding differences are Ofgem figures)*[20]

27. Indeed, some networks voluntarily returned money during this period. Ofgem also introduced the Green Recovery Scheme[21], which made use of excess funding that had been provided to bring forward investment.

28. This is a repeated pattern across price controls as the CMA previously acknowledged: '*We accept GEMA's assessment that, on average, there has been significant totex outperformance in previous energy price control periods*'[22]. This should be taken into account when assessing if NPg is likely to receive funding below that required to meet expenditure and so whether it has been underfunded.

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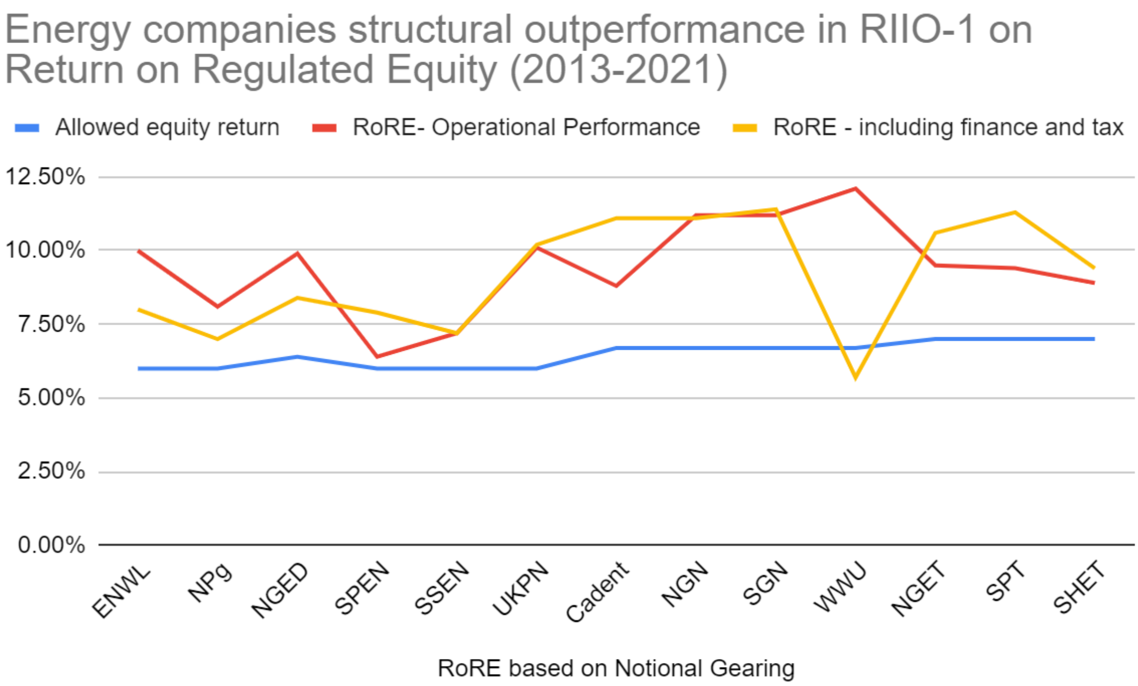
[20] Ofgem (2022): RIIO-ET1 Network Performance Summary 2020-21, Ofgem (2022): RIIO-GT1 Network Performance Summary 2020-21, Ofgem (2022): RIIO-GD1 Network Performance Summary 2020-21, Ofgem (2022): RIIO-ED1 Network Performance Summary 2020-21

[21] Ofgem (2021): Decision on RIIO-ED1 Green Recovery Scheme

[22] CMA (2021): RIIO-2 Appeal Volume 2B

29. There is strong evidence of structural outperformance in RIIO-1 and previous price controls. Being provided allowances that are too high is one part of that. Across RIIO-1, despite numerous instances of failure to meet performance targets or forecast failure to meet targets across electricity transmission[23], gas transmission[24], gas distribution[25] and electricity distribution[26] current expectations are that nearly all companies will outperform compared to their allowed Cost of Equity:




*Ofgem 2020-21 RIIO-1 network performance data*[27]

30. In a well-calibrated price control settlement, we would expect to see companies' performance distributed around the allowed Cost of Equity. That companies are generally distributed above the allowed Cost of Equity demonstrates the structural outperformance.

[23] Ofgem (2022): [RIIO-ET1 Network Performance Summary 2020-21]
[24] Ofgem (2022): [RIIO-GT1 Network Performance Summary 2020-21]
[25] Ofgem (2022): [RIIO-GD1 Network Performance Summary 2020-21]
[26] Ofgem (2022): [RIIO-ED1 Network Performance Summary 2020-21]
[27] Ofgem (2022): [Supporting data file to Regulatory financial performance annex to RIIO-1 Annual Reports - 2020-21]

*ED2 should be expected to already be generous to NPg*

31. As we outlined in our response to the Ofgem consultation on the RIIO-ED2 Draft Determinations[28], we believe that the cost of capital and incentive returns are over-generous to the sector. As such, we do not believe that there is a material risk that NPg will be unable to achieve returns above the allowed costs of capital, which itself we believe is above that required to attract investment. This is relevant as NPg are claiming that they will be underfunded. Whilst we do not accept this at a detailed level, it is also highly unlikely to hold at a higher level. NPg should be expected to make returns above the allowed cost of capital. Allowing this appeal is likely to simply result in returns further in excess of the cost of capital.

32. We continue to be concerned that the overall approach to cost of equity over-estimates the level of returns required and that many detailed decisions in the Final Determinations work in favour of the network companies. There is clear evidence provided, through the cross-checks performed by Ofgem, that the cost of equity is too high and that this evidence has not been acted on. Specifically, we believe that:
    a. No measures for addressing expected outperformance were considered, despite the CMA previously supporting this[29]
    b. The approach to the Capital Asset Pricing Model (CAPM) favours the network companies
    c. The stronger protections and lower risk in ED2 are not reflected
    d. There is a consistently generous approach to detailed decisions

33. These points are supported by Ofgem's cross-checks. We estimate that consumers will pay over £1.5 billion more than needed across ED2. This will increase when additional expenditure is included through the ED2 uncertainty mechanisms.

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[28] Citizens Advice (2022): Citizens Advice response to the Ofgem RIIO-ED2 Draft Determinations Consultation - Overview and Core Methodology Questions

[29] CMA (2021): RIIO-2 Appeal Volume 2B '*Our view is that the overall extent of operational outperformance in RIIO-1, and evidence on totex outperformance in previous energy price control periods, provided strong support for GEMA treating the scope for operational outperformance as an important risk area for RIIO-2*'

34. We also remain of the opinion that incentive mechanisms are not stretching enough so that Distribution Network Operators will be able to generate incentive rewards with little additional effort in many cases. Details of our concerns can be found within our response to the ED2 Draft Determinations.

**STATEMENT OF TRUTH**

**The Intervenor believes that the facts stated in this Application to Intervene are true**

Signature of Authorised Representative

Andy Manning

Date: 24/4/2023

Andy Manning, Principal Economic Regulation Specialist,

**for and on behalf of Citizens Advice**