

BEFORE THE COMPETITION AND MARKETS AUTHORITY

**IN THE MATTER OF APPEALS UNDER SECTION 11C OF THE ELECTRICITY
ACT 1989**

B E T W E E N:

(1) NORTHERN POWERGRID (NORTHEAST) PLC

(2) NORTHERN POWERGRID (YORKSHIRE) PLC

Appellants

and

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

**RIIO-ED2 PRICE CONTROL
GEMA'S RESPONSE TO NOTICE OF APPEAL**

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A. INTRODUCTION AND SUMMARY

a. Introduction

1. This is the response of the Gas and Electricity Markets Authority (“**GEMA**”) to the Notice of Appeal dated 2 March 2023 filed by Northern Powergrid (Northeast) Plc (“**NPgN**”) and Northern Powergrid (Yorkshire) Plc (“**NPgY**”) (together, “**NPg**”).
2. NPgN and NPgY are each electricity distribution network operators (“**DNOs**”) and hold distribution licences granted by GEMA pursuant to s. 6(1)(c) of the Electricity Act 1989 (“**EA89**”).
3. The Notice of Appeal (or “**NoA**”) sets out NPg’s appeals against modifications made by GEMA to its licence conditions published on 3 February 2023 (“**the Decision**”). The Decision was made pursuant to s. 11A of the EA89 to give effect to GEMA’s price control determinations in relation to the new price control for the electricity distribution sector which is known as RIIO-ED2. RIIO-ED2 runs from 1 April 2023 to 31 March 2028.
4. The appeals are brought under s. 11C EA89 which confers on licensees the right to appeal on specified statutory grounds to the Competition and Markets Authority (“**CMA**”). Under s. 11C(3) EA89, the permission of the CMA is required for the bringing of an appeal. By a decision dated 30 March 2023, the CMA granted NPg permission to appeal.
5. Where GEMA does not expressly respond to a particular paragraph of the Notice of Appeal, it should not be taken to accept it.

b. Summary of GEMA’s response

6. NPg’s appeal focuses on two specific issues:
 - 6.1. First, NPg allege that GEMA, when allocating DNO’s efficient modelled costs to different costs categories, did so irrationally and illogically. This is said to be because GEMA relied on the DNOs’ submitted cost proportions (from DNO business plans) as one of two inputs into its cost allocation methodology. NPg

alleges that GEMA should have disregarded submitted cost proportions because they were based on decarbonisation scenarios said to be “*manifestly different from the one that GEMA intended to fund*” (NoA, §3.3).

- 6.2. Secondly, NPgY alleges that GEMA erred in failing to grant it a Business Plan Incentive (“**BPI**”) Stage 4 reward. The BPI Stage 4 reward is intended to reward DNOs which submit high quality and ambitious business plans which assist GEMA in its cost assessment. DNOs whose submitted costs are below GEMA’s view of efficient modelled costs for that DNO receive an upfront reward. NPgY alleges that, when determining the eligibility for a reward, GEMA failed to compare DNOs’ submitted costs to modelled costs on a rational and consistent basis. In particular, NPgY contends that GEMA was wrong to compare DNOs’ submitted costs to their modelled costs after workload adjustments had been applied in the disaggregated modelling because workload adjustments (or some workload adjustments) do not relate to a DNOs’ efficiency but rather the particular scenario on which they based their submitted costs. By comparing submitted costs to modelled costs after adjustments which stripped out the effect of a DNO’s chosen scenario, NPgY alleges that GEMA failed to compare like with like.
7. GEMA’s decision-making in respect of the RIIO-2 price controls involved a complex assessment by GEMA based on substantial data, comprehensive expert analysis, extensive consultation over a three-year period, and the careful balancing of regulatory objectives. The Decision is the product of that work, and of the interaction of a broad range of factors considered by GEMA in accordance with its statutory duties. In these circumstances, GEMA submits that each of NPg’s grounds of appeal is without merit and should be dismissed.
8. As to the alleged misallocation of costs (**Ground 1**), NPg contends that GEMA erred in adopting a 50/50 split for its cost allocation methodology, which took into account both (1) submitted cost proportions from DNOs’ business plans; and (2) cost proportions derived from the disaggregated benchmarking modelling. NPg contends that it was

necessary to take into account only the cost proportions derived from (2), i.e. the disaggregated benchmarking modelling; and that any consideration of (1) (submitted cost proportions from DNOs) was irrational. That approach would, however, entirely ignore DNOs' business plans. Those plans formed an important input into GEMA's costs benchmarking process.

9. In its Draft Determinations, GEMA had initially suggested that only submitted cost proportions should be taken into account. Following representations from the DNOs, in its Final Determinations GEMA took account of both factors. Notably, none of the DNOs, apart from NPg, contended for an approach which excluded reference to business plans. All other DNOs contended that GEMA should consider both measures of cost proportions.
10. NPg's approach focussing only on cost proportions from the disaggregated benchmarking modelling would lead to cost allocations which are not in consumers' interests: in particular, enabling excessive or disproportionate non-variant¹ cost allowances, where DNOs can 'pocket' allowances without necessarily securing demonstrable benefits to consumers. Excessive non-variant allowances would carry particular risks for consumers in RIIO-ED2 because of the degree of uncertainty surrounding levels of future demand and associated network investment. Consumers should not have to pay high ex ante costs based on a view of future demand which might not materialise. In contrast to NPg's preferred approach, GEMA's chosen methodology is more reflective of the cost assessment approach, and it generates balanced and appropriate outcomes which are consistent with a range of reasonable cross-checks.
11. As to the BPI Stage 4 issue (**Ground 2**), NPg's appeal proceeds on the incorrect premise that all or most workload adjustments related to the particular scenario which a DNO has adopted as the basis for their submitted costs and did not therefore relate to efficiency. They did not. In fact, workload adjustments are predominantly related to (and a vital step

¹ 'Non-variant' or 'fixed' allowances are fungible for DNOs. In contrast 'variant' or 'contingent' allowances are subject to conditionality and are not fungible. See further paragraph 66 below, and McMahon 1, §§93, 143-144, explaining that, for RIIO-ED2, between 71-86% of ex ante totex allowances for each licensee are 'non-variant', with the balance variant. For the Appellants the figure is 77% non-variant and 23% variant allowances.

towards assessing) efficiency: they make adjustments to DNOs' submitted work *volumes* in the same way that cost adjustments make adjustments to DNOs' submitted work *costs*. In the case of NPgY in particular, workload adjustments were overwhelmingly reflective of efficiency rather than "scenario related" as NPgY suggests. It follows that GEMA made no error in including workload adjustments in the modelled costs to which it compared NPgY's submitted costs for the purposes of determining its eligibility for a BPI Stage 4 reward; had it not done so, it would have omitted an important aspect of its assessment of efficiency.

12. Nor is there any inconsistency between GEMA's decision to include workload adjustments but exclude a separate post-modelling adjustment, the Demand Driver Adjustment. NPgY contends that there is such a consistency insofar as both adjustments relate to the DNOs' chosen "scenarios". However, the Demand Driver Adjustment is a different adjustment which is reflective of demand in a way that workload adjustments are not. Only one component of the workload adjustment applied in relation to one of the 11 cost activities in relation to which workload adjustments are made (Secondary Reinforcement) relates to forecast demand in a manner which could be regarded as similar to the Demand Driver Adjustment. Further and in any event, the value of this particular adjustment is relatively minor in the case of NPgY and even if were excluded for the purposes of calculating the BPI Stage 4 reward, NPgY would still not receive a reward. In all the circumstances, GEMA's decision cannot be said to be wrong. On the contrary, it was consistent with the objective of the BPI and the interests of consumers.
13. In short, the Appellants' complaints proceed on incorrect premises or amount to no more than disagreements with the way in which GEMA has exercised its expert regulatory discretion and are without merit. GEMA accordingly invites the CMA to dismiss the appeals.

c. Key documents filed with this response

14. GEMA files with this appeal the first witness statement of Steven McMahon dated 24 April 2022, Deputy Director of Onshore Price Control Setting within the Networks

Division of GEMA, who was centrally involved in GEMA's Decision ("**McMahon 1**").
GEMA relies on the contents of McMahon 1 in full in response to these appeals.

B. LEGAL FRAMEWORK

15. This section sets out the legal framework and relevant principles in an appeal to the CMA against a licence modification decision by GEMA as follows:

15.1. GEMA’s statutory duties;

15.2. The statutory grounds of appeal;

15.3. The standard of review to be applied by the CMA and the scope of GEMA’s regulatory discretion; and

15.4. Materiality.

a. GEMA’s statutory duties

16. Section 3A(1) EA89 establishes GEMA’s principal objective as follows:

“The principal objective of ...[GEMA] in carrying out [its] functions under this Part is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems.”

17. This is further clarified in s.3A(1A) EA89, which states:

“Those interests of existing and future consumers are their interests taken as a whole, including— (a) their interests in the reduction of [gas/electricity]-supply emissions of targeted greenhouse gases; [...] (b) their interests in the security of the supply of [gas/electricity] to them; and (c) their interests in the fulfilment by the Authority, when carrying out its designated regulatory functions, of the designated regulatory objectives.”

18. Section 3A(1B) of the EA89 imposes a duty on GEMA in respect of the principal objective:

“[GEMA] shall carry out [its] functions under this Part in the manner which...[it] considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation,

transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.”

19. Section 3A(1C) EA89 imposes a further duty on GEMA to have regard to the interests of consumers. That section provides:

“Before deciding to carry out functions under this Part in a particular manner with a view to promoting competition as mentioned in subsection (1B), [...] the Authority shall consider— (a) to what extent the interests referred to in subsection (1) of consumers would be protected by that manner of carrying out those functions; and (b) whether there is any other manner (whether or not it would promote competition as mentioned in subsection (1B)) in which [...] the Authority ... could carry out those functions which would better protect those interests.”

20. Particular regard must be had to the interests of certain specified groups of consumers. Section 3A(3) EA89 provides:

“(3) In performing the duties under subsections (1B), (1C) and (2) ... the Authority shall have regard to the interests of—

(a) individuals who are disabled or chronically sick;

(b) individuals of pensionable age;

(c) individuals with low incomes; and

(d) individuals residing in rural areas;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.”

21. Section 3A(6) EA89 deals with the temporal scope of the concept of a “consumer” for the purposes of the obligations set out in s.3A EA89. It states, *“in subsections (1C), (3) and (4) references to consumers include both existing and future consumers”*.

22. Further duties are imposed by s.3A(2) EA89:

“In performing the duties under subsections (1B) and (1C), ... the Authority shall have regard to:

(a) the need to secure that all reasonable demands for electricity are met;

(b) 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 [and other relevant legislation]; and

(c) the need to contribute to the achievement of sustainable development.”

23. In carrying out functions pursuant to s.3A EA89, GEMA “may” also have regard to the interests of consumers in respect of water, gas or telecommunications. Section 3A(4) EA89 provides:

“(4) The Secretary of State and the Authority may, in carrying out any function under this Part, have regard to—

(a) the interests of consumers in relation to gas conveyed through pipes (within the meaning of the Gas Act 1986); and

(b) any interests of consumers in relation to—

(i) communications services and electronic communications apparatus, or

(ii) water services or sewerage services (within the meaning of the Water Industry Act 1991),

which are affected by the carrying out of that function.”

24. Pursuant to s.3A(5) EA89, subject to subsections (1B) and (2) and to GEMA’s duty to carry out functions in a manner best calculated to further delivery of policy outcomes under s.132(2) of the Energy Act 2013, GEMA must carry out its respective functions in a manner which it considers is best calculated:

“(a) to promote efficiency and economy on the part of [licensees] and the efficient use of electricity conveyed by distribution systems or transmission systems;

(b) To protect the public from dangers arising from the generation, transmission, distribution or supply of electricity or the provision of a smart meter communication service; and

(c) to secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment of activities connected with the [conveyance of gas through pipes /generation, transmission, distribution or supply of electricity] or the provision of a smart meter communication service.”

25. As regards the exercise by GEMA of its statutory functions, s.3A(5A) EA89 provides:

“In carrying out their respective functions under this Part in accordance with the preceding provisions of this section the Secretary of State and the Authority must each have regard to—

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

(b) any other principles appearing to him or, as the case may be, it to represent the best regulatory practice.”

b. The statutory grounds of appeal

26. The potential grounds of appeal against licence modification decisions are set out in s.11E(4) EA89. The CMA “*may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds*” (emphasis added). Those grounds are as follows:

26.1. *“that GEMA failed properly to have regard to any matter mentioned in subsection (2) [i.e., GEMA’s relevant statutory duties]”;*

26.2. *“that GEMA failed to give the appropriate weight to any matter mentioned in subsection (2)”;*

26.3. *“that the decision was based, wholly or partly, on an error of fact”;*

26.4. *“that the modifications fail to achieve, in whole or in part, the effect stated by GEMA by virtue of section 11A(7)(b) EA89”;* or

26.5. *“that the decision was wrong in law”.*

27. These grounds are exhaustive. In *SONI Limited v Northern Ireland Authority for Utility Regulation* (CMA, 10 November 2017), the CMA explained that “[t]he 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” and “the test is not whether the decision under appeal was “unreasonable” (§3.35).

28. Section 11E(5) EA89 provides: “[t]o the extent that the CMA does not allow the appeal, it must confirm the decision appealed against.”

c. **Standard of review to be applied by the CMA and the scope of GEMA’s regulatory discretion.**

29. By s.11E(2) EA89, in determining an appeal the CMA must have regard, to the same extent as is required of GEMA, to the matters to which GEMA must have regard in carrying out its principal objective under s.3A EA89; in the performance of its duties under those sections; and in the performance of its duties under ss.3B and 3C EA89 (i.e. to guidance on social and environmental matters, and to health and safety).

30. Pursuant to s.11(3) EA89, in determining the appeal, the CMA may have regard to any matters to which GEMA was not able to have regard, save that the CMA must not have regard to matters which GEMA would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so.

31. In the first appeal brought under s. 11C EA89, in *British Gas Trading v GEMA* (CMA, 29 September 2015) at §3.26, the CMA adopted the reasoning of the Competition Commission in an earlier appeal under s.175 of the Energy Act 2004 in *E.ON UK plc* (CC, 10 July 2007):

“As a specialist appellate body charged with considering whether a decision of GEMA is wrong, the function of the CC is to provide accountability in relation to the substance of code modifications decisions. However, leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator.” (§5.11)

32. In the 2021 Energy Licence Modification Appeals in relation to the RIIO-T2 and GD2 price controls (“**ELMA 2021**”), the CMA noted that the decision in *British Gas* had not been challenged by any party and that the applicable legislation remained unchanged, and that the same standard of review therefore applied: *ELMA 2021* (CMA, 28 October 2021), §3.23. The CMA rejected the submission from WWU that the appropriate standard of review was that of a full rehearing (§3.31). The CMA held:

“We are required to consider the merits of the Decision but only through the prism of the specific errors alleged by the appellants. The appeals do not entitle the CMA to proceed with a re-run of the original investigation or have a de novo re-hearing of all the evidence. The key question is whether GEMA made a decision that was wrong (on one of the prescribed statutory grounds). Only to that extent must the merits of the Decision be taken into account and we have done so in the present appeals.”

33. It is not, therefore, the CMA’s role to substitute its judgment for that of GEMA simply on the basis that it would have taken a different view of the matter if it had been the regulator (at §3.27 in British Gas) (see further SONI Limited at §3.36 and Cadent Gas at §3.43). The CMA is not to be regarded as a fully equipped regulatory body waiting in the wings - it is “*an appeal body and no more*”: see T-Mobile (UK) Ltd & Anor v Office of Communications [2009] 1 WLR 1565, §31 (Jacobs LJ) (quoted with approval in British Gas, §3.36).

34. On the contrary, the CMA in British Gas at §3.28 adopted the further explanation given by the CC in relation to the statutory test (emphasis added):

“...our role is to determine whether GEMA’s decision is wrong, because it failed properly to have regard to, or failed to give the appropriate weight to, the matters to which GEMA must have regard, or because GEMA has erred in law or fact. In our view, this test clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA’s decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider to be inappropriate in the circumstances.”

35. In Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation (CMA, 26 June 2017), at §3.20 the CMA summarised the relevant principles from the CC and CMA decisions in the E.ON and RIIO-ED1 Determinations as to when a decision is “wrong”:

“(a) It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that the regulator’s decision was wrong.

(b) An appeal is against the decision, not the reasons for the decision. Therefore, it is not enough for the appellant to identify some error of reasoning; the appeal can only succeed if the decision cannot stand in the light of that error.

(c) Where the appellant contends that the regulator ought to have adopted an alternative price control measure, it is for the appellant to deploy all the evidence and material it considers will support that alternative. It must show that its proposed alternative price control measure should be adopted.

(d) Usually an appellant will succeed by demonstrating the flaws in the decision and the merits of an alternative solution. Also, the courts have not ruled out the possibility that there could be a case in which an appellant succeeds in so undermining the foundations of a decision that it cannot stand, without establishing what the alternative should be. In such a case, if there is no other basis for maintaining the decision, the CMA would be at liberty to conclude that the decision was wrong but that it could not say what decision should be substituted. Disposal of the appeal without substituting an alternative decision is not unknown, but is expected to be rare.

(e) If the CMA is satisfied that the regulator's decision was correct, then the fact that the regulator's consultation process was deficient ought not to matter, unless that process was so deficient that the CMA cannot be assured that the regulator did indeed get it right.

(f) Where a decision of the regulator requires an exercise of judgment, the regulator will have a margin of appreciation. The CMA should apply appropriate restraint and should not interfere with the regulator's exercise of judgment unless satisfied that it was wrong.

(g) A regulator's assessment of the adequacy of the evidence and material before it will not be wrong unless it is outwith the range of reasonable conclusions.

(h) If the CMA concludes that the decision can be supported on a basis other than that on which the regulator relied, then the appellant will not have shown that the decision was wrong and will fail."

36. The CMA's starting point is the error the regulator is alleged to have made; it will not pre-empt the regulator's decision by considering whether an alternative approach might have been better, as explained in *SONI Limited* at §3.29:

“we consider that it is not appropriate for the CMA to start by considering an alternative approach and to say that if that approach is considered superior, then there is an error. The first question for the CMA is whether there has been an error in the regulator’s approach, not whether an [sic] alternative approach might be better. The question of what alternative approach should be adopted is primarily relevant once an error has been identified.”

37. The type of error that GEMA is alleged to have made also affects the approach the CMA will take.
38. First, where GEMA’s decision is alleged to include an error of fact, the CMA will determine whether GEMA was correct in its conclusions as to primary facts, or inferences that it drew from those facts. The CMA in *British Gas* at §3.30 and in *Cadent Gas ELMA 2021* at §3.34 adopted the CC’s reliance on the Court of Appeal’s decision in *Azzicurazioni Generali Spa v Arab Insurance Group* [2003] 1 WLR 577, which reasoned as follows (emphasis added):

“where the correctness of a finding of primary fact or of inference is in issue, it cannot be a matter of simple discretion how an appellate court approaches the matter. Once the appellant has shown a real prospect (justifying permission to appeal) that a finding or inference is wrong, the role of an appellate court is to determine whether or not this is so, giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the claimants challenge, while (b) reminding ourselves that, so far as the appeal raises issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge’s conclusion lay outside the bounds within which reasonable disagreement is possible. In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence.”

39. Further, the CMA in *SONI Limited* (§3.31) took into account the view of the CC in the *E.ON* decision (§5.16) that (emphasis added):

“...the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the advantage may be less than that which the trial judge has over the Court of Appeal, because [the regulator’s] decisions are not based on the evidence and cross examination of witnesses. [The regulator] nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry... For these reasons, the CC will be slow to impugn [the regulator’s] findings of fact”.

40. Secondly, as is clear from the passages cited above, where the alleged error lies in the judgment GEMA has made about an unchallenged primary fact or inference, provided GEMA has not made an error of law, the CMA should not substitute its own judgement simply because it would have taken a different view had it been in the position of the regulator. In other words, there is a field of possible judgements in which GEMA may exercise its regulatory discretion lawfully, and reasonable people may disagree about the judgment which is ultimately made. SONI Limited summarised the correct approach at §3.32 and §3.36:

“As regards the exercise of discretion, we have taken into account that the CC and CMA have consistently applied the principle in regulatory appeals that the statutory test admits of circumstances in which we might reach a different view from the regulator, but in which it cannot be said that the regulator’s decision was wrong on one of the statutory grounds. It is not the CMA’s role to substitute our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator....

... we consider that there is an important difference between the CMA making up our own mind about the correctness or otherwise of any findings of primary fact, or inference from primary fact, made in the Price Control Decision, which is permissible, and the CMA substituting our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator, which is not permissible.”

41. Thirdly, where the alleged error lies in GEMA’s evaluation of a fact, as distinct from a finding of primary fact, the CMA will regard this as it would an exercise of regulatory discretion. The CMA in British Gas at §3.31 explained (emphasis added):

“We also agree that where the errors relate to evaluations of fact by GEMA rather than conclusions of primary fact then we should approach such evaluations in the same way that we approach the exercise of discretion.”

42. Fourthly, where an error of law is alleged, the CMA must make its own decision as to what was the correct conclusion, without showing deference to GEMA’s reasoning or regulatory discretion.
43. Accordingly, the standard of review applied by the CMA is more intense than the approach taken by the courts in an application for judicial review, but falls short of a full rehearing or appeal on the merits. The CMA will take into account the merits of GEMA’s decision, but the question for the CMA will be whether GEMA’s decision was wrong on one of the statutory grounds and not whether the CMA would have made the same decision as GEMA, had it been in the regulator’s position. The position is encapsulated as follows:

“[The CMA is] 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”: British Gas at §3.24.

d. Materiality

44. Where the CMA finds that GEMA has made an error on one of the five statutory grounds of appeal, that error must have a material effect on the price control decision in order for the decision to be “wrong”.
45. The following principles are relevant to materiality:²
 - 45.1. The materiality of an alleged error may not be capable of full assessment until after permission to appeal has been granted. Section 11E(4) EA89 and s. 23B(4) GA86 permit the CMA to decide not to allow an appeal where, after permission has been granted, it becomes apparent that the result of an error is immaterial.³

² See generally the CMA’s Open Letter on Energy Licence Modification Appeal, 30 October 2019, §§3-11.

³ CMA letter of 30 October 2019, §10.

- 45.2. Where the financial impact of the alleged error is low, this is an indication that the error is not material. The CC has made reference to “0.1%” as a size of error which was clearly not material and this has been referred to in subsequent cases, although it is not a “bright line” test.⁴
- 45.3. Other factors relevant to materiality include whether the cost of addressing the error would be disproportionate to the value of the error; whether the error is likely to have an effect on future price controls; and whether the error relates to a matter of economic or regulatory principle.⁵
- 45.4. Many decisions taken by regulators involve judgment and an estimation of what might happen in an uncertain context, and the CMA is not expected to impose its own judgment in place of that of the sector regulator provided that the regulator’s response is reasonable.⁶ In that sense, there may be examples where it is not a material error to choose one from a range of options for the price control, even where that decision might in itself have a material effect on the Appellant.⁷
- 45.5. Clear and obvious factual errors should be corrected even where the impact of the error is low value.⁸
46. GEMA further submits that the test of materiality should be applied to each of the specific errors advanced by an Appellant. The important statutory safeguard would be subverted if it were open to Appellants to advance a series of individual errors each of which had a de minimis impact on the price control but which were alleged in the aggregate to have

⁴ *Firmus Energy (Distribution) Limited v NIAUR* [2017] §3.24.

⁵ *British Gas Trading Limited v GEMA* [2015] §3.61, *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA* [2015] §3.58.

⁶ *British Gas Trading Limited v GEMA* [2015] §3.43, *E.ON UK plc v GEMA* [2007] §5.11 and *SONI Limited v NIAUR* [2017] §§3.29 and 3.36.

⁷ *E.ON UK plc v GEMA* [2007] §5.12, *Hutchison 3G UK Limited v Office of Communications* and *British Telecommunications plc v Office of Communications* [2009] §1.33 and *Firmus Energy (Distribution) Limited v NIAUR* [2017] §3.19.

⁸ CMA’s Open Letter on Energy Licence Modification Appeals, 30 October 2019, §5

a material effect. The CMA's Open Letter on the Energy Licence Modification Appeals dated 30 October 2019 stated, "*what appears to be a large error may only arise due to the presentation of an aggregation of smaller and potentially immaterial errors*" (§5). The CMA must be satisfied with respect to each alleged error that it is sufficiently material to warrant further attention.

C. BACKGROUND AND COST ASSESSMENT PROCESS

47. The full background to NPg's appeals and GEMA's RIIO-ED2 cost assessment process is set out in McMahon 1. GEMA emphasises below certain points of relevance to these appeals, namely: (a) the key challenges in developing RIIO-ED2; (b) business plan development and submission; (c) the cost assessment process; (d) the uncertainty mechanisms which GEMA used; and (e) financeability.

a. Key challenges in developing RIIO-ED2

48. The RIIO-ED2 price control was developed over a more than three-year period of consultation and review (McMahon 1, §14). The material context was the major transformation in the energy sector to support the government target of net-zero carbon emissions by 2050. The net-zero commitment created uncertainties around the level of investment which would be needed in networks to support activities such as the increased use of Low Carbon Technologies ("LCTs", e.g. electric vehicles and heat pumps). As further explained below, GEMA was broadly concerned to allow DNOs to base their investment plans on forecasts of demand growth across a broad range of pathways by which the net-zero commitment could be achieved.

49. One of the key challenges of RIIO-ED2 was the need to design incentives which would allow DNOs to make optimal choices between, on the one hand, investing in upgrading the network, and on the other hand, investing in flexibility services and other smart technologies, to better utilise existing network capabilities (McMahon 1, §§24-25). In particular, in its Sector-Specific Methodology Decision ("SSMD"), GEMA explained that it would require persuasive justification for proposals to invest in new capacity over the longer term (McMahon 1, §33). This was because, while the growth in LCTs connecting to the network was likely to increase demand in the future, the use of flexibility, smart technologies and other market-based solutions could meet that increased demand, without carrying some of the risks of over-investment and mistargeted expenditure from building new capacity (McMahon 1, §33).

50. In its SSMD, GEMA decided not to provide DNOs with a central planning scenario to inform the demand forecasting in their business plans. This followed consultation responses which had highlighted matters such as: the likelihood that climate change ambitions could vary across the country; the regional variations in network upgrade requirements; and that proximity to gas mains would determine the types of decarbonised heating solutions which might be required in different areas (McMahon 1, §30). GEMA considered that DNOs would need to be able to accommodate different regional trajectories and ambitions in their planning and that imposing a common national central scenario could hinder that (McMahon 1, §§36-37).
51. Despite deciding not to adopt a central planning scenario, GEMA did emphasise that DNOs would need to have collective arrangements in place to ensure that national net-zero efforts were not undermined (McMahon 1, §32). GEMA therefore set out a range of different forecast assumptions and net-zero pathways that DNOs should apply to the development of their business plans, to mitigate the risk that, if DNOs planned off an entirely decentralised scenario, this would lead to nationally inconsistent plans and/or undermine the national net-zero effort (McMahon 1, §32).
52. GEMA's approach to cost assessment was itself the subject of extensive consultation. Two key challenges were (1) adopting an approach to cost assessment which was neutral to the wide range of operational and technological options which are open to DNOs; and (2) the higher levels of uncertainty for RIIO-ED2 than in previous price controls, due to the challenges of net zero. To minimise the impact of forecasting uncertainty resulting from net zero, GEMA decided to make greater use of uncertainty mechanisms (McMahon 1, §§34-37). These were designed to ensure that DNOs' allowances could flex to meet evolving demand on the networks, rather than fixing allowances to a common scenario or single view of future demand at the beginning of the price control period (McMahon 1, §37).

b. Business plan development and submission

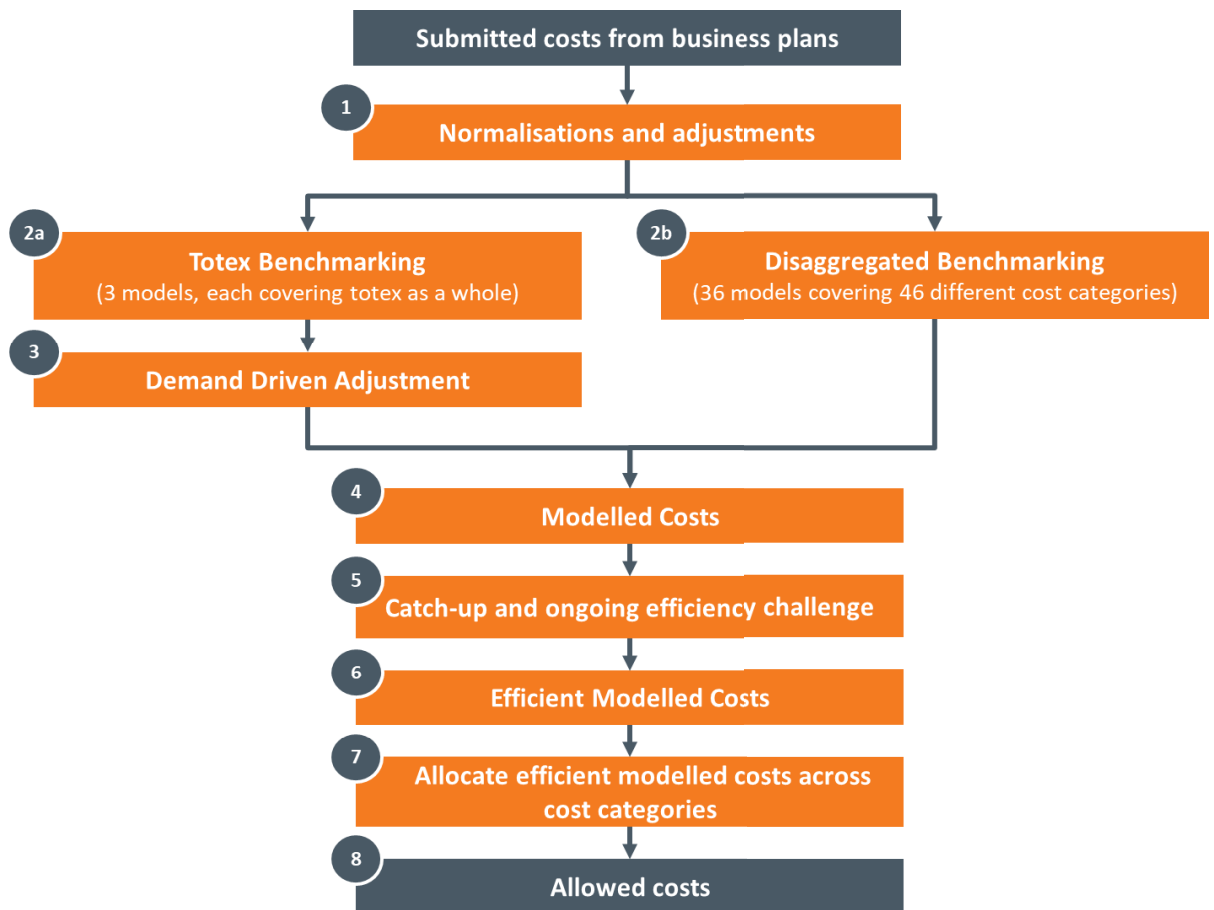
53. A key component of GEMA’s approach to cost assessment for RIIO-ED2 was the introduction of the BPI. As further explained below, this was designed to encourage complete and efficiently costed business plans, with rewards available for companies that were ambitious and went beyond what GEMA would expect as business as usual (McMahon 1, §38). To provide further support to DNOs in developing their business plans, GEMA also published Business Plan Data Templates (“**BPDTs**”) accompanied by detailed guidance (McMahon 1, §§39-41).
54. DNOs’ business plans set out costs on a discrete activity-by-activity basis, across a total of 51 cost activities (McMahon 1, §84). These different cost activities are split across the following six areas of expenditure:
- 54.1. Load-Related Expenditure (“**LRE**”). This is typically capex incurred to build new assets or reinforce existing assets to accommodate changes in the level or pattern of electricity supply and demand (McMahon 1, §§41.3, 72). Examples include reinforcing network assets (such as transformers or circuits) or building new connections to the distribution network (McMahon 1, §72). LRE can be further broken down into the following sub-categories (McMahon 1, §72):
- 54.1.1. Connections within price control: LRE associated with connecting new assets to the network;
- 54.1.2. Primary reinforcement: LRE associated with reinforcing assets on the primary network (i.e. higher voltage networks);
- 54.1.3. Secondary reinforcement: LRE associated with reinforcing assets on the secondary networks (i.e. lower voltage networks);
- 54.1.4. Fault level reinforcement: LRE associated with alleviating faults with specific network assets; and

- 54.1.5. New transmission capacity charges: charges incurred in relation to Transmission Connection Points.
- 54.2. Non-Load Related Expenditure (“**NLRE**”). This largely relates to capex incurred on health and condition-based asset replacement and refurbishment, and investments to ensure networks remain resilient (McMahon 1, §84).
- 54.3. Non-Operational capex (“**Non-Op**”). This covers investments incurred on new and replacement IT & telecoms assets, management of non-operational property and vehicles, and small tools and equipment (McMahon 1, §84).
- 54.4. Network Operating Costs (“**NOCs**”). This covers expenditure incurred in operating the networks, such as responding to faults, tree cutting, inspections and maintenance (McMahon 1, §84).
- 54.5. Closely Associated Indirects (“**CAIs**”). This covers opex incurred on network design, policy, project management and engineering staff, as well as operational training and vehicles and transport (McMahon 1, §84).
- 54.6. Business Support Costs (“**BSCs**”). This covers expenditure associated with core business support functions such as HR, IT and telecoms, and property management (McMahon 1, §84).
55. Relevantly for the purposes of these appeals, GEMA explained in the business plan guidance that DNOs should assume that there would be uncertainty mechanisms for LRE, since baseline allowances alone would not be appropriate given the levels of uncertainty in this area (McMahon 1, §41.3).
56. In addition to granular activity-by-activity cost data submission in the business plans, GEMA asked DNOs to submit further data on their forecasts under different scenarios. This data included forecast volumes for LCTs and additional forecast costs specifically for LRE (McMahon 1, §42).

57. Draft business plans were reviewed by the independent RIIO-ED2 Challenge Group, which held meetings with the DNOs during preparation of the plans, and provided observations and feedback to DNOs. The Challenge Group was highly critical of the Appellants' draft business plan, particularly in relation to LRE (which they forecasted to increase by 351% from RIIO-ED1 to RIIO-ED2, without appropriate justification) (McMahon 1, §§45-48).
58. All DNOs' final business plans included substantial increases in forecast annual spend relative to RIIO-ED1. LRE, in particular, was subject to very substantial increases against RIIO-ED1 with average annual increases across all DNOs of c.120% (McMahon 1, §52). The Appellants' LRE increases were considerably higher than the average, with NPg forecasting an average annual increase of LRE spending of c.290% compared to RIIO-ED1 (McMahon 1, §52). The Challenge Group assessed the Appellants' final business plan to have an amber rating (a score of 2: Limited ambition and justification) for proposed LRE expenditure, noting that it did not fully exploit opportunities to better utilise existing network capacity (McMahon 1, §§53-55).
59. While GEMA had expected DNOs to need increased LRE for RIIO-ED2, it was clear that increases would have to be justified robustly to protect consumers from higher costs than necessary (McMahon 1, §75). Indeed, GEMA set out at both Draft and Final Determinations (at which point further economic uncertainty had developed in light of inflation and the gas crisis) that it would prefer to set ex ante LRE allowances only where network investment was justified, efficient and represented consumer best-value, and then flex these up as required (rather than setting a higher allowance which would have to flex down for large parts of the sector) (McMahon 1, §62, 80).
60. The very significant increases in LRE across all DNOs at Draft Determinations, together with the absence of sufficiently robust justification for those increases, and the increased economic uncertainty, prompted GEMA to develop the Demand Driven Adjustment (“**DDA**”) (McMahon 1, §77). The DDA is explained further below.

c. **Cost assessment process**

61. GEMA’s cost assessment process prior to allocation can be divided into several steps (McMahon 1, §§82-92 and 133-174).



62. Step 1 was to make normalisations and adjustments to DNOs’ submitted costs (such as for regional and company specific factors) to ensure that costs are comparable for benchmarking purposes (McMahon 1, §85).

63. Step 2 was to benchmark these normalised submitted costs, to assess relative efficiencies between DNOs. As in RIIO-ED2, GEMA used two different benchmarking approaches to ensure that no single approach was determinative of its assessment of DNO efficiency (McMahon 1, §86). These were:

- 63.1. Total expenditure (“**totex**”) benchmarking (Step 2a). This produced a set of total modelled costs for each DNO. Three separate regression benchmarking models were used for this purpose; and
- 63.2. Disaggregated (activity-level) benchmarking (Step 2b). This compared DNOs’ costs on an activity-by-activity basis, using 36 different models to assess 46 different activities, including applying workload adjustments as well as models to deal with separately assessed projects and sub-categories.⁹ The output of each model was then summed to produce a set of total modelled costs for each DNO.
64. Step 3 was to calculate the DDA (as to which see further below), designed to account for the insufficient justification for LCT forecasts (particularly the significant increase in average annual LRE, as explained above) (McMahon 1, §89).
65. Step 4 was to calculate GEMA’s overall view of modelled costs. This was done by assigning equal weight to the total view of modelled costs derived from each of (1) Step 2a and Step 3 (i.e. modelled costs derived from the totex benchmarking plus DDA; and (2) Step 2b (i.e. modelled costs derived from the disaggregated benchmarking) (McMahon 1, §90).
66. Step 5 was the application of the catch-up efficiency challenge and ongoing efficiency challenge (McMahon 1, §91).
67. Step 6 was GEMA’s overall view of efficient costs, derived from Steps 1 to 5 above (McMahon 1, §92).
68. Finally, after these steps have been completed, GEMA needed to allocate efficient total modelled costs across each of the different cost categories to determine the allowed costs by activity (McMahon 1, §92).

⁹ McMahon 1 explains (at §86.2) that while the DNOs report their expenditure against 51 cost activities, GEMA’s disaggregated benchmarking used 36 models to assess 46 cost activities.

69. Within totex, there are two different kinds of allowances: fixed (non-variant) and contingent (variant) allowances. The vast majority of RIIO-ED2 allowances for all DNOs are non-variant (between 71-86%) with the remainder variant (i.e. subject to uncertainty mechanisms) (McMahon 1, §143). In general,¹⁰ non-variant allowances are fungible and can be used by DNOs as they see fit (McMahon 1, §144). In contrast, variant allowances are subject to specific activity-level controls (i.e. uncertainty mechanisms), so they cannot be transferred between activities or cost categories.

d. Uncertainty mechanisms

70. GEMA uses a number of different types of uncertainty mechanisms for the RIIO-ED2 price control (McMahon 1, §36). These include:

70.1. volume drivers (varying allowances based on volumes of actual work delivered);

70.2. re-openers (allowing adjustment of allowances, outputs and/or delivery dates within the price control period);

70.3. pass-through mechanisms for costs over which DNOs have limited control (such as business rates);

70.4. indexation (to protect against e.g. price inflation); and

70.5. “Use-it-or-lose-it” (“**UIOLI**”) allowances, where funding is not available unless the expenditure is incurred in delivering the specific output.

71. Given the nature and extent of LRE uncertainty, GEMA decided to use volume drivers as a key uncertainty mechanism for this category. The possibility of volume drivers being used for LRE expenditure had been discussed with DNOs prior to Draft and Final Determinations (McMahon 1, §§94-97). Consequently, all DNOs (including the Appellants) made proposals in their business plans for LRE uncertainty mechanisms,

¹⁰ Subject to breakdowns provided for tax pool purposes: see McMahon 1, §146.

many of which included volume drivers (McMahon 1, §97). The use of LRE uncertainty mechanisms should have been no surprise to NPg.¹¹

72. At Final Determinations, GEMA set an initial funding package of £3.2bn to fund network upgrades to support the rollout of LCTs, out of a total funding package of £22.2bn. Of this, £1bn was for Secondary Reinforcement (one of the sub-categories of LRE, see paragraph 54.1 above) and £2.2bn was for all other LRE activities.
73. The £1bn of Secondary Reinforcement funding is entirely variant whereas the £2.2bn for other LRE activities is non-variant (McMahon 1, §79). At its heart, NPg's challenge seeks to redirect some of the £1bn of (variant) Secondary Reinforcement funding towards the total non-variant activities. This would allow NPg to benefit from a larger fungible allowance, without having to satisfy the conditionality associated with uncertainty mechanisms.
74. The Secondary Reinforcement uncertainty mechanisms include four particular measures (McMahon 1, §79.2):
 - 74.1. Secondary Reinforcement volume driver: this is a capacity-based mechanism to vary allowances based on (a) the volume of substation and circuit reinforcement delivered, or (b) the volume of secondary reinforcement deferred through the use of flexibility services.
 - 74.2. Low Voltage ("LV") Services volume driver: this is an asset-based mechanism to vary allowances based on volumes of LV Services assets reinforced (e.g. fuse upgrades).
 - 74.3. LRE re-opener: this allows DNOs to apply for additional funding if their LRE expenditure (excluding areas covered by LRE volume drivers) exceeds the ex ante fixed allowances.

¹¹ See further McMahon 1, §§87-94.

- 74.4. Indirects Scaler: this allows indirect costs to be scaled in line with adjustments to LRE allowances.
75. GEMA considered that ‘automatic’ volume driver uncertainty mechanisms would be particularly effective for delivering reinforcement on the secondary network and LV services, because there is a reasonable degree of ex ante unit cost certainty in these areas but the volume of work would be driven by the rate of LCT uptake. Volume drivers would permit DNO allowances to increase without delay if this was required by LCT uptake. This would ensure that RIIO-ED2 would not obstruct net-zero, while at the same time protecting consumers from high ex ante fixed allowances if LCT uptake did not materialise (McMahon 1, §80).
76. GEMA worked closely with DNOs on the design of the LRE volume drivers through several LRE working group meetings (McMahon 1, §§66, 95-98). All DNOs (including the Appellants) were broadly supportive of the existence of LRE volume drivers.

e. **Financeability**

77. The RIIO-ED2 price control included a comprehensive assessment of the financeability of the DNOs. This assessment considered whether, when all the individual components of the determination are taken together (including totex, allowed return, notional gearing, depreciation and capitalisation), a notionally-structured efficient operator was able to generate sufficient cashflows to meet its financing needs. The assessment included consideration of: (i) financial projections from GEMA’s financial models as used to calculate revenues; (ii) the strength of quantitative metrics of credit quality, particularly metrics emphasised by credit rating agencies or that are under pressure; (iii) the strength of qualitative factors; and (iv) stress test results.
78. GEMA’s review considered modelled credit metrics and credit ratings in both baseline and high totex scenarios (to account for the use of uncertainty mechanisms). GEMA made an in-the-round assessment that targeted each DNO at the notional capital structure being broadly at a comfortable investment grade credit quality (rather than applying strict threshold levels to particular credit metrics that had to be met in all circumstances).

79. GEMA was ultimately satisfied that, in general, credit quality could be considered as two notches above minimum investment grade in the round, even if there was a possibility that one or more rating agencies may rate it slightly lower or higher. Further, under the range of plausible downside scenarios that GEMA reviewed (including a 200 bps RoRE downside, 10% overspend and -1% inflation sensitivity) all DNOs with the notional capital structure applied were modelled as Baa3 (eg, ‘investment grade’) or higher when using both the base and higher totex cases. Full details of this assessment are set out in section 5 of the Financial Annex of the RIIO-ED2 Final Determinations.
80. On 17 February 2023, following consideration of Final Determinations (among other factors), Moody’s affirmed the rating of NPgY (A3 stable) and NPgN (A3 stable).

D. RESPONSE TO GROUND 1: ALLEGED MISALLOCATION

f. Introduction

81. The first ground of appeal seeks to challenge the methodology used by GEMA in its cost allocation process. NPg claims that GEMA acted irrationally and illogically in using the cost proportions reflected in DNOs' submitted business plans as one of the inputs into the allocation methodology. This is said to be "*because DNOs' submitted costs were based on decarbonisation planning scenarios that were manifestly different from the one that GEMA intended to fund*" (NoA, §3.3). To be clear, the Appellants do not take issue with the overall level of the totex allowance, or with any aspect of GEMA's cost benchmarking process. Rather, the Appellants challenge GEMA's approach to allocating costs between different cost categories, after the completion of Steps 1 to 6, described at paragraphs 61 - 67 above.
82. There is no single "correct" way to allocate costs between cost categories, based on the information available for RIIO-ED2. Rather, there are a range of approaches which an expert regulator might choose to adopt, in the exercise of its regulatory judgement. The approach which GEMA took for RIIO-ED2 was to allocate costs using a 50/50 weighting between (1) the cost proportions used in DNOs' submitted business plans, and (2) cost proportions informed by the results of the disaggregated modelling. That approach was plainly reasonable.
83. The Appellants claim that GEMA should have used only the results of the disaggregated modelling for the cost allocation exercise. To place any weight on the costs proportions derived from submitted business plans is said to be irrational because of the (alleged) decision to impose a so-called "Common Scenario" after submission of business plans. That is wrong. The true position is that GEMA made modest adjustments to reflect the differences between the Appellants' (poorly justified) forecasts of LCT uptake, and the forecast yielded by the System Transformation Future Energy Scenarios 2022 ("**System Transformation FES**") data. This was not a wholesale re-baselining of the Appellants' business plan such as would render it irrational for GEMA to have any regard to the cost

proportions derived from that plan. It was a modest adjustment which has been thoroughly accounted for and justified in GEMA's decision documents.

84. Although NPg does not challenge the overall level of the totex allowance, their appeal would, if successful, result in reallocation of costs from 'variant' to 'non-variant' cost categories. But given the degree of uncertainty around levels of future demand and associated network investment for RIIO-ED2, GEMA reasonably concluded that the balance of variant and non-variant allowances generated by its chosen cost allocation methodology was appropriate. In particular, excessive non-variant allowances could lead to consumers overpaying based on a view of future demand which might not materialise (see further below).

g. Background and GEMA's decision in relation to cost allocation

85. GEMA's cost assessment process is explained briefly above and in further detail in McMahon 1 at §§82-92 and 133-170. In particular, the cost assessment process uses two different benchmarking models (totex benchmarking and disaggregated benchmarking) to produce an overall totex allowance (McMahon 1, §147). Because the outcome of that process is to arrive at modelled costs at a totex level, after Step 6 of the cost assessment process, there is then a further step required in order to allocate costs to the 51 different activities reported in DNOs' business plans (across five different cost categories: see paragraph 54 above).
86. There are a number of different ways of carrying out that cost allocation exercise. In particular, at Draft Determinations, GEMA identified three possible approaches (McMahon 1, §150):
 - 86.1. Use the cost proportions derived from DNOs' business plans ("**submitted cost shares**");
 - 86.2. Use the cost proportions derived from the results of the disaggregated modelling ("**disaggregated benchmarking cost shares**"); or
 - 86.3. Use an industry average proportional split of costs by activity.

87. GEMA explored the relative strengths and weaknesses of each of these approaches at some length at Draft Determinations (McMahon 1, §§151-158). On balance, GEMA considered that the first approach, submitted cost shares, would be likely to strike the right balance (McMahon 1, §151). It also considered that the third approach, of industry average cost shares, was not appropriate. While using an industry average would have the advantage of consistency across DNOs, it would fail to take account of the differences between business plans and between different levels of activity in different areas, which could reflect planned efficiencies or different activity investment cycles (McMahon 1, §152). This would not reflect how GEMA expected DNOs would actually spend their allowances in RIIO-ED2 and was considered to be the least appropriate of the options considered (McMahon 1, §152).
88. However, all DNOs opposed GEMA's proposed approach of relying solely on submitted cost shares. Their primary concern was that the outcomes of the disaggregated modelling would not be reflected in the allocation methodology at all, in circumstances where that had been an important contribution to GEMA's cost assessment process. All DNOs save the Appellants considered that a blended approach using both submitted cost shares, and disaggregated benchmarking cost shares, would be preferable (McMahon 1, §155). The Appellants considered that only disaggregated benchmarking cost shares should be used.
89. In response, GEMA conducted extensive analysis, discussion and engagement with DNOs over several months (McMahon 1, §§159-169). This included bilateral and multilateral engagement, stakeholder workshops, and extensive testing and analysis of each of the main options proposed (McMahon 1, §162).
90. At Final Determinations, GEMA concluded that the methodology it had proposed at Draft Determinations (using 100% submitted cost shares) had an important weakness, in that it did not incorporate the outcomes of the disaggregated benchmarking at all. GEMA considered that this created a degree of internal inconsistency, because the disaggregating modelling outputs had been used to determine the value of the modelled allowances, but had been disregarded for the purposes of cost allocation. A blended approach, using 50/50 shares of submitted cost shares and disaggregated benchmarking cost shares,

offered a more internally consistent and overall preferable balance, in the best interests of consumers (McMahon 1, §169).

h. Response to the ground of appeal

91. The Appellants contend that GEMA erred in having regard to both submitted cost shares and disaggregated benchmarking cost shares in allocating costs between cost categories. The error is said to arise because the Appellants' business plan was based on a much faster pace of LCT uptake than envisaged by the Electricity System Operator's (i.e. National Grid's) System Transformation FES projection, with the consequence that LRE forms a correspondingly higher proportion of its total costs, than would have been the case if the Appellants had used the FES as the basis for its business plan (see NoA §18.5). The FES adjustment is said to have stripped out a large proportion of the Appellants' LRE and significantly altered the proportional split of costs, as compared to NPg's submitted costs.
92. In fact, the relevant adjustment was much more minor than the NoA suggests. As explained further in relation to Ground 2 below, the FES Transformation data was used only in a limited way, in the context of (1) the DDA following Step 2a of the cost assessment process for the totex benchmarking exercise (see paragraphs 64-65 above); and (2) in the demand-driven workload adjustments to the Secondary Reinforcement model (which is one of the 46 cost activities modelled in the disaggregated benchmarking). The impact of GEMA's demand-based adjustments amounted to £116m, or c.3.6% of the Appellants' totex (McMahon 1, §200). This did not amount to a wholesale re-baselining of business plans (compare the Appellants' own forecast difference in LRE between their baseline planning scenario and the FES System Transformation scenario was £354m) (McMahon 1, §200).
93. The Appellants contend that the impact of GEMA's approach results in their activities being underfunded by £157m. But that is a simplification: it confuses LRE and non-LRE allowances with variant and non-variant allowances and the indirect costs provided to support LRE allowances (McMahon 1, §193). In fact, the correct figure is no higher than

£130m, which is the difference between the non-variant allowance under GEMA's approach, and the non-variant allowance under NPg's proposed approach (McMahon 1, §§194-196). However, even the £130m figure far overstates the materiality of any risk of underfunding (McMahon 1, §198).

94. The Appellants' proposed approach of having regard only to the disaggregated benchmarking cost shares would not have been in the interests of consumers for the following reasons (McMahon 1, §201):

94.1. There are inherent limitations of a disaggregated benchmarking cost assessment premised on a combination of separately modelled costs that mean the distribution of allowed totex resulting from the allocation may not necessarily reflect an efficient split of totex across DNO activities (or at least, the disaggregated benchmarking cost shares are only one view of the cost splits of an efficient DNO);

94.2. GEMA only made demand-based workload adjustments within the Secondary Reinforcement disaggregated benchmarking model. As a result, relying solely on the disaggregated benchmarking cost shares would be expected, all other things being equal, to result in an allocation to non-variant totex that is disproportionate, given other elements of a DNOs' cost base (see further McMahon 1, §§201.2 and 185, explaining that disaggregated benchmarking costs shares produce a relative over-allocation to Closely Associated Indirects or CAIs, which are primarily funded through non-variant allowances);

94.3. In particular, a comparison to non-variant totex allowances calculated using GEMA's cost models and the Appellants' submitted forecasts of LCT uptake clearly shows that using only disaggregated benchmarking cost shares would have resulted in a non-variant totex allowance which is higher than can be justified from the outputs of GEMA's (uncontested) cost modelling.

95. An outcome which leads to an excessive or disproportionate non-variant totex allowance could lead to DNOs reaping excessive rewards which are unconnected to specific outputs

or other tangible benefits for consumers. While GEMA does not exclude the possibility that such outperformance could have consumer benefits, it considered the position carefully and concluded, in the exercise of its discretion, that the interests of existing and future consumers were better served by the balanced approach which it ultimately chose to adopt, not least given the high degree of uncertainty for RIIO-ED2. GEMA reasonably rejected the Appellants' proposed approach of relying solely on the cost shares produced by disaggregated benchmarking modelling, which was methodologically inappropriate (since it disregarded submitted costs, a key input into the costs benchmarking process) and would have resulted in disproportionately high non-variant totex allowances.

96. The Appellants contend that the consequence of GEMA's approach is that they will be starting from a position of underfunding of their non-variant totex allowances, and that GEMA's approach will not permit them to recover their efficient costs under any scenario. This is wrong (McMahon 1, §§205-212). The comparator against which the alleged "underfunding" is measured is the level of non-variant totex allowance produced by the sole use of disaggregated benchmarking cost shares. But that is not an objectively correct approach. It is only one view of the appropriate level of non-variant totex allowance, and does not take account of other reasonable approaches. Further:

96.1. The Appellants' non-variant totex allowance for RIIO-ED2 is still a significant increase on their non-variant totex allowance compared to the actual costs that the Appellants incurred for the same non-variant cost activities in RIIO-ED1 (McMahon 1 §209.1);

96.2. Even excluding all demand-based adjustments from the analysis, the difference between the non-variant allowance under NPg's proposed approach as compared to GEMA's chosen approach is just £21m for NPgN and £30m for NPgY (McMahon 1, §209.2 and Appendix C); and

96.3. In general, reasonable cross-checks result in similar levels of non-variant totex as adopted in the final allowances in Final Determinations (McMahon 1, §209.3).

97. Taken in the round, the Appellants have not demonstrated that they will be materially underfunded for non-variant totex for RIIO-ED2 (McMahon 1, §§210-211).
98. Nor is it correct to characterise GEMA's allocation methodology as a further "unjustified and discriminatory ratchet on final allowances" (*cf* NoA §18.27). That is a pejorative and tendentious description which does little more than restate the Appellants' disagreement with the outcome. But there is no arguable legal error: GEMA's approach, in using a 50/50 blend between totex benchmarking cost shares and disaggregated benchmarking cost shares, was a reasonable judgment which it was open to the expert regulator to take.
99. It is not the case that GEMA has mechanically capped the allowance for each activity at the lower of submitted and modelled efficient costs (McMahon 1, §217). On the contrary, GEMA has conducted a number of comparisons and cross-checks to ascertain that the allocation approach is reasonable across the sector and does not unfairly reward or penalise any DNO (See McMahon 1, §§213-217 and Appendix C). GEMA reasonably concluded that the outcomes produced by this methodology were appropriate, and allowed DNOs to recover their efficient costs, while protecting the interests of existing and future consumers (McMahon, §217).
100. The alternative so-called volume driver "cross check" proposed by Frontier Economics does not take the Appellants any further (Frontier, §4.67(c)), (McMahon, §§218-219). That cross check is based on unit costs and corresponding volumes which are derived from the disaggregated modelling, and so it is wholly unsurprising that the results it produces conform to the results of the disaggregated benchmarking cost shares (McMahon, §219).
101. For substantially the same reasons, GEMA's decision to use submitted cost shares as one element of its methodology for the cost allocation process cannot be dressed up as an error of fact (*cf* NoA §21.1(i)). Nor is it tenable to contend that the licence modifications fail to achieve their stated effect (*cf* NoA §21.1(ii)). GEMA's allocation methodology reflects a balanced regulatory judgement, which takes into account both major sources of data used in the cost assessment process, and which yields outcomes which are

reasonable when measured against a wide range of cross checks. The Appellants' proposed approach would ignore one of the two inputs into the cost assessment process in favour of exclusively focussing on the other, and the results of that approach would lead to disproportionate non-variant allowances which are not in consumers' interests. Indeed, NPg's NoA fails to advance any case at all for why their approach would be in consumers' interests; in fact, it would be contrary to those interests.

102. The Appellants' add-on financeability ground, raised tellingly late, is entirely parasitic on the other aspects of this ground. It is only if all their previous arguments are accepted that there would be any consequence at all for the Appellants' bottom lines — but in that case, the duty to have regard to financeability adds nothing in any event. The duty in s.3A(2)(b) EA89 does not impose an obligation of result. GEMA's approach to this duty was upheld by the CMA in *ELMA 2021*, where the CMA held (at §14.74), “*we do not accept WWU's submission that the duty to have regard to financeability requires GEMA to secure the actual financeability of particular licence-holders*”. Further, “*the use of a notional company approach does properly have regard to the need to secure that licensees are able to finance their activities, bearing always in mind GEMA's principal objective of protecting the consumer interest*” (§14.81). That reasoning is plainly correct.
103. GEMA has had careful regard to its principal objective and to all its statutory duties, including the duty to have regard to financeability, in reaching its decision on the cost allocation methodology. GEMA conducted a comprehensive assessment of the financeability of DNOs in the round, and considered modelled credit metrics and credit ratings in both baseline and high totex scenarios (see paragraphs 77-80 above). The duty to ‘have regard’ is not a duty of outcome, and in any event, GEMA's decision was well within the bounds of the expert regulator's discretionary judgement.

i. Conclusion

104. For the reasons explained above, the first ground of appeal is wholly without merit and should be dismissed.

E. RESPONSE TO GROUND 2: BPI STAGE 4 REWARD

j. Introduction

105. The second part of NPg's appeal (which concerns NPgY's licence only) relates to GEMA's decision not to grant NPgY a BPI Stage 4 reward. NPgY contends that GEMA *"failed to compare costs on a rational and consistent basis when determining eligibility for a reward, generating an arbitrary difference in treatment between DNOs"* (NoA, §11.1).
106. The BPI is an incentive mechanism designed to encourage DNOs to submit high quality business plans. At the fourth and final stage of the BPI, GEMA rewards those DNOs whose submitted business plans represent (in GEMA's view) better value than GEMA's own benchmark of efficient costs. In order to determine the eligibility of a DNO to a BPI Stage 4 reward, GEMA must compare each DNO's submitted costs to GEMA's efficient benchmark, or the efficient modelled costs for that DNO. If the DNO's submitted costs fall below GEMA's efficient modelled costs, the DNO receives a BPI Stage 4 reward.
107. NPgY's appeal concerns how GEMA undertook that comparative exercise and in particular, the adjustments which GEMA made to NPgY's modelled costs for the purposes of the exercise (as a result of which GEMA determined that NPgY fell below GEMA's efficient benchmark). The modelled costs were based on both GEMA's totex and disaggregated models (weighted equally). NPgY's essential complaint is that GEMA erred insofar as it compared submitted costs to modelled costs after workload adjustments had been included in the disaggregated modelled costs. NPgY claims that this was wrong because, *"[w]orkload adjustments are driven overwhelmingly not by efficiency assessments, but reflect differences between GEMA's chosen Common Scenario and the planning scenario that was used for the purposes of a DNO's business plan"* (NoA, §11.8(i)). On that basis, NPgY claims that the BPI Stage 4 reward decision *"penalis[es] DNOs that assumed a different decarbonisation scenario to the Common Scenario without a coherent rationale"* (NoA, §11.8(i)).

108. NPgY further alleges inconsistencies: (i) within GEMA’s approach to the BPI Stage 4 reward, because it compared submitted costs to totex modelled costs before making the DDA, which NPgY alleges is “*functionally equivalent to*” workload adjustments; and (ii) with GEMA’s approach to catch-up efficiency (NoA, §11.8).
109. Against that background, NPgY alleges that GEMA’s decision with respect to the BPI Stage 4 reward: (i) was based on errors of facts (i.e. the proposition that workload adjustments are predominantly reflective of efficiency judgments); (ii) fails to achieve its stated objective (because NPgY did not receive a reward but should have done); and (iii) was irrational (NoA, §28.1). NPgY further alleges that GEMA failed to have proper regard to its principal objective and the performance of its duties (NoA, §28.2).
110. For the reasons further developed below, GEMA’s position is that NPgY’s challenge to the BPI Stage 4 reward decision is without merit and should be dismissed:
 - 110.1. The essential premise of NPgY’s appeal in relation to the BPI Stage 4 reward is that workload adjustments are “*overwhelmingly scenario-driven*”. This is wrong. Workload adjustments are predominantly reflective of GEMA’s views of efficient *volumes* just as GEMA’s cost adjustments are reflective of its views of efficient *costs*. Indeed, in the case of NPgY in particular, this was overwhelmingly the case. It follows that there was no error in GEMA’s inclusion of workload adjustments for the purposes of considering the efficiency of NPgY’s business plan at BPI Stage 4.
 - 110.2. NPgY is wrong to contend that there is an inconsistency in GEMA’s inclusion of workload adjustments but exclusion of the DDA. Unlike workload adjustments, the DDA is a post-modelling adjustment which reflects the difference between the DNOs’ submitted scenarios and a particular projection of LCT uptake contained in the System Transformation FES projection. There was nothing inconsistent about not applying the DDA but including workload adjustments.

110.3. NPgY is equally wrong to contend that there is an inconsistency between GEMA's determination of the BPI Stage 4 reward and the catch-up efficiency challenge. The latter was a sector-wide challenge which GEMA decided should focus on the efficiency of the *delivery* of DNOs' business plans. The former (which aimed to encourage ambitious business plans) naturally entailed an assessment of the efficiency of DNOs' business plans themselves. In these circumstances, GEMA made no error in including workload adjustments (predominantly reflective of volume efficiencies) in its assessment of the BPI Stage 4 reward.

k. Background and GEMA's decision in relation to the BPI

(i) Purpose and structure of the BPI

111. The purpose of the BPI is to encourage companies to submit high-quality and ambitious business plans that contain sufficient information for GEMA to be able to undertake a robust assessment of those plans.¹² The BPI offers financial rewards to companies whose business plans (i) represent additional value for money compared to business-as-usual and (ii) provide high quality and high confidence information that was useful to GEMA in setting the price control.¹³

112. The BPI comprises a four-stage process under which GEMA undertakes a qualitative assessment of the companies' business plans and a quantitative assessment of their submitted costs:

112.1. At Stage 1, GEMA imposes financial penalties on DNOs whose business plans fail to meet certain minimum criteria set out in the RIIO-ED2 Business Plan Guidance. GEMA decided that all DNOs had passed Stage 1.¹⁴

¹² McMahan 1, §232

¹³ McMahan 1, §232

¹⁴ McMahan 1, §237

- 112.2. At Stage 2, GEMA carried out a qualitative assessment of consumer value propositions (“CVPs”) advanced by DNOs in their business plans in order to determine whether their plans provided value to consumers beyond business-as-usual.¹⁵
- 112.3. At Stage 3, GEMA imposed financial penalties on DNOs whose business plans contained poorly justified and lower confidence baseline costs. Such poorly justified costs were removed as part of the cost assessment process and GEMA imposed an additional penalty of 10% of the costs in question.¹⁶
- 112.4. At Stage 4, GEMA provided financial rewards to those DNOs whose high-confidence baseline costs were lower than an independent benchmark set by GEMA.¹⁷
113. The purpose of Stage 4 is to reduce any incentives that a DNO might have to hold back cost information (and so be rewarded over the course of the price control by underspending against their allowances) by providing a reward for revealing that information through the business plan. By incentivising DNOs to reveal the best information, GEMA is able to conduct a more robust cost assessment. Where a DNO’s submitted costs are lower than GEMA’s independent benchmark, that DNO’s allowances are set at the level of its submitted costs and the DNO receives a cash reward based on the difference between submitted and modelled costs.¹⁸
- (ii) GEMA’s independent benchmark
114. The independent benchmark which GEMA used when determining DNOs’ eligibility for a BPI Stage 4 reward was intended to represent GEMA’s final estimate of modelled costs. GEMA arrived at the benchmark through its cost modelling process. As explained above, it used three totex benchmarking models and 36 disaggregated models covering different

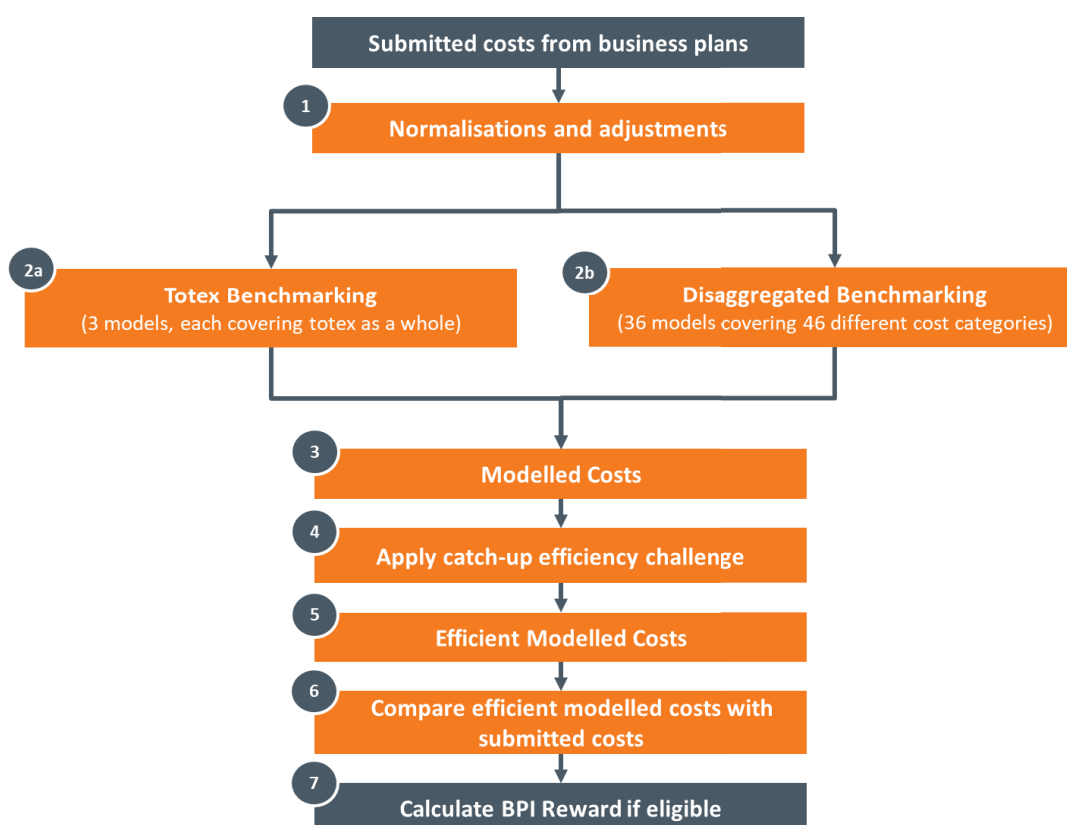
¹⁵ McMahan 1, §237

¹⁶ McMahan 1, §237

¹⁷ McMahan 1, §237

¹⁸ McMahan 1, §238-240

costs categories. GEMA derived its modelled costs from a weighted average of the results of these various models (50% weight on the disaggregated modelling and 50% weight on the totex modelling, which each of the three totex models afforded equal weight). Finally, GEMA applied its “catch-up” efficiency challenge¹⁹ to the modelled costs, which allowed it to reach a view of *efficient* modelled costs, which then formed the benchmark against which DNOs’ submitted costs could be compared.²⁰ A simplified schematic representing how GEMA arrived at the benchmark and then determined the BPI Stage 4 reward is provided below:²¹



¹⁹ The “catch-up” efficiency challenge is a challenge set by GEMA with a view to encouraging DNOs to catch up to the level of costs which GEMA considers a notionally efficient DNO should be able to achieve. GEMA sets it by first calculating the modelled costs of the various DNOs and then selecting a benchmark within the distribution of those modelled costs to represent the level of costs a notionally efficient DNO should be able to achieve. In RIIO-ED2, GEMA set the catch-up efficiency challenge at the 75th percentile in the first year of RIIO-ED2, with a glidepath to the 85th percentile which will apply in the last two years of RIIO GD2: McMahon 1, §91.

²⁰ McMahon 1, §259

²¹ Cf. McMahon 1, §243 and Figure 11.

115. In order to arrive at the modelled costs at Stage 3 in the above schematic, GEMA did not apply the DDA. However, workload adjustments were included within certain of the disaggregated models used at Stage 2b of the above schematic, which related to 11 out of the 46 cost activities which were modelled: principally, “Primary Reinforcement”; “Secondary Reinforcement”; “Tree Cutting”; “Smart Metering Roll Out”; and “Civil Works (Condition Driven)”. Each of these terms is described in greater detail below.

(iii) Workload adjustments

116. By its costs assessment, GEMA carries out two forms of efficiency-related adjustments which are relevant for present purposes:²²

116.1. Cost adjustments: these are adjustments made to a DNO’s submitted *unit costs* based on GEMA’s view of efficiency. For example, GEMA may consider that a DNO’s submitted costs per connection are too high.

116.2. Workload adjustments: these are adjustments made to a DNO’s submitted work *volumes* based on GEMA’s view of what an efficient volume might be. For example, GEMA might consider that a DNO’s projections for the number of assets it needs to replace or the length of circuits it needs to reinforce is inefficient or unnecessary. Workload adjustments can be either “needs related” – for example, where a proposed intervention is unnecessary such that the associated expenditure is unjustified – or “efficiency related” – for example, where the intervention is necessary, but the DNO has submitted inefficient volumes of work to achieve the relevant output.

117. Workload adjustments only form part of the disaggregated modelling and are not a specific stage in the totex modelling. Moreover, workload adjustments are only made to 11 out of the 46 cost activities that are modelled.²³

²² McMahon 1, §107

²³ The reason for this is that workload data is not reported for all of the cost activities to which the disaggregated models relate (e.g. business support). Where workload data is reported, GEMA reviews the submitted workload

118. In the disaggregated models in which GEMA makes no workload adjustments, GEMA does not take a view on the efficiency of the volumes which the DNOs have submitted; rather GEMA has taken a view of the cost efficiency of the DNOs' submitted costs based on the planning scenarios which they have each submitted.²⁴
119. In the relation to the 11 cost activities subject to disaggregated modelling where GEMA does make workload adjustments, the adjustments are generally made by either (i) benchmarking DNOs' workloads over time or (ii) applying adjustments for specific projects based on GEMA's review of the DNOs' submitted engineering justification papers (or "EJPs"), rather than by determining an appropriate level of activity under a particular scenario and then inputting that into the modelling. For example, in the case of the Civil Works (Condition Driven) model, GEMA has benchmarked DNO volumes by using the ratio of annual average condition-driven civil works volumes to associated Total Asset Register asset volumes, using a RIIO-ED1 and RIIO-ED2 industry median.²⁵ GEMA did not model all the separate cost activities in the disaggregated modelling to a particular scenario (which would in any event have been impractical).²⁶ The only disaggregated model in which GEMA made workload adjustments based (in part) on a forecast of LCT uptake was the Secondary Reinforcement model (as explained further below).

(iv) Demand Driven Adjustment

120. GEMA's modelling used the DNOs' own forecasts of load growth, which depended on their forecasts of issues such as LCT uptake. The totex models sought to allow for these differences by including independent explanatory variables in relation to load growth. Some of the disaggregated models adjusted workloads to reflect an efficient view of workloads on the basis of the DNOs' forecasts of load growth.

forecasts and determines whether to make workload adjustments or accept the submitted data (see McMahon 1, §111; Appendix A).

²⁴ McMahon 1, §111

²⁵ McMahon 1, §§109-110; Appendix A

²⁶ McMahon 1, §127

121. GEMA introduced a range of uncertainty mechanisms which were designed to address risks associated with the under- or over-provision of allowances as a result of uncertainty around load growth following LCT uptake. Given these uncertainty mechanisms, GEMA decided it was appropriate to set ex ante allowances based on a conservative view of load growth (which could be flexed upwards as necessary through the uncertainty mechanisms). In order to do so, GEMA introduced a post-modelling adjustment – the DDA. In short, the DDA adjusted modelled costs (derived from the totex models), informed by a view of load growth which was, itself, informed by the System Transformation FES projection (which set out a conservative projection of LCT uptake consistent with achieving net zero targets).²⁷ This post-modelling adjustment was applied to the totex models but not to the disaggregated models (but for the avoidance of doubt was not applied for the purposes of determining the BPI Stage 4 reward). GEMA took this approach to avoid any issues of double-counting with the volume adjustments already made by those models.²⁸
122. Contrary to NPg’s suggestion, GEMA’s demand-based adjustments did not involve aligning DNOs’ costs to any “Common Scenario”.²⁹ Rebasing DNOs’ business plans to another scenario entirely would have been a significant, challenging and impractical change. The adjustments rather represented a proportionate scaling of DNOs’ modelled costs and was anchored on the relative difference between the DNOs’ forecast of LCT uptake and the System Transformation FES forecast.³⁰ Moreover, the effect of the demand-based adjustments was small – roughly 2.8% of totex on average and, in the case of NPg, £116 million, amounting to 3.6% of totex – which reflects the fact that it is not a wholesale scenario adjustment.³¹

²⁷ McMahan 1, §§73, 116-117

²⁸ McMahan 1, §117

²⁹ NoA, §9.4

³⁰ McMahan 1, §§127-128 and Appendix E

³¹ McMahan 1, §128. By contrast, the difference between NPg’s own forecast of their required LRE under their business planning scenario and the System Transformation FES projection was £354m: McMahan 1, §130.

123. GEMA made a similar adjustment in the Secondary Reinforcement disaggregated model. The workload adjustment within the Secondary Reinforcement model *first* adjusted DNOs' submitted reinforcement volumes according to a benchmark which was an industry median ratio of reinforcement relative to DNOs' own forecast demand growth for the transformers, circuit and reactive service upgrade categories. However, in a *second* step, the industry median ratio was also combined with the System Transformation FES view of LCT uptake to calculate adjusted reinforcement volumes. In this sense, the workload adjustment for the Secondary Reinforcement model included an adjustment akin to that made by the DDA.³²
124. As explained in McMahon 1, the Secondary Reinforcement cost category comprises only 4% of NPg's disaggregated modelled costs and only 3% of disaggregated modelled costs across all DNOs. In the case of NPgY, the System Transformation FES projection adjustment element represented 14% of the overall workload adjustment applied to it in the Secondary Reinforcement disaggregated model.³³

1. Response to alleged error / grounds of appeal

125. Against the background explained above, it is clear that NPgY's grounds of challenge in relation to the BPI Stage 4 are without merit.
- (i) Workload adjustments are not "scenario adjustments"
126. The essential premise of NPgY's challenge is that workload adjustments are reflective of "scenario adjustments". On that basis, NPgY argues that GEMA was wrong to include them in the modelled costs to which its submitted costs were compared for the purposes of the BPI Stage 4 reward: the inclusion of those adjustments meant that GEMA failed to compare like with like and penalised those DNOs with high electrification planning

³² McMahon 1, §124

³³ McMahon 1, §125

scenarios, like NPgY.³⁴ However, the premise on which NPgY's challenge relies is wrong.

127. As explained above, workload adjustments are not “scenario adjustments”. On the contrary, they generally reflect GEMA's view of efficient *volumes* in the same way that cost adjustments reflect GEMA's views of efficient *unit costs*. A workload adjustment is made where, for example, GEMA does not consider it efficient for a DNO to undertake a project at all; or does not consider that the workload volumes the DNO has submitted in relation to a project are efficient. Such workload adjustments are therefore a vital step in arriving at an efficient benchmark against which submitted costs can be compared for the purposes of the BPI Stage 4 reward.
128. Only one out of the 11 disaggregated models which involve workload adjustments includes an adjustment which has a *component* which is reflective of demand. That is the Secondary Reinforcement model, in which the industry median ratio of reinforcement relative to DNOs' forecasts is combined with the ratio of those forecasts to the System Transformation FES view of LCT uptake. However, as explained at §124 above, the Secondary Reinforcement model accounts for only a small percentage of NPg's disaggregated modelled costs (4%) – and the component of the workload adjustment which related to the System Transformation FES represented only 14% of the overall adjustment (86% related to the first step of the adjustment according to the industry median ratio). Accordingly, in the case of NPgY, the proportion of the workload adjustments which can be said to be reflective of demand is very small. GEMA therefore rejects NPgY's contention at NoA, §25.7, that £273 million out of a total of £279 million of workload adjustments reflect rebasing to a “Common Scenario”: see McMahon 1, Appendix E.
129. NPgY is therefore wrong to assert that workload adjustments are “*overwhelmingly scenario-driven*”.³⁵ On the contrary, workload adjustments are predominantly efficiency

³⁴ NoA, §§25.1-25.3

³⁵ NoA, §25.7; cf. §11.8(i)

or needs-related and, in the case of NPgY, overwhelmingly so. It follows that the key plank of NPgY's challenge to their inclusion for the purposes of the BPI Stage 4 reward falls away. GEMA cannot be said to have made any error in including those workload adjustments; on the contrary, if it had somehow sought to exclude them from the disaggregated modelling, it would have excluded a critical aspect of its assessment of efficiency.

(ii) No inconsistency with the application of the DDA

130. NPgY is further wrong to suggest an inconsistency between GEMA's decision not to apply the DDA to totex modelled costs for the purposes of the BPI Stage 4 comparative exercise on the one hand and its inclusion of workload adjustments on the other.³⁶

131. As explained above, although the DDA did not involve the wholesale adjustment of DNOs' costs to any "Common Scenario", it was demand-related insofar as it was a post-modelling adjustment which sought to make an adjustment to DNOs' costs informed by the System Transformation FES project of LCT uptake. The workload adjustments were different. For the reasons given above, they are not post-modelling adjustments but represent a critical step in assessing efficiency in the disaggregated modelling. In the case of NPgY at least and as explained above, they are overwhelmingly efficiency-related. NPgY is therefore wrong to suggest that they are "*in the main part functionally equivalent to the DDA*".³⁷

(iii) No inconsistency with the efficiency challenge

132. Nor is NPgY correct to assert that GEMA's decision in relation to the BPI Stage 4 reward is wrong insofar as there is an inconsistency between its approach to assessing this reward and its approach to the calculation of efficiency scores.³⁸

³⁶ NoA, §§11.8(ii) and 24.5

³⁷ NoA, §11.8(ii). The DDA in the totex modelling and the workload adjustments in the Secondary Reinforcement model have the further differences outlined in McMahon 1, §277.

³⁸ NoA, §§11.8(v) and 25.4

133. As explained above, the catch-up efficiency challenge is a further adjustment applied to modelled costs to reflect the costs which GEMA considers a notionally efficient DNO should be able to achieve. GEMA sets the challenge at the 75th percentile of the distribution of DNOs' modelled costs in the first year of the price control, rising via a glidepath to the 85th percentile in the last two years of the price control. DNOs performing behind the benchmark have their allowances reduced to the benchmark and are expected to catch up to it.
134. NPgY is correct that, when calculating the efficiency scores which informed the catch-up efficiency challenge, GEMA used the totex and disaggregated modelled costs before applying either the DDA or any workload adjustments; and that, in contrast, when determining the BPI Stage 4 reward, GEMA compared submitted costs to modelled costs including workload adjustments. However, the difference in assessment is justified by the different context.
135. The catch-up efficiency challenge sets a challenge applicable to the entire sector and is determined by reference to the efficiency scores of all DNOs. Given its effect on the entirety of the sector, it is important to minimise the risks of interpreting differences in business strategies as differences in efficiency. The catch-up efficiency challenge should therefore be informed by GEMA's view of the efficiency in the *delivery* of the DNOs' business plans rather than a wholesale appraisal of the efficiency of the business plans themselves, including the workloads contained therein. For this reason, GEMA uses disaggregated modelled costs *before* workload adjustments. This approach allowed it to focus on the efficiency of delivery and minimise any risks that its catch-up efficiency challenge might be influenced by differences in DNOs' strategies.³⁹
136. The context and objectives of the BPI Stage 4 reward are very different. The purpose of the BPI is to encourage DNOs to submit high-quality, efficient business plans which will assist GEMA's cost assessment process. It is therefore evident that the determination of the BPI Stage 4 reward should focus on the efficiency of the business plan itself (rather

³⁹ McMahon 1, §§267-268

than just the efficiency of the delivering of it). In those circumstances, GEMA was entitled to exercise its judgment so as to include workload adjustments in the disaggregated modelled costs which it compared to the DNOs' submitted costs. The inclusion of those adjustments was wholly consistent with the underlying purpose of the BPI which was to reward ambitious and efficient business plans; to exclude them would have been to omit a key step in the assessment of the business plans' efficiencies. GEMA's decision in this respect, and the difference in approach to the BPI Stage 4 reward and the catch-up efficiency challenge, was therefore an exercise in regulatory judgment which cannot be said to be wrong on any of the grounds advanced by NPgY.

137. NPgY further contends that, by its efficiency score, it ranks as "*the second-most efficient DNO, between South Eastern Power Networks plc ("SPN") (first) and London Power Networks plc ("LPN") (third).*"⁴⁰ However, this metric is not truly reflective of the overall modelled costs and the final efficient modelled costs used to set NPgY's allowances. As explained at §§302-305 and Figure 14 of McMahon 1:

137.1. NPgY does not beat the 75th percentile in any of the three totex models. By contrast, the two DNOs that received a BPI Stage 4 reward (LPN and SPN) beat the 75th and 85th percentile benchmarks in each of the three totex models.

137.2. In the disaggregated modelling, including workload adjustments, NPgY does not rank highly. The exclusion of workload adjustments would heavily skew NPgY's score, giving rise to a change of 16% compared to the result when workload adjustments are excluded. The large variation for NPgY (no other DNO's score changes by more than 5%) reflects its extremely high (and in GEMA's view inefficient) workload volumes relating to secondary network reinforcement.

138. It follows from this that NPgY is wrong to suggest that its submitted costs were close to the frontier of efficiency and so should have received a BPI Stage 4 reward.

⁴⁰ NoA, §25.4

(iv) Response to pleaded grounds of appeal

139. For these reasons, each of NPgY's grounds of appeal pleaded at NoA, §28.1, is without merit:

139.1. The Decision was not based on any error of fact (s. 11E(4)(c) EA89). Workload adjustments are predominantly reflective of efficiency; they are not "scenario adjustments".

139.2. The relevant modifications achieve the effect stated by GEMA (s. 11E(4)(d) EA89). NPgY's high confidence costs did not beat the appropriate independent benchmark and so NPgY rightly did not receive any reward.

139.3. GEMA did not err in law by acting irrationally (s. 11E(4)(e) EA89). The judicial review standard of irrationality which NPgY has chosen to invoke is extremely high in the regulatory context and NPgY does not come close to surpassing it. It is well-established that an enhanced margin of appreciation is afforded to a regulator in an expert field: see for example *Crest Nicholson Operations Ltd v West Berkshire DC* [2021] EWHC 289 (Admin), §81 per Thornton J (relying on *R (Mott) v Environment Agency* [2016] 1 WLR 4338). GEMA's decision plainly falls within that enhanced margin.

140. NPgY finally contends that GEMA failed to have proper regard to or attach appropriate weight to its principal objective. However, NPgY has not begun to explain how GEMA's decision not to award it a BPI Stage 4 reward fails to pursue the principal objective of protecting consumer interests. In reality, and as explained in McMahon 1 at §§282-287, the fact that NPgY did not receive a BPI Stage 4 reward was consistent with the objective of BPI Stage 4 reward in incentivising and rewarding the most ambitious business plans (an objective which was plainly in the interests of consumers). For all the reasons given above, this ground too (in addition to being inadequately explained and formulated) is without merit.

m. Relief claimed

141. By way of relief, NPgY requests that the CMA should (i) quash GEMA’s decision in relation to the BPI Stage 4 reward in relation to NPgY and (ii) substitute for that 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*” (or alternatively make directions to GEMA to retake the decision in a similar manner).⁴¹
142. It is evident that this relief is inappropriate (and, amongst other things, would not further GEMA’s principal objective by delivering an outcome which better protected consumers):
- 142.1. There is no basis for excluding *all* workload adjustments. For the reasons given above, it is evident that for the most part they are reflective of efficiency. It would be inconsistent with the very purpose of the BPI Stage 4 reward for all workload adjustments to be excluded.
- 142.2. It is also inappropriate to exclude any workload adjustments in respect of Secondary Reinforcement. As explained above, in the case of NPgY, only a minority (14%) of those workload adjustments related to GEMA’s use of the System Transformation FES scenario.
143. Accordingly, even if NPgY were to establish that GEMA was wrong to include the limited component of the Secondary Reinforcement workload adjustment which was scenario related in its determination of the BPI Stage 4 reward, its proposed remedies would not reflect this outcome; they go inappropriately further to the detriment of consumers.

n. **Impact and materiality**

⁴¹ NoA, §§29.1-29.2

144. In relation to materiality, NPgY contends that (i) if the BPI Stage 4 reward is calculated before all workload adjustments, NPgY would receive a BPI Stage 4 reward of £15 million and (ii) if the BPI Stage 4 reward were instead 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.⁴²
145. However, for the reasons given at §§141-143 above, NPgY's proposed remedies are inappropriate. If NPgY were to establish that GEMA should not have included the limited component of the Secondary Reinforcement workload readjustment which was scenario related in its determination of the BPI Stage 4 reward, the appropriate remedy would be to exclude this adjustment alone. If it were excluded, however, NPgY's submitted costs would still not beat GEMA's benchmark and NPgY would not be entitled to any reward: McMahon 1, §311.

o. Conclusion

146. GEMA therefore asks the CMA to dismiss all NPg's grounds of appeal in relation to the BPI Stage 4 reward.

DANIEL BEARD KC
Monckton Chambers

TOM COATES
NATASHA SIMONSEN
Blackstone Chambers

⁴² NoA, §§27.2-27.3

F. STATEMENT OF TRUTH

GEMA believes that the facts stated in this Response are true. I am duly authorised to sign this statement on behalf of GEMA.

Signed:

A rectangular box containing a solid black redaction mark, obscuring the signature of the person.

Name:

Steven McMahon

Position:

Deputy Director, Onshore Networks – Price Control Setting

Dated:

24 April 2023