

Northern Powergrid (Northeast) Plc and Northern Powergrid (Yorkshire) Plc v Gas and Electricity Markets Authority

Final determination

21 September 2023



You may reuse this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence.

To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

**The appeal was heard by the following Group of Competition and Markets
Authority Panel Members**

Kip Meek

Robin Cohen

Susan Hankey

Chief Executive of the Competition and Markets Authority

Sarah Cardell

Contents

Page

1. Introduction	11
Conduct of the Appeal	13
2. Industry background	15
Electricity Networks	15
The Distribution Network Operators and their ownership structures.....	15
Northern Powergrid (NPg)	17
Regulation – RII0-2	17
GEMA’s overall process	19
3. Legal framework	22
The decision under appeal.....	22
GEMA’s objectives, powers and duties.....	22
The appeal.....	25
The legal test on appeal.....	26
Introduction.....	26
Standard of review.....	27
The meaning of ‘wrong’	30
GEMA’s margin of appreciation	32
Failure properly to have regard and/or failure to give appropriate weight to the relevant matters in carrying out GEMA’s principal objective and statutory duties (section 11E(4)(a) and (b) EA89).....	34
Error of fact (section 11E(4)(c) EA89)	35
The licence modifications fail to achieve the effect stated by GEMA (section 11E(4)(d) EA89)	38
Wrong in law (section 11E(4)(e) EA89)	38
Materiality	41
Precedents	43
The CMA’s powers on determination of the appeal	43
4. Ground 1 – Misallocation of allowances between cost categories	45
Introduction	45
Background.....	46
Uncertainty around decarbonisation	46
The main steps of GEMA’s approach in cost assessment.....	49
Parties’ and Intervener’s submissions.....	58
NPg’s submissions	58
GEMA’s submissions.....	68
Intervener’s submissions	77
Our assessment of Ground 1	80
The adjustments to LRE	82
GEMA’s submission on the disaggregated benchmarking proportions.....	87
Summary of our assessment.....	90
Statutory appeal grounds	91
Our determination on Ground 1	92
5. Ground 2 – BPI Stage 4 reward	93
Introduction	93
Background.....	94
Parties’ submissions	96
NPg’s submissions	96

GEMA's submissions	101
Our assessment of Ground 2	105
Secondary Reinforcement workload adjustment	106
GEMA's stated aim of the BPI Stage 4 reward	109
Alleged inconsistencies in GEMA's approach	112
Procedural points.....	114
Statutory appeal grounds	117
Our determination on Ground 2	118
6. Remedies.....	119
Introduction	119
Design and implementation of the remedies	122
Our assessment	122

Summary of final determination

Overview of our final determination

1. The Competition and Markets Authority (CMA) has issued its final determination following an appeal from Northern Powergrid (Northeast) Plc (NPgN) and Northern Powergrid (Yorkshire) Plc (NPgY), (together Northern Powergrid or NPg), against the decision by GEMA¹ to proceed with modifications to NPgN's and NPgY's distribution licences (the Decision) in order to implement its RIIO-ED2 price control.²
2. NPg has appealed the decision on two Grounds. The CMA has allowed the appeal in respect of Ground 1 and dismissed the appeal in respect of Ground 2.

The appeal

3. On 3 February 2023, GEMA published its decision on proposed modifications to electricity Distribution Network Operators' (DNOs') licences. These modifications are based on GEMA's RIIO-ED2 price control decisions of 30 November 2022.
4. On 2 March 2023, NPgN and NPgY applied for permission to appeal the Decision. The CMA granted permission to appeal on all grounds on 30 March 2023.
5. The CMA conducted this appeal in accordance with the procedure set out in Schedule 5A to the Electricity Act 1989 (EA89), the Energy Licence Modification Appeals: Competition and Markets Authority Rules (CMA70) (the Rules) and the associated Energy Licence Modification Appeals: Competition and Markets Authority Guide (CMA71).

The evidence

6. We have considered NPg's Notice of Appeal (NoA) and supporting documents, GEMA's response to the NoA (GEMA Response) and supporting documents, NPg's reply to the Response (NPg Reply), and the responses from NPg and GEMA to a Request for Information (RFI). We also allowed an application from Citizens Advice to intervene in the appeal and considered its

¹ The Office of Gas and Electricity Markets (Ofgem) regulates the companies that run the gas and electricity networks. Ofgem is governed by the Gas and Electricity Markets Authority (GEMA).

² RIIO: Revenue = Incentives + Innovation + Outputs

submissions. We heard from NPg and GEMA in a clarification session on 12 May 2023, and held a Main Party Hearing on 12 June 2023 attended by NPg, GEMA and Citizens Advice. We also received and considered responses to requests for further information subsequent to the Main Party Hearing and submissions made by NPg, GEMA and Citizens Advice in response to the CMA's provisional determination and additional submissions made in respect of potential remedies.

Our final determination – Ground 1

7. Ground 1 of NPg's appeal relates to the alleged misallocation of allowances between cost categories. NPg submitted that GEMA was wrong to rely on cost proportions derived from DNOs' submitted costs³ when allocating DNOs' efficient modelled costs because DNOs' submitted costs were based on decarbonisation planning scenarios⁴ that were manifestly different from the one that GEMA intended to fund. NPg submitted that the effect of this approach was that some of its costs that GEMA had determined to be efficient would be irrecoverable in practice.
8. GEMA stated that its cost assessment produced allowances at an overall, total expenditure level. It said that allowances needed to be broken down into cost categories for the operation of uncertainty mechanisms⁵ that allow changes to DNOs' baseline allowances for efficient decarbonisation expenditures in response to changing developments during the price control period. GEMA stated that it was also important to have allowances disaggregated at an activity level in order to allow comparisons against DNOs' submitted costs, and to monitor in-period performance. GEMA used the average of cost proportions derived from DNOs' submitted costs and its disaggregated modelling to allocate total allowances.
9. We have concluded that the Decision was 'wrong in law' (section 11E(4)(e) EA89) because the cost proportions derived from NPg's submitted costs (based on its decarbonisation planning scenario without any specific further adjustment for the purposes of the allocation of NPg's total efficient modelled costs) were an irrelevant consideration, and/or it was otherwise irrational for GEMA to rely on the proportions derived from NPg's submitted costs for the

³ See paragraph 4.2 and its accompanying footnote for an explanation of references to 'submitted costs' in the context of the normalisation adjustments made by GEMA to the costs submitted by each DNO in its business plan.

⁴ A DNO's 'best view' of decarbonisation scenarios with planning for how to deal with them.

⁵ Uncertainty mechanisms allow changes to a company's base revenue to be made during the price control period to reflect significant cost changes that are out of the company's control. Ofgem clarification session slides, 12 May 2023

purposes of allocating NPg's total efficient modelled costs to different cost categories.

10. That is because, in circumstances in which GEMA rejected NPg's Load Related Expenditure (LRE) in its submitted costs and the share of the LRE in NPg's submitted costs was materially higher than the share of LRE within total efficient modelled costs, the cost proportions that were derived by GEMA from NPg's submitted costs⁶ were not relevant, and could not legitimately be relied on at all, for the purposes of GEMA's allocation of NPg's total efficient modelled costs. Therefore, it was 'wrong in law' for GEMA to use those cost proportions when allocating NPg's total efficient modelled costs. In these circumstances and given the importance of the allocation of total efficient modelled costs for the purposes of the price control and the fact that the error was one of economic or regulatory principle (namely, it was an error to use an inappropriate input for those purposes), the error was material.
11. Given that, for the purposes of section 11E(4) EA89, we may allow an appeal on one or more of the statutory appeal grounds, in the interests of the overriding objective,⁷ we do not consider and determine whether any of the other statutory grounds relied on by NPg (in section 11E(4)(a) to (d) EA89) has also been met.
12. In view of the above, we have concluded that the Decision was 'wrong in law' (section 11E(4)(e) EA89) and we allow the appeal to that extent.

Our final determination – Ground 2

13. NPg's second ground of appeal concerns GEMA's failure to grant NPgY a Business Plan Incentive (BPI) Stage 4 reward when it should have done so. NPg submitted that the BPI Stage 4 reward is designed to reward DNOs that provide information about their projected costs that aids GEMA in setting accurate price controls for the sector based on efficient costs.
14. GEMA described the BPI as an incentive mechanism designed to encourage DNOs to submit high quality business plans. It added that 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. To determine the eligibility of a DNO for a BPI Stage 4

⁶ Unless the context otherwise requires, references in this final determination to our assessment in relation to 'submitted costs' are to submitted costs (based on a DNO's decarbonisation planning scenario) after the normalisation adjustments applied by GEMA and without any specific further adjustment for the purposes of the allocation of total efficient modelled costs. See paragraph 4.117 for further explanation.

⁷ Throughout this appeal, we have had regard to the overriding objective of the Rules which is to enable the CMA to dispose of appeals 'fairly and efficiently and at proportionate cost' within the time period prescribed by EA89.

reward, GEMA compared each DNO's submitted costs to GEMA's efficient benchmark (ie the total efficient modelled costs for that DNO). If the DNO's submitted costs fell below GEMA's efficient modelled costs, the DNO received a BPI Stage 4 reward.

15. NPg submitted that GEMA was wrong to compare submitted costs to modelled costs after workload adjustments in the disaggregated modelling as this approach was at odds with the logic of the process as well as inconsistent with the approach taken elsewhere by GEMA in the RIIO-ED2 cost assessment process. NPg further submitted that GEMA's approach created an arbitrary difference in treatment between DNOs to the detriment of DNOs in the position of NPg.
16. GEMA submitted that it was not wrong to include workload adjustments for the purpose of considering the efficiency of NPgY's business plan at BPI Stage 4. GEMA stated that workload adjustments were predominantly reflective of GEMA's view of efficient volumes.
17. We have found that GEMA was not 'wrong' (section 11E(4)(a) to (e) EA89) to apply workload adjustments when determining NPg's eligibility for a BPI Stage 4 reward. In particular, GEMA was not 'wrong', in the case of NPg, to treat Secondary Reinforcement workload adjustments as related predominantly to (in)efficiency. NPg submitted that the justification for its LRE forecast was provided by detailed engineering assessment; GEMA's view was that NPg's planning lacked sufficient justification. GEMA stated that its view was supported by GEMA's independent challenge group which reviewed the business plans. GEMA conducted benchmarking in its assessment of NPg's LRE forecast. Our view is that, in these circumstances, it was not 'wrong' for GEMA to have determined that NPg's high LRE forecast was related predominantly to (in)efficiency. In addition, we have found that GEMA was not 'wrong' on the basis of any alleged inconsistency as set out by NPg.
18. Therefore, we do not allow the appeal, and accordingly confirm the Decision to the extent that we have determined that GEMA was not 'wrong' on the basis contended by NPg.

Remedies

19. We have found GEMA to be 'wrong in law' (section 11E(4)(e) EA89) in respect of Ground 1.
20. We have decided to remit the matter back to GEMA for reconsideration and determination without directions.

21. In case it may assist GEMA in its reconsideration and determination of the matter, we do not envisage that GEMA would necessarily rely solely on the proportions derived from the disaggregated benchmarking for the purposes of GEMA's allocation of NPg's total efficient modelled costs. Rather it may be the case that some of the information derived from NPg's business plan submission would be informative given that the DNOs' submitted costs are an important input to GEMA's benchmarking. We note that in our assessment of the challenge brought by NPg, we do not take issue with GEMA's use of a blended approach (that is, an approach that blends differently derived cost proportions), nor in principle with the use of information derived from NPg's business plan submission.
22. We acknowledge that the complexity of the matter will require time for a proper consideration and implementation of the necessary corrective action, however our expectation is that in view of the importance of the matter (including the need for NPg to have timely clarity for planning and following year charges) GEMA will proceed expeditiously, including in relation to the applicable statutory consultation periods.

1. Introduction

- 1.1 The Office of Gas and Electricity Markets (Ofgem) regulates the monopoly companies that run the gas and electricity networks. Ofgem takes decisions on price controls and enforcement, acting in the best interests of consumers and helping the industries achieve environmental improvements. Ofgem is a non-ministerial department.⁸
- 1.2 Ofgem is governed by the Gas and Electricity Markets Authority (GEMA). GEMA was established by section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.⁹ The Electricity Act 1989 (EA89) sets out that GEMA's principal objective is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution or transmission systems.¹⁰
- 1.3 On 3 February 2023 GEMA published its decision on proposed modifications to electricity Distribution Network Operators' (DNOs') licences. These modifications are based on GEMA's RIIO-ED2 price control decisions of 30 November 2022.¹¹
- 1.4 Northern Powergrid (Northeast) Plc (NPgN) and Northern Powergrid (Yorkshire) Plc (NPgY) are the electricity DNOs for the North East of England and for Yorkshire and Northern Lincolnshire, respectively. They each hold a distribution licence under section 6(1)(c) EA89 (each a Licence and together, the Licences).¹²
- 1.5 On 2 March 2023 NPgN and NPgY, referred to collectively as Northern Powergrid or NPg, applied for permission to appeal GEMA's decision on the proposed modifications to their Licences (the Decision).
- 1.6 On 30 March 2023 the CMA granted permission to appeal on all grounds. On the same date, the CMA appointed a group of three panel members to determine the appeal.
- 1.7 GEMA submitted its Response to the NoA (GEMA Response) on 24 April 2023.¹³

⁸ [Ofgem website](#)

⁹ Energy companies in Northern Ireland are regulated separately by the Northern Ireland Authority for Utility Regulation.

¹⁰ Section 3A(1) EA89.

¹¹ [RIIO-ED2 Final Determinations](#)

¹² [Notice of Appeal \(NoA\)](#), paragraph 1.2.

¹³ [GEMA response to the NoA \(GEMA Response\)](#).

- 1.8 On 24 April 2023 the CMA received an application for permission to intervene in the appeal from Citizens Advice (CA Intervention). Citizens Advice is a charity that provides free advice on issues such as debt, consumer rights and witness support.¹⁴ It also acts as the statutory consumer advocate for energy in Great Britain.¹⁵
- 1.9 On 26 April 2023 the CMA issued its decision to allow Citizens Advice to intervene.
- 1.10 On 12 May 2023 the CMA held a clarification session with NPg and GEMA. Citizens Advice attended as an observer.
- 1.11 On 15 May 2023 NPg submitted its reply to GEMA Response to the NoA (NPg Reply).¹⁶
- 1.12 On 12 June 2023 the CMA held a Main Party Hearing with NPg, GEMA and Citizens Advice.
- 1.13 On 28 July 2023 the CMA issued its provisional determination to NPg, GEMA and Citizens Advice (the Provisional Determination).
- 1.14 On 16 August 2023 the participants (NPg,¹⁷ GEMA¹⁸ and Citizens Advice¹⁹) submitted their responses to the Provisional Determination. Further to a request made by NPg in its response, the CMA invited the Parties to engage without prejudice to the outcome of the appeal to see if they could agree on remedies and directions in the event that the CMA were to uphold its Provisional Determination on Ground 1 in the final determination. The Parties subsequently reported to us that although they did engage in discussions on the topic, a remedy could not be agreed upon.²⁰
- 1.15 This document sets out our final determination on the appeal. In reaching our determination, we have considered the NoA and supporting documents, the GEMA Response and supporting documents, NPg Reply, the parties' responses to a Request for Information (RFI) and the CA Intervention.²¹ We also considered representations made by NPg, GEMA and Citizens Advice at the Main Party Hearing. All participants were permitted to file skeleton arguments ahead of the Main Party Hearing and did so. In addition, NPg and

¹⁴ [Citizens Advice website](#)

¹⁵ CA Intervention, paragraph 11.

¹⁶ [NPg reply to GEMA Response \(NPg Reply\)](#).

¹⁷ NPg Response to PD.

¹⁸ GEMA Response to PD.

¹⁹ Citizens Advice Response to PD.

²⁰ GEMA further submissions on remedies dated 31 August 2023 and NPg further submissions on remedies dated 1 September 2023.

²¹ [CA Intervention](#)

GEMA were asked to submit an agreed joint list of issues (LOI) and did so. We have also considered responses to requests for further information subsequent to the Main Party Hearing and the representations made by NPg, GEMA and Citizens Advice in response to the Provisional Determination and the additional submissions made by GEMA and NPg in respect of potential remedies.

- 1.16 In this document we refer to NPg and GEMA collectively as the Parties, and (as applicable) to Citizens Advice as the Intervener. Under the applicable statutory framework for the appeal process, the CMA must reach its final determination by 29 September 2023.²²
- 1.17 In Chapter 2 of this document, we briefly summarise the role of electricity distribution networks in Great Britain and GEMA's high level process when setting the price control.
- 1.18 Chapter 3 sets out the legal framework for the appeal.
- 1.19 Chapters 4 and 5 address each of NPg's grounds of appeal, summarising the key submissions made in the NoA, GEMA Response, NPg Reply, and those submissions put forward both in skeleton arguments and at the Main Party Hearing by the Parties and Citizens Advice, before turning to our assessment and determination:
 - (a) Ground 1: Misallocation of allowances between cost categories (chapter 4);
 - (b) Ground 2: BPI Stage 4 reward (chapter 5).
- 1.20 Chapter 6 sets out our decision on remedies.

Conduct of the Appeal

- 1.21 The CMA conducted this appeal in accordance with the procedure set out in Schedule 5A EA89, the Energy Licence Modification Appeals: Competition and Markets Authority Rules (CMA70) (the Rules) and the associated Energy Licence Modification Appeals: Competition and Markets Authority Guide (CMA71).

²² That is, within the period of 6 months beginning with the date permission to appeal was granted (section 11G(1)(a) EA89).

1.22 Throughout this appeal, we have had regard to the overriding objective of the Rules which is to enable the CMA to dispose of appeals 'fairly and efficiently and at proportionate cost' within the time period prescribed by EA89.²³

²³ Rule 4.1 of the Rules.

2. Industry background

2.1 This chapter briefly summarises the role of DNOs in Great Britain, their ownership structures and GEMA's high level process when setting the price control.²⁴

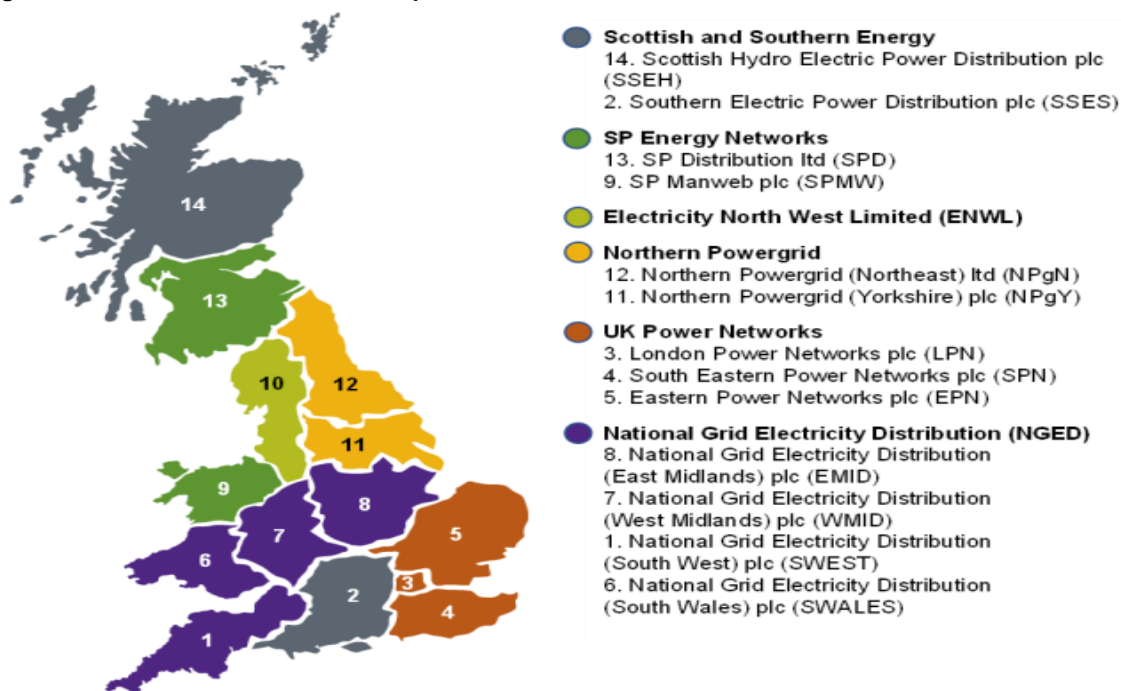
Electricity Networks

2.2 Electricity is transported from generators to consumers via networks: the high voltage transmission network, operated by Transmission Operators (TOs); and the lower voltage distribution networks, operated by Distribution Network Operators (DNOs). DNOs use the lower voltage networks to carry electricity to industrial, commercial and domestic users up to their meter points.²⁵

The Distribution Network Operators and their ownership structures

2.3 DNOs are regional monopolies, owned and operated by private companies. There are 14 DNOs owned and managed by six groups in Great Britain (see Figure 2.1 and Table 2.1 and Table 2.2).

Figure 2.1 DNO location and ownership²⁶



²⁴ The information in this chapter is taken from: [Northern Powergrid \(Northeast\) Limited and Northern Powergrid \(Yorkshire\) plc v the Gas and Electricity Markets Authority \(NPg 2015\)](#); [RIIO-ED2 Final Determinations \(2022\)](#); and Final Determination in respect of the RIIO-GD2/T2 price control regime, 28 October 2021 (ELMA 2021).

²⁵ The vast majority of customers in Great Britain are connected to the distribution network. There are a smaller number of large customers connected directly to the transmission grid.

²⁶ Ofgem clarification session slides, 12 May 2023.

Table 2.1: DNO Groups²⁷

DNO Group		DNO	
ENWL	Electricity North West Ltd	ENWL	Electricity North West Limited
NPg	Northern Powergrid	NPgN	Northern Powergrid: Northeast
		NPgY	Northern Powergrid: Yorkshire
NGED	National Grid Electricity Distribution	WMID	National Grid Electricity Distribution (West Midlands)
		EMID	National Grid Electricity Distribution (East Midlands)
		SWALES	National Grid Electricity Distribution (South Wales)
		SWEST	National Grid Electricity Distribution (South West)
UKPN	UK Power Networks	LPN	UK Power Networks: London Power Networks
		SPN	UK Power Networks: South East Power Networks
		EPN	UK Power Networks: Eastern Power Networks
SPEN	SPEN Energy Networks	SPD	SPEN Energy Networks: Distribution
		SPMW	SPEN Energy Networks: Manweb
SSEPD	Scottish and Southern Energy Power Distribution	SSEH	Scottish and Southern Energy Power Distribution: Scottish Hydro Electric Power Distribution
		SSES	Scottish and Southern Energy Power Distribution: Southern Electric Power Distribution

Table 2.2: Relative size of the six DNO groups²⁸

	Regulatory Asset Value (RAV)	Annual Revenue	ED2 FD Allowed Totex
NGED	£9.6bn	£1.5bn	£6.0bn
UKPN	£7.1bn	£1.4bn	£5.2bn
SSEPD	£4.7bn	£0.8bn	£3.6bn
SPEN	£4.5bn	£0.8bn	£2.9bn
NPg	£4.0bn	£0.7bn	£2.8bn
ENWL	£2.3bn	£0.4bn	£1.7bn

2.4 DNOs (as monopolies) are licensed operators subject to regulation by GEMA.

2.5 Broadly, DNOs' obligations are:

- (a) to maintain security of supply;
- (b) to provide connections for generation and supply; and
- (c) to operate in an efficient, economic and non-discriminatory manner.

2.6 Electricity suppliers buy energy in the wholesale market, or directly from producers, and are obliged to enter into contractual arrangements with TOs and DNOs so that the electricity is delivered to consumers. Suppliers are the

²⁷ CMA analysis of RIIO-ED2 Final Determinations Finance Annex 8 and 9.

²⁸ Based on the RIIO-2 average, CMA analysis of RIIO-ED2 Final Determinations Finance Annex 8 and 9.

primary point of contact for most consumers for matters relating to the supply of electricity.

- 2.7 DNOs also have interactions with consumers. These interactions are often about ensuring that consumers receive a safe and reliable supply of electricity. For example, during power cuts it is the DNOs which supply information on the location and duration of the power cut; provide special assistance to consumers with priority needs; and liaise with other bodies (local councils, charities etc) to ensure vulnerable consumers are protected.²⁹

Northern Powergrid

- 2.8 NPg distributes energy to around 3.9 million homes and businesses across urban and rural communities in the North East, Yorkshire and northern Lincolnshire. NPg is owned by Berkshire Hathaway Energy, a US corporation. It is the second smallest of the six DNO groups.

Regulation – RIIO-2³⁰

- 2.9 DNOs do not charge consumers directly for using the system; they charge generators and suppliers (use of system charges). It is up to suppliers how to reflect these costs in their charges to their customers, by including the distribution charges in those customers' energy bills. Due to the differences in distribution networks across the country, charges in different areas can vary significantly.
- 2.10 Through price controls, which are given effect by modifications to DNOs' distribution licences, GEMA regulates the revenues that DNOs can recover from generators and suppliers. It also seeks to incentivise the DNOs to innovate and find new ways to improve their efficiency and quality of service.
- 2.11 At pre-defined intervals GEMA conducts a price control review in which it sets the revenues for the DNOs over the next price control period. Historically, price control periods lasted for five years but in 2015 with the introduction of RIIO³¹ this changed to eight years. The sixth electricity distribution price control period, RIIO-ED1, set allowed revenues for the period from 1 April 2015 to 31 March 2023. RIIO-ED2 returned to a five-year control period from 1 April 2023 to 31 March 2028. This latest iteration of GEMA's

²⁹ Other consumers may have (or require) a more significant interaction with the DNO. For example, they might need a new or modified connection, have trees that are close to overhead power lines, or require covered overhead power lines that are near to their property.

³⁰ RIIO: Revenue = Incentives + Innovation + Outputs; RIIO-2 is the second set of price controls implemented under the RIIO model which is used to set price controls for the gas and electricity network companies of Great Britain. [Ofgem's website](#)

updated regulatory framework (RIIO-2) is the price control that is subject to this appeal.

- 2.12 The RIIO model is an incentive-based model under which GEMA sets both the amount that regulated companies can earn over the price control period and what the companies must deliver in return for those revenues. Although it is referred to as a price control, GEMA actually controls the total revenues each company can recover rather than specific prices.
- 2.13 Total allowed revenue comprises the following regulatory building blocks:
- (a) the baseline revenue;
 - (b) mechanisms that adjust this revenue during the price control period relative to company performance, eg rewards and penalties that create specific incentives; and
 - (c) other adjustments to baseline revenue, eg due to the availability of uncertainty mechanisms that increase or reduce allowances within the price control period.
- 2.14 Baseline revenue is the revenue the company needs to cover the efficient operating and financing costs of delivering outputs and long-term value for money, including allowances for maintenance of, and investment in, capital assets and taxation. GEMA assesses the efficiency of these costs.
- 2.15 GEMA describes baseline revenue as comprising four different categories:
- (a) An allowance for expenditures that is set at the time of the price control review. These expenditures are called total expenditure (totex), a share of which is included in the in-period revenues;
 - (b) The depreciation of the existing regulatory asset value (RAV);
 - (c) An allowance intended to reflect the cost of capital for an efficient, notional company;
 - (d) Tax.
- 2.16 RIIO adopts a totex approach to ensure companies make balanced decisions between different types of solution. Totex includes capital expenditure (capex) and operating expenditure (opex). Totex is remunerated by a combination of 'fast money' and 'slow money':

- (a) Fast money may be thought of as akin to operating costs or expenditure and is provided in-year (contributing to the baseline revenue described above);
- (b) Slow money remunerates costs that are added to the RAV, through an annual depreciation charge on the RAV together with an annual allowance for the cost of financing the RAV (contributing to the baseline revenue described above).

2.17 As part of its planning for RIIO-2, GEMA consulted on what had worked well in RIIO-1, and what needed to change. GEMA subsequently made a number of changes from RIIO-1, in particular:

- (a) Length of the price control: This was reduced from eight years to five years for RIIO-2;
- (b) Price control deliverables: This was baseline funding linked to delivery outputs, so consumers are refunded if the work is not needed or not carried out;
- (c) Baseline funding vs uncertainty mechanisms: This increased the proportion of costs expected to be funded through uncertainty mechanisms to allow for more flexibility as both needs and costs become clearer over time;
- (d) Increased efficiency challenge: Catch-up efficiency set to rise to 85th percentile in later years of the price control;
- (e) Indexation: The use of indexation for elements of input prices and financial metrics;
- (f) Cost of equity and allowed returns: This reduced the cost of equity allowance from that allowed in RIIO-1; and
- (g) Return adjustment mechanisms: Implementation of a symmetrical return adjustment mechanism if return on equity is significantly above or below the expected value.

GEMA's overall process

2.18 The price control for RIIO-ED2 took effect on 1 April 2023. The preceding process of price control setting was significant and intensive, involving extensive consultation and engagement with stakeholders over a three-year period.

2.19 GEMA's timeline included the following key consultations and formal decisions:

- (a) August 2019: Open Letter – GEMA engaged with stakeholders seeking input on the key issues that were considered a priority for the price control to address;
- (b) December 2019: Framework Decision – GEMA made several substantive decisions associated with the objectives of the price control, the overarching framework for outputs and incentives, fair returns and financeability and other matters;
- (c) July 2020: Sector-Specific Methodology Consultation – this proposed a detailed sector methodology that GEMA would use to apply the framework and help set the price control;
- (d) December 2020: Sector-Specific Methodology Decision – following the Sector-Specific Methodology Consultation this Decision set out much of the detail in GEMA's approach to setting the price control;
- (e) July 2021: Draft Business Plan Submissions – the DNOs submitted information requested by GEMA relating to their historical and forecast expenditure. These were accompanied by reports from the DNOs' customer engagement groups;³²
- (f) December 2021: Final Business Plan Submissions;
- (g) June 2022: Draft Determinations – GEMA published its Draft Determinations which set out a proposed initial funding package of £20.9 billion across all DNOs;
- (h) November 2022: Final Determinations – following consultation on its Draft Determinations, GEMA published its Final Determinations with a revised funding package of £22.2 billion across all DNOs;

³² As part of the RIIO-ED2 enhanced engagement process, each DNO undertook a programme of research and engagement to inform its business planning and established an independent customer engagement group. These groups challenged the DNOs to develop business plans that address the needs and preferences of their stakeholders and provided Ofgem with a public report on their views and the business plans ([RIIO-ED2 Final Determinations Overview document](#), paragraph 1.7 and Appendix 1 - Glossary, page 101). Separately, Ofgem set up a central RIIO-ED2 challenge group that is independently chaired and which provided Ofgem with a public report on companies' business plans from the perspective of end consumers ([RIIO-ED2 Final Determinations Overview document](#), paragraph 1.7 and Appendix 1 - Glossary, page 112).

- (i) December 2022: Statutory consultation on licence modifications – this included the proposed licence changes to implement the Final Determinations; and
- (j) February 2023: Decision on licence modifications – this represented the final licence changes and it is this Decision that is appealable to the CMA.³³

³³ *McMahon 1 (GEMA)*, paragraph 14.

3. Legal framework

The decision under appeal

- 3.1 One of GEMA's specific functions under the EA89 is to license persons engaged in various activities in the electricity supply chain, including the generation, transmission and distribution of electricity for the purpose of giving or enabling a supply to any premises, as well as the supply of electricity to premises.³⁴
- 3.2 GEMA's periodic changes to price controls are given effect by way of modifications to licences. By virtue of section 11A EA89, subject to the prescribed notice having been provided,³⁵ GEMA may make modifications of: (a) the conditions of a particular licence; and (b) the standard conditions of licences of any types mentioned in section 6(1) EA89 (including distribution licences).
- 3.3 The price controls which are at issue in the present appeal were introduced by way of modification to the affected DNOs' licences under section 11A EA89. The decision to modify the licences was published on 3 February 2023, giving effect to the 'RIIO-ED2 Final Determinations'. Prior to issuing the FD on 30 November 2022,³⁶ GEMA consulted on its Draft Determinations published on 29 June 2022.

GEMA's objectives, powers and duties

- 3.4 In carrying out its functions under Part I EA89 (including in relation to the generation, transmission, distribution and supply of electricity), GEMA is subject to a statutory 'principal objective', which is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems.³⁷
- 3.5 For these purposes, the interests of existing and future consumers means their interests taken as a whole, including:³⁸
- (a) their interests in the reduction of electricity-supply emissions of targeted greenhouse gases;

³⁴ Section 6(1) EA89.

³⁵ Section 11A(2) EA89.

³⁶ [RIIO-ED2 Final Determinations](#)

³⁷ Section 3A(1) EA89.

³⁸ Section 3A(1A) EA89.

- (b) their interests in the security of the supply of electricity to them, and
 - (c) their interests in the fulfilment by GEMA, when carrying out its designated regulatory functions, of the 'designated regulatory objectives'.³⁹
- 3.6 Section 3A EA89 goes on to set out a series of specific duties with which GEMA must comply in relation to its principal objective, as well as a series of considerations to which it must (or, in some cases, may) have regard in performing those duties.
- 3.7 First, GEMA is required to carry out its functions under EA89 in a 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.⁴⁰
- 3.8 Second, before deciding to carry out its functions in a particular manner with a view to promoting competition, GEMA must consider:
- (a) to what extent the interests of consumers would be protected by the manner of carrying out those functions; and
 - (b) whether there is any other manner (whether or not it would promote competition) in which GEMA could carry out those functions which would better protect those interests.⁴¹
- 3.9 Third, in performing the duties described in paragraphs 3.7 and 3.8 above, GEMA must 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 their activities; and
 - (c) the need to contribute to the achievement of sustainable development.⁴²
- 3.10 Fourth, in performing its duties set out in paragraphs 3.7, 3.8 and 3.9 above, GEMA must have regard to the interests of a number of specified categories of individuals (eg those who are disabled and those with low incomes), but

³⁹ For these purposes the 'designated regulatory objectives' means the objectives set out in Article 36(c) to (h) of the Electricity Directive 2009/72/EC but read with modifications made by the Electricity and Gas etc. (Amendment etc.) (EU Exit) Regulations 2019, SI 2019/530.

⁴⁰ Section 3A(1B) EA89.

⁴¹ Section 3A(1C) EA89.

⁴² Section 3A(2) EA89.

that does not imply that regard may not be had to the interests of other descriptions of consumer.⁴³

3.11 Fifth, and subject to the requirements set out in paragraphs 3.7 and 3.9 above, GEMA must carry out its functions in relation to the supply of electricity in the manner which it considers is best calculated:

- (a) to promote efficiency and economy on the part of persons authorised by licences or exemptions to distribute, supply or participate in the transmission of electricity, to participate in the operation of electricity interconnectors, to provide a smart meter communication service 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.⁴⁴

3.12 In carrying out those functions in the manner which it considers is best calculated to fulfil the above considerations, GEMA must have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity or the provision of a smart meter communication service.⁴⁵

3.13 Sixth, in carrying out its functions in relation to the supply of electricity, GEMA:

- (a) must have regard to:
 - i. the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed;⁴⁶
 - ii. any other principles appearing to it to represent the best regulatory practice;⁴⁷

⁴³ Section 3A(3) EA89.

⁴⁴ Section 3A(5) EA89.

⁴⁵ Ibid.

⁴⁶ Section 3A(5A)(a) EA89.

⁴⁷ Section 3A(5A)(b) EA89.

- iii. any guidance issued by the Secretary of State about the making by GEMA of a contribution towards the attainment of any social or environmental policies;⁴⁸ and
 - (b) must take into account any advice given by the Health and Safety Executive or the Office for Nuclear Regulation about any electricity safety issue.⁴⁹
- 3.14 Seventh, where the following is affected by the carrying out of any of its electricity supply functions, GEMA may have regard to the interests of consumers in relation to these services:
- (a) gas conveyed through pipes;
 - (b) communication services and electronic communications apparatus; or
 - (c) water services or sewerage services.⁵⁰

The appeal

- 3.15 GEMA's decisions to modify electricity licences are subject to a specific appellate regime. The present appeal has been brought pursuant to section 11C EA89, which provides that an appeal lies to the CMA against a decision by GEMA to proceed with the modification of a condition of a licence under section 11A EA89.
- 3.16 Only certain persons are entitled to appeal such decisions of GEMA to the CMA.⁵¹ These include a person who holds a licence under section 6(1) EA89, where the decision at issue involves a modification to the terms of that licence (referred to in EA89 as a 'relevant licence holder').⁵²
- 3.17 Potential appellants require permission from the CMA to bring an appeal.⁵³ On 2 March 2023, NPgN and NPgY together sought permission to appeal on the basis that each was a 'relevant licence holder' and was named as such in the Decision.⁵⁴
- 3.18 The CMA granted permission to appeal on 30 March 2023.

⁴⁸ Section 3B(2) EA89.

⁴⁹ Section 3C(3) EA89.

⁵⁰ Section 3A(4) EA89.

⁵¹ Section 11C(2) EA89.

⁵² Section 11C(2)(a) EA89.

⁵³ Section 11C(3) EA89.

⁵⁴ NoA, paragraphs 1.2 and 2.3.

3.19 Section 11G(1) EA89 provides that the CMA must determine an appeal against a price control decision within the period of 6 months beginning with the permission date. Accordingly, the statutory deadline for our final determination on the appeal is 29 September 2023.

The legal test on appeal

Introduction

3.20 The Parties made a number of submissions on various aspects of the legal test on appeal, including the standard of review, the meaning of ‘wrong’ and other parts of the statutory grounds of appeal. In this section, we summarise their key submissions and set out our position on the legal test applicable to the statutory grounds for the purposes of the present appeal.

3.21 In considering the Parties’ submissions and setting out our position, we have taken the following steps:

(a) We have drawn primarily from the approach taken in other regulatory appeals determined by the CMA involving substantially the same statutory framework, where relevant. Most notably, we have drawn from the determinations of the appeals against the RIIO-1 price control decision (the ED1 Determinations⁵⁵) and the RIIO-GD2/T2 price control (ELMA 2021⁵⁶), but as in those determinations we have also had regard to cases under the Energy Act 2004⁵⁷ on the basis that the grounds for allowing an appeal under that statute are very similar to the grounds for allowing an appeal under EA89. As such, these provide helpful guidance as to the level of scrutiny which an appellate body with particular expertise such as the CMA should adopt in reviewing GEMA’s decisions in the present case.⁵⁸

(b) We have also taken guidance from the approaches taken in the appeals brought under the Gas (Northern Ireland) Order 1996⁵⁹ and the Electricity (Northern Ireland) Order 1992,⁶⁰ given that the statutory grounds for allowing an appeal under those regimes are essentially the same as the

⁵⁵ The ED1 Determinations were: *British Gas Trading Limited v The Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 (‘BGTL v GEMA’); and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 (‘NPg v GEMA’).

⁵⁶ Final Determination in respect of the RIIO-GD2/T2 price control regime, 28 October 2021.

⁵⁷ *E.ON UK plc v GEMA: energy code modification appeal*, 10 July 2007 (‘E.ON’).

⁵⁸ *BGTL v GEMA*, paragraph 3.25 and *NPg v GEMA*, paragraph 3.24.

⁵⁹ *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 26 June 2017 (‘Firmus Energy’).

⁶⁰ *SONI Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 10 November 2017 (‘SONI’).

grounds for allowing an appeal under EA89. We consider that the approaches taken in those determinations are instructive for the approach which the CMA should take in the present appeals.

- (c) We have also taken guidance from appeals brought under other regimes such as the Communications Act 2003 (CA03). Whilst we acknowledge that there is no direct analogy with the present appeals given some differences in the statutory provisions, we consider the approach adopted in these cases by the Competition Appeal Tribunal (the CAT) to be broadly analogous to the approach taken by the CMA in the ED1 Determinations and that they therefore also provide some guidance as to the level of scrutiny which an appellate body with particular expertise such as the CMA should adopt in reviewing GEMA's decision in the present case.⁶¹

Standard of review

3.22 Under section 11E(4) EA89, the CMA may allow an appeal only to the extent that it is satisfied that the decision appealed against was 'wrong' on one or more of the following specified grounds, namely that:

- (a) GEMA failed properly to have regard to any matter to which GEMA must have regard in carrying out its principal objective under section 3A EA89, and its duties under sections 3A, 3B and 3C EA89;
- (b) GEMA failed to give the appropriate weight to any such matter;
- (c) The decision was based, wholly or partly, on an error of fact;
- (d) The modifications fail to achieve, in whole or in part, the effect stated by GEMA in the decision as required by section 11A(7)(b) EA89;
- (e) The decision was wrong in law.

⁶¹ Previously, CA03 required consideration of appeals on the merits by reference to whether the decision under appeal was 'wrong'. It was amended in July 2017 by the Digital Economy Act 2017 which introduced a new standard of review. As a result of the changes, the CAT is required to 'apply the same principles as would apply in a judicial review case but also to ensure that the merits of the case are duly taken into account' (see *TalkTalk and Vodafone v. Ofcom* [2020] CAT 8, at [120]; see also at [139], where the CAT considered that it 'should continue, as before, to scrutinise the Decision for procedural unfairness, illegality and unreasonableness, but, in addition, we should form our own assessment of whether the Decision was wrong'). For the purposes of the present appeal, we have drawn guidance from cases brought both before and after the CA03 was amended where we consider that they raise points about the standard of review that are relevant to the regime under EA89.

- 3.23 Section 11E(2) EA89 provides that 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:
- (a) in the carrying out of its principal objective under section 3A EA89 (see paragraphs 3.4 and 3.5 above);
 - (b) in the performance of its duties under section 3A EA89 (see paragraphs 3.6 to 3.13 (a)(ii) above); and
 - (c) in the performance of its duties under section 3B and 3C EA89 (set out at paragraphs 3.13(a)iii to 3.13(b) above).
- 3.24 Section 11E(3) EA89 provides that in determining the appeal, the CMA (a) may have regard to any matter to which GEMA was not able to have regard in relation to the decision, but (b) must not, in the exercise of that power, have regard to any matter to which GEMA would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so.

Submissions from the Parties

- 3.25 In their general submissions on the standard of review to be applied by the CMA, the Parties referred to a number of points that had been made by the CMA in its previous determinations of regulatory appeals. We summarise the key references below, which, in our view, show that there was a measure of common ground between the Parties:
- (a) The standard of review goes further (in GEMA's view it is more intense) than the traditional grounds of judicial review, in that, to determine whether the decision under appeal is wrong, the CMA is required to consider the merits of that decision;⁶²
 - (b) The merits of the decision are to be considered by reference to the prescribed statutory appeal grounds;⁶³
 - (c) A consideration of the merits for these purposes is distinct from a de novo consideration of the merits or re-hearing of all the evidence;⁶⁴

⁶² [NoA](#), paragraph 14.3, citing *BGTL v GEMA*, paragraph 3.43; and *NPg v GEMA*, paragraph 3.42. See also [NoA](#), paragraphs 14.5 and 14.6, citing *ELMA 2021*, *Firmus Energy* and *SONI*, which *NPg* submitted reflected the line of reasoning that a merits review of the regulator's decision is required. [GEMA Response](#), paragraph 43.

⁶³ [NoA](#), paragraph 14.4, citing *BGTL v GEMA*, paragraph 3.24 and *NPg v GEMA*, paragraph 3.23. [GEMA Response](#), paragraph 32, citing *ELMA 2021*, paragraph 3.31, and paragraph 43, citing *BGTL v GEMA*, paragraph 3.24.

⁶⁴ [NoA](#), paragraph 14.7, citing *R (Wales & West Utilities Ltd) v CMA [2022] EWHC 2940 (Admin)* at paragraphs 26-33. [GEMA Response](#), paragraph 32, citing *ELMA 2021*, paragraph 3.31 and paragraph 43.

(d) The CMA should not substitute its views or judgement for GEMA's solely on the basis that it would have taken a different approach or view if it had been the energy regulator (eg on the weight to be attached to particular considerations or factors).⁶⁵ GEMA added that the legal test on appeal clearly admits of circumstances in which the CMA might reach a different view from GEMA, but in which it cannot be said that GEMA's decision was wrong on one of the statutory grounds.⁶⁶

Our position

3.26 Based on the statutory provisions referred to at paragraphs 3.22 to 3.24 above, and drawing from the approach taken in other regulatory appeals determined by the CMA and other bodies, as described at paragraph 3.21 above, we set out the following general principles arising in relation to the standard of review with which we agree and adopt.

3.27 First, the CMA's role goes further than the traditional judicial review grounds in that the CMA is required to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal⁶⁷ laid down in the statute.⁶⁸ In this context, it is relevant to note that, when this appeal mechanism was inserted into the provisions of EA89, the preceding consultation document referred to the grounds of appeal that would be available to appellants, stating:

It is the Government's intention that the proposed grounds for appeal for licence modification decisions also enable the appeal body to take account of the merits of the case in a similar manner [to energy code modification appeals]. The Government considers the Competition Commission's (CC) approach in relation to code modifications to be helpful in this regard.⁶⁹

3.28 Second, the merits of the decision are to be considered by reference to the specific errors alleged by the appellant and within the confines of the prescribed statutory appeal grounds as pleaded.⁷⁰

⁶⁵ [NoA](#), paragraph 14.3, citing *BGTL v GEMA*, paragraph 3.43 and *NPg v GEMA*, paragraph 3.42. GEMA Response, paragraphs 31, 32 and 33, citing *BGTL v GEMA*, paragraph 3.26 and *ELMA 2021*, paragraph 3.23 among other determinations.

⁶⁶ [GEMA Response](#), paragraph 34.

⁶⁷ That is, the grounds of appeal set out in section 11E(4)(a)-(e) EA89.

⁶⁸ *BGTL v GEMA*, paragraph 3.24 and *NPg v GEMA*, paragraph 3.23; see also *ELMA 2021*, paragraph 3.26.

⁶⁹ Department of Energy and Climate Change, 'Implementation of the EU Third Internal Energy Package: Government Response' (January 2010), at paragraph 2.24.

⁷⁰ *ELMA 2021*, paragraphs 3.28 (citing *BGTL v GEMA*, paragraph 3.37 and *NPg v GEMA*, paragraph 3.36) and 3.31.

- 3.29 Third, a consideration of the merits does not involve a re-run of the original investigation or a de novo re-hearing of all the evidence. The key question is whether GEMA made a decision that was ‘wrong’, on one or more of the prescribed statutory grounds.⁷¹
- 3.30 Fourth, it is not our role to substitute our judgement for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator.⁷²

The meaning of ‘wrong’

- 3.31 As explained at paragraph 3.22 above, the CMA must decide whether the Decision was ‘wrong’ on one or more of the statutory appeal grounds.
- 3.32 We set out first the general submissions made by the Parties on the meaning of ‘wrong’, followed by submissions they made on the general nature of the specific statutory appeal grounds.

Submissions from the Parties

- 3.33 In their general submissions on the meaning of ‘wrong’, the Parties referred to a number of points that had been made by the CMA in its previous determinations of regulatory appeals. We summarise the key references below:
- (a) Both NPg and GEMA stated that the test applied by the CMA (NPg referred to this as the CMA’s starting point) was whether the decision appealed against was wrong (and that the error was material), not whether it was unreasonable;⁷³
 - (b) GEMA added that 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;⁷⁴

⁷¹ ELMA 2021, paragraphs 3.27, 3.28 (citing BGTL v GEMA, paragraph 3.36 and NPg v GEMA, paragraph 3.35) and 3.31. See also, by analogy, BT v Ofcom [2010] CAT 17, at [76], cited in ELMA 2021, paragraph 3.27, in which the CAT stated, in the context of appeals against Ofcom price controls in the telecommunications sector, that ‘[w]hat is intended is the very reverse of a de novo hearing. OFCOM’s decision is reviewed through the prism of the specific errors that are alleged by the appellant ... What is intended is an appeal on specific points’. See also Virgin Media Limited v Ofcom [2020] CAT 5, at [57], where the CAT stated that ‘the focus is Ofcom’s decision’ and ‘[t]he question is not what decision the appellate body might itself have reached if it had started afresh’.

⁷² E.ON, paragraph 5.11, cited in BGTL v GEMA, paragraphs 3.27 and 3.43; NPg v GEMA, paragraphs 3.26 and 3.41.

⁷³ NoA, paragraph 14.8, citing ELMA 2021, paragraph 3.65, citing SONI, paragraph 3.35. [GEMA Response](#), paragraph 27, citing SONI, paragraph 3.35.

⁷⁴ [GEMA Response](#), paragraph 36, citing SONI, paragraph 3.29.

- (c) GEMA also referred to the CMA's summary of relevant principles, set out in Firmus Energy.⁷⁵ We do not set out those principles here, as we refer to the principles most relevant to the present appeal in the sections below.

Our position

- 3.34 Our starting point when considering an appeal is as set out in SONI, where the CMA stated that:

The test is whether the CMA is satisfied the regulator's decision was wrong on one or more of the statutory grounds and that the error was material.⁷⁶

- 3.35 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'.⁷⁷

- 3.36 As regards potential alternative approaches, our starting point should not be to determine whether there is an alternative approach and then decide whether it is better. Rather, we should only determine whether there is an error in the approach chosen by GEMA, as alleged by the appellant.⁷⁸

- 3.37 In considering whether GEMA's chosen approach discloses an error, we will consider its inherent merits including by comparing its merits with those of any reasonable alternatives advanced by the appellant. If, out of the alternatives available, we conclude that some alternatives clearly had greater merit than the solution chosen by GEMA, this may assist in determining whether – although it will not necessarily imply that – GEMA's solution was 'wrong' on one or more of the statutory grounds. On the other hand, where the alternative options each have competing pros and cons, and none is clearly superior, we do not think it would be right to determine that GEMA has erred on the basis that it took a course other than the one we would have taken.⁷⁹ However, in any event, we may find that GEMA's decision was 'wrong' in circumstances where the appellant has not identified an alternative approach

⁷⁵ [GEMA Response](#), paragraph 35, citing Firmus Energy, paragraph 3.20.

⁷⁶ SONI, paragraph 3.35, which was also cited in ELMA 2021, paragraph 3.65.

⁷⁷ Firmus Energy, paragraph 3.20(a).

⁷⁸ ELMA 2021, paragraphs 3.40 and 3.41, citing SONI, paragraph 3.29. If the CMA were to find that GEMA's decision was 'wrong', it may then be appropriate for the CMA to consider alternative approaches insofar as it intends to exercise its power to substitute its own decision for that of GEMA (see paragraph 3.89 below).

⁷⁹ The Carphone Warehouse Group v Ofcom (Local Loop Unbundling) Final Determination of 31 August 2010 ('Carphone Warehouse'), paragraph 1.34, cited in ELMA 2021, paragraph 3.43. See also Firmus Energy, paragraph 3.20(c) for the statement of principle that, 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.

that we consider appropriate if we are nonetheless persuaded that there was an error in the approach chosen by GEMA.⁸⁰

GEMA's margin of appreciation

- 3.38 Before we turn to the meaning of 'wrong' for the purposes of the specific statutory appeal grounds, we cover general points relating to GEMA's margin of appreciation, that is the degree of deference to be given in an appeal to a specialist regulator on matters falling within its expert judgement.
- 3.39 The question of the margin of appreciation as it applies to specific statutory appeal grounds is addressed in the next section, under each of those grounds, as applicable.

Submissions from the Parties

- 3.40 NPg submitted that if (unlike in the present appeal) there is a challenge to the exercise of 'an overall value judgment', the regulator is entitled to a substantial margin of appreciation.⁸¹
- 3.41 GEMA submitted that it was well-established that an enhanced margin of appreciation is afforded to a regulator in an expert field.⁸² GEMA also referred to the statement of principle set out in *Firmus Energy* to the effect that the CMA should not interfere with the regulator's exercise of judgement unless satisfied that it was wrong.⁸³

Our position

- 3.42 The margin of appreciation afforded to GEMA in matters of regulatory judgement is an important consideration in reaching a finding as to whether a decision is 'wrong', as recognised by the CMA and courts in previous regulatory appeals.⁸⁴
- 3.43 For example, the CMA set out the following statement of principle in *Firmus Energy*:

⁸⁰ See *Firmus Energy*, paragraph 3.20(d) which noted that the courts had 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.

⁸¹ *NoA*, paragraph 14.7.

⁸² [GEMA Response](#), paragraph 139.3, citing, by way of example, *Crest Nicholson Operations Ltd v West Berkshire DC* [2021] EWHC 289 (Admin), paragraph 81.

⁸³ [GEMA Response](#), paragraph 35, citing *Firmus Energy*, paragraph 3.20(f).

⁸⁴ *ELMA 2021*, paragraph 3.55.

Where a decision of the regulator requires an exercise of judgement, the regulator will have a margin of appreciation. The CMA should apply appropriate restraint and should not interfere with the regulator's exercise of judgement unless satisfied that it was wrong.⁸⁵

3.44 In *Virgin Media*, which was a case brought under CA03, the CAT held that:

[p]roper respect must be accorded to Ofcom's role as a specialist regulator, and the expertise of Ofcom's staff.⁸⁶

3.45 In *E.ON* the CC took the view that the statutory test under section 175 of Energy Act 2004:

...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.⁸⁷

3.46 In line with the above, where the exercise of regulatory judgement is involved, GEMA will have a margin of appreciation as an expert regulator. GEMA's margin of appreciation will be at its greatest where all that is impugned is an overall value judgement based upon competing considerations in the context of a public policy decision.⁸⁸ However, GEMA's margin of appreciation is not unbounded and we must not uncritically accept GEMA's assessment and weighting of the considerations before it simply because GEMA is an expert body.⁸⁹ We shall carefully scrutinise the substance of GEMA's decision-making in line with the grounds of appeal advanced before us and we shall intervene where we are persuaded that GEMA has made a material error.⁹⁰

3.47 As explained below, as applicable in relation to the specific statutory appeal grounds, we consider that the approach we should take in relation to GEMA's margin of appreciation will differ depending on the nature of the error alleged by the appellant.

⁸⁵ *Firmus Energy*, paragraph 3.20(f), citing *BT v Ofcom* [2014] EWCA Civ 133, at paragraphs 87 and 88.

⁸⁶ *Virgin Media Limited v Ofcom* [2020] CAT 5, at [57], cited in *ELMA 2021*, paragraph 3.66.

⁸⁷ *E.ON*, at paragraph 5.12, cited most recently in *ELMA 2021*, paragraph 3.74.

⁸⁸ See the dicta of the Court of Appeal to this effect in *T-Mobile v Ofcom* [2008] EWCA Civ 1373, paragraph 31; see also *ELMA 2021*, paragraph 3.76.

⁸⁹ *ELMA 2021*, paragraphs 3.68 and 3.78.

⁹⁰ *ELMA 2021*, paragraph 3.78.

Failure properly to have regard and/or failure to give appropriate weight to the relevant matters in carrying out GEMA’s principal objective and statutory duties (section 11E(4)(a) and (b) EA89)

Submissions from the Parties

- 3.48 NPg set out the requirement for GEMA to have regard to the principal objective and the related statutory duties.⁹¹ It submitted that the duty on GEMA, under section 3A(2)(b) EA89, to have regard to the need to secure that licence holders are able to finance their relevant activities (the financeability duty) required that price control decisions ensure that DNOs are able to (i) cover the reasonable costs of meeting the required outputs, (ii) make reasonable returns on capital for providing distribution services and (iii) raise any necessary debt or equity financing readily and on reasonable terms. NPg added that this required a consideration of both short-term and longer-term effects on the availability of finance.⁹²
- 3.49 NPg also submitted that GEMA will have failed to give appropriate weight to any of the matters to which it must have regard in the carrying out of its principal objective and in the performance of its related statutory duties, where it has given insufficient or excessive weight to them.⁹³
- 3.50 GEMA did not make any submissions on the general nature of the provisions of section 11E(4)(a) and (b) EA89.

Our position

- 3.51 In view of our conclusions on Grounds 1 and 2 (see chapters 4⁹⁴ and 5⁹⁵ respectively), we do not need to express a view on NPg’s general submission on the financeability duty, nor on the approach to be taken in relation to the weight to be given to the matters to which GEMA must have regard in the carrying out of its principal objective and in the performance of its related statutory duties.

⁹¹ NoA, paragraphs 15.3-15.8.

⁹² NoA, paragraph 15.9.

⁹³ NoA, paragraph 15.10, citing E.ON UK Plc v GEMA, Decision and Order of the Competition Commission, 10 July 2007 ('E.ON'), paragraph 7.16.

⁹⁴ In particular, paragraphs 4.149 to 4.150.

⁹⁵ In particular, paragraph 5.78.

Error of fact (section 11E(4)(c) EA89)

Submissions from the Parties

- 3.52 NPg submitted that under this ground, GEMA will have erred where it has made a factual error in making its decision and that error materially affects the decision.⁹⁶
- 3.53 NPg noted that if the CMA finds that GEMA's decision is based on a plain error of fact, there is no room for a margin of appreciation.⁹⁷
- 3.54 GEMA submitted that the type of error alleged to have been made should affect the approach to be taken by the CMA.⁹⁸ As regards error of fact, it made three points:
- (a) The CMA will determine whether GEMA was correct in its conclusions as to primary facts, or inferences that it drew from those facts.⁹⁹ However, it will be slow to impugn the specialist regulator's findings of fact given that (a) the regulator may well have an advantage over the CMA in finding the relevant primary facts and (b) the regulator has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry;¹⁰⁰
 - (b) Where the alleged error lies in GEMA's judgement in relation to unchallenged primary fact or inference, then 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, GEMA submitted, there is a field of possible judgements in which GEMA may exercise its discretion lawfully, and reasonable people may disagree about the judgement it made;¹⁰¹

⁹⁶ [NoA](#), paragraph 15.11, citing E.ON, paragraph 5.16 in which the CC stated that there was a 'clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact'.

⁹⁷ [NoA](#), paragraph 14.9, citing ELMA 2021, paragraph 3.72.

⁹⁸ [GEMA Response](#), paragraph 37.

⁹⁹ [GEMA Response](#), paragraph 38, citing BGTL v GEMA, paragraph 3.30 and ELMA 2021, paragraph 3.34 in relation to the point of principle stated by the Court of Appeal in *Assicurazioni Generali Spa v Arab Insurance Group* [2003] 1 WLR 577 [2002] EWCA Civ 1642 (*Assicurazioni*).

¹⁰⁰ [GEMA Response](#), paragraph 39, citing SONI, paragraph 3.31 and E.ON, paragraph 5.16.

¹⁰¹ [GEMA Response](#), paragraph 40, citing SONI, paragraphs 3.32 and 3.36; see also [GEMA Response](#), paragraph 38 on the similar point made in *Assicurazioni Generali Spa v Arab Insurance Group* [2003] 1 WLR 577 [2002] EWCA Civ 1642 about the approach to issues of judgement on unchallenged primary findings and inferences.

- (c) Where the alleged error lies in GEMA's evaluation of a fact, as distinct from primary fact, the CMA will regard it as it would an exercise of regulatory discretion.¹⁰²

Our position

- 3.55 Our starting point is that, as regards findings of primary fact, we will show a degree of deference to GEMA, as the specialist regulator, but we have a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact. As stated by the CC in E.ON:

GEMA, as the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. ... GEMA ... 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 GEMA's findings of fact. Nevertheless, the CC has a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact.¹⁰³

- 3.56 This principle extends to the correctness or otherwise of any inference drawn from primary fact. As noted most recently in ELMA 2021,¹⁰⁴ in 2003 the Court of Appeal in *Assicurazioni Generali Spa v Arab Insurance Group* issued a Practice Note where the Court held that:

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. ... the role of an appellate court is to determine whether or not [a finding or inference is wrong], 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 ... 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.

¹⁰² [GEMA Response](#), paragraph 41, citing *BGTL v GEMA*, paragraph 3.31, which in turn referred to *Assicurazioni Generali Spa v Arab Insurance Group*.

¹⁰³ E.ON, paragraph 5.16, cited in the ED1 Determinations and in ELMA 2021, paragraph 3.73.

¹⁰⁴ ELMA 2021, paragraphs 3.34 and 3.35, which in turn referred back to the ED1 Determinations and E.ON.

3.57 When applying the five statutory grounds¹⁰⁵ and the exercise of judgement in relation to primary fact or inference is engaged in relation to the statutory ground of error of fact (as also for the ground of ‘wrong in law’), our position is as follows.

3.58 Where the alleged error lies in GEMA’s judgement in relation to unchallenged primary fact or inference, we ought not to interfere unless we are satisfied that GEMA’s conclusion lay outside the bounds within which reasonable disagreement is possible. As stated in *Assicurazioni Generali Spa v Arab Insurance Group*:

... 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.

3.59 Moreover, we should not substitute our own judgement simply because we would have taken a different view had we been in the position of the regulator. As stated in *SONI*,¹⁰⁶ having referred to *Assicurazioni*, the CMA concluded that:

when applying the five statutory tests¹⁰⁷... 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.

3.60 Where the alleged error relates to evaluations of fact by GEMA, rather than conclusions of primary fact, then we should ask ourselves whether it discloses any error on one or more of the statutory grounds, approaching such evaluations in the same way that we approach the exercise of discretion.¹⁰⁸

¹⁰⁵ These are the grounds set out in section 11E(4) EA89.

¹⁰⁶ *SONI*, paragraph 3.36, cited in *ELMA 2021*, paragraph 3.36.

¹⁰⁷ These are the tests in section 14D of the Electricity (Northern Ireland) Order 1992, which are substantially the same as those in section 11E(4) EA89.

¹⁰⁸ *BGTL v GEMA*, paragraph 3.31.

The licence modifications fail to achieve the effect stated by GEMA (section 11E(4)(d) EA89)

- 3.61 Neither NPg nor GEMA made any submissions on the general nature of the provisions of section 11E(4)(d) EA89.¹⁰⁹
- 3.62 We do not have any general points of principle to make in relation to this statutory appeal ground for the purposes of the present appeal.

Wrong in law (section 11E(4)(e) EA89)

Submissions from the Parties

3.63 NPg made three submissions:

- (a) GEMA's decision will be wrong in law where, amongst other things, GEMA has misdirected itself on its objectives (including more broadly any relevant requirements of EA89) in making its decision;¹¹⁰
- (b) A decision is also wrong in law where it contravenes the principles applicable in judicial review, including that a decision is unlawful where it falls outside 'the range of responses which a reasonable decision-maker might have made in the circumstances' (ie it is irrational in the public law sense);¹¹¹
- (c) The concept of 'wrong in law' also covers basic arithmetic errors.¹¹²

3.64 GEMA submitted that the judicial review standard of irrationality which NPg had chosen to invoke was 'extremely high' in the regulatory context.¹¹³

3.65 As regards the margin of appreciation to be afforded to GEMA under this statutory appeal ground:

¹⁰⁹ Instead, NPg set out the requirements of section 11A(7) EA89, of which requirement (b) is that GEMA must state the effect of the licence modifications (NoA, paragraph 15.13).

¹¹⁰ NoA, paragraph 15.15.

¹¹¹ NoA, paragraph 15.16, citing the formulation used by the Privy Council in *Soomatee Gokool & Ors v Permanent Secretary of the Ministry of Health and Quality of Life & Anor* [2008] UKPC 54, at [18].

¹¹² NoA, paragraph 15.17, citing *Danae Air Transport v Air Canada* [2000] 1 WLR 395, at page 406.

¹¹³ [GEMA Response](#), paragraph 139.3; see also *GEMA Response to PD*, paragraph 23 (noting that the threshold of irrationality was high in any context and had been described as requiring, among other matters, 'perversity' (*Reid v Secretary of State for Scotland* [1999] AC 512, 541G, 542C) or 'absurdity' (*R v Secretary of State for the Environment, ex p Nottinghamshire CC* [1986] AC 240, 247H and 248C-D)) and paragraph 24 (noting that in the regulatory context the irrationality hurdle was one of 'manifest error' (*R (Mott) v Environment Agency* [2016] 1 WLR 4338, paragraph 74)).

- (a) NPg submitted that if the CMA finds that GEMA's decision was 'wrong in law', there is no room for a margin of appreciation;¹¹⁴
- (b) GEMA submitted that 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;¹¹⁵
- (c) GEMA further submitted that, in the context of the judicial review standard of irrationality (the application of which it did not dispute for the purposes of this appeal), it was well-established that an enhanced margin of appreciation is afforded to a regulator in an expert field.¹¹⁶

Our position

- 3.66 The concept of 'wrong in law' is not defined in the EA89. In other statutory contexts, however, appeals on a 'point of law' or a 'question of law' have been held to include matters of legal interpretation and also the full range of issues which would otherwise be the subject of an application to the High Court for judicial review.¹¹⁷ These include challenges on grounds of procedural error, irrationality, inadequacy of reasons, having regard to irrelevant matters, and failing to have regard to relevant matters.¹¹⁸
- 3.67 The language and context of section 11E(4)(e) EA89 are different from the legislation at issue in the case law cited in the previous paragraph. Nevertheless, we consider that this case law provides useful guidance as to the kinds of error that may render a decision 'wrong in law' for the purposes of section 11E(4)(e) EA89.
- 3.68 Accordingly, we agree with NPg that GEMA's decision will be 'wrong in law' where GEMA has misdirected itself as to the law. For example, a decision will be 'wrong in law' where GEMA has misdirected itself as to its principal objective and related statutory duties, but also more broadly as to any other applicable legal provisions, when making its decision that is the subject of an appeal under section 11C(1) EA89.
- 3.69 As regards the adequacy of GEMA's reasoning, in line with the statement of principle summarised in *Firmus Energy*, an appeal is against the decision, not

¹¹⁴ [NoA](#), paragraph 14.9, citing *ELMA 2021*, paragraph 3.72.

¹¹⁵ [GEMA Response](#), paragraph 42.

¹¹⁶ [GEMA Response](#), paragraph 139.3, citing, by way of example, *Crest Nicholson Operations Ltd v West Berkshire DC* [2021] EWHC 289 (Admin), paragraph 81; see also *GEMA Response to PD*, paragraph 24, citing *R (Mott) v Environment Agency* [2016] 1 WLR 4338, paragraphs 69 and 72 to 74.

¹¹⁷ See, for example, *E v Secretary of State for the Home Department* [2004] EWCA Civ 49, paragraph 42; *Mohamoud v Birmingham City Council* [2014] EWCA Civ 227, paragraph 23.

¹¹⁸ *RB (Algeria) v Secretary of State for the Home Department* [2008] EWCA Civ 290, paragraphs 62, 73; *James v Hertsmeere Borough Council* [2020] EWCA Civ 489, paragraph 31.

the reasons for the decision. Therefore, it is not enough for an appellant to identify some error of reasoning; an appeal can only succeed if the decision cannot stand in light of that error.¹¹⁹ If 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.¹²⁰

- 3.70 GEMA’s decision may also be ‘wrong in law’ on the basis of a procedural deficiency. Consistent with the statement of principle summarised in Firmus Energy, the decision will be ‘wrong in law’ only where the procedural deficiency (including a flawed consultation process) was so serious that we cannot be assured that the decision was not ‘wrong’.¹²¹
- 3.71 In accordance with the case law cited in paragraph 3.66 above, we consider that GEMA’s decision will also be ‘wrong in law’ if it is based on irrelevant considerations or is otherwise irrational.
- 3.72 It is not necessary, in this case, for us to decide whether ‘wrong in law’ extends to other errors beyond those identified in paragraph 3.66 above, for example evaluative errors that fall short of irrationality, and we do not make any such decision.
- 3.73 We disagree with NPg’s contention that ‘wrong in law’ covers basic arithmetical errors. Such errors would more likely be considered as errors of fact, for which specific provision is made in section 11E(4)(c) EA89.
- 3.74 As regards GEMA’s margin of appreciation, we agree that where GEMA’s decision is found to be ‘wrong in law’ in that GEMA misdirected itself as to the law (in other words, there was an error of law), there is no room for a margin of appreciation. We note that in its recent decision in the SSE code modifications appeal, the CMA agreed with the parties that ‘in the context of challenges relying on an alleged error of law, ... there [is] no role for “regulatory judgement” or discretion on the question of what is the correct construction of legislation’ and also that ‘on that question, the concept of reasonable judgement, as embodied in the Wednesbury test, has no part to play’.¹²²

¹¹⁹ Firmus Energy, paragraph 3.20(b).

¹²⁰ ELMA 2021, paragraphs 3.50 (citing Firmus Energy, paragraph 3.20(h)) and 3.51.

¹²¹ ELMA 2021, paragraphs 3.53 (citing Firmus Energy, paragraph 3.20(e)) and 3.54.

¹²² ELMA 2021, paragraph 3.70, citing SSE Generation Limited v GEMA and National Grid Electricity System Operator Limited and Centrica plc/British Gas Trading Limited, Decision, 30 March 2021, at paragraph 5.17.

Materiality

Submissions from the Parties

- 3.75 In their submissions on materiality, the Parties referred to a number of points that had been made by the CMA in its previous determinations of regulatory appeals. We summarise the key references below, which, in our view, show that there was common ground between the Parties:
- (a) Where the CMA finds that GEMA has made an error, that error must be material in order for GEMA's decision to be 'wrong';¹²³
 - (b) Materiality is to be assessed by reference to a range of factors, which have been set out in previous CMA determinations.¹²⁴ These are not listed here, but are referred to in the statement of our position below.
- 3.76 NPg added that the assessment is to be made on a case-by-case basis taking into account the particular circumstances of each case.¹²⁵
- 3.77 GEMA submitted that in relation to matters of judgement and estimation of what might happen in an uncertain context, there may be examples where it is not a material error to choose from a range of options for the price control, even where that decision might in itself have a material effect on the appellant.¹²⁶
- 3.78 GEMA further submitted that clear and obvious factual errors should be corrected even where the impact of the error is low value.¹²⁷
- 3.79 As regards the potential aggregation of immaterial errors, the Parties took differing positions:
- (a) NPg noted that in ELMA 2021, the CMA had stated that certain circumstances may necessitate assessing whether the cumulative effect of immaterial errors could have a highly significant impact on the price control;¹²⁸
 - (b) GEMA submitted that the materiality test should be applied to each of the specific errors advanced by an appellant, otherwise the important safeguard would be subverted if it were open to appellants to advance a

¹²³ [NoA](#), paragraphs 14.10 (citing ELMA 2021, paragraph 3.89) and 14.14; [GEMA Response](#), paragraph 44.

¹²⁴ [NoA](#), paragraphs 14.11-14.13, citing various CMA determinations; [GEMA Response](#), paragraphs 45.2 and 45.3.

¹²⁵ [NoA](#), paragraph 14.11, citing BGTL v GEMA, paragraph 3.61 and NPg v GEMA, paragraph 3.58.

¹²⁶ [GEMA Response](#), paragraph 45.4.

¹²⁷ [GEMA Response](#), paragraph 45.5.

¹²⁸ [NoA](#), paragraph 14.13, citing ELMA 2021, paragraph 3.97.

series of individual errors each of which had a de minimis impact on the price control, but which were alleged in aggregate to have a material effect.¹²⁹

Our position

- 3.80 We note that it was common ground between the Parties that we should only interfere with the Decision if we consider that the error identified is material, and this is consistent with the approach the CMA has adopted in previous cases.
- 3.81 We have taken the same approach in determining the present appeal. We summarise below the key principles from past CMA determinations, which we have adopted for present purposes.
- 3.82 In the ED1 Determinations, the CMA adopted the approach that ‘an error will not be a material error where it has an insignificant or negligible impact on the overall level of price control set by GEMA.’¹³⁰
- 3.83 Offering a non-exhaustive list of criteria that the CMA may take into account in determining materiality, the decisions in the ED1 Determinations stated:
- Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, 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.¹³¹
- 3.84 In *Firmus Energy*, the CMA noted that in the context of a telecoms appeal, the CMA has stated that where the impact of the error as a percentage of the charge control is below 0.1%, the error is unlikely to be capable of producing a material effect on the charge control. The CMA noted further that this is ‘not intended to be a “bright–line test”’; it is but one factor in an overall assessment based on all the circumstances of the case.’¹³²
- 3.85 As regards the potential aggregation of several errors, we acknowledge that, in principle, we should determine whether each alleged error is material in itself. However, we note that in *Firmus Energy* the CMA, quoting the CC’s

¹²⁹ [GEMA Response](#), paragraph 46.

¹³⁰ *BGTL v GEMA*, paragraph 3.60 and *NPg v GEMA*, paragraph 3.58, cited in *ELMA 2021*, paragraph 3.91.

¹³¹ *BGTL v GEMA*, paragraph 3.61 and *NPg v GEMA*, paragraph 3.58, cited in *ELMA 2021*, paragraph 3.92.

¹³² *Firmus Energy*, paragraph 3.24, cited in *ELMA 2021*, paragraph 3.93.

approach, did not exclude the possibility that in certain cases an aggregation of immaterial errors could amount to a material error:

No formal general approach has been identified that would determine when, if at all, immaterial errors should be aggregated. The CC was mindful that to aggregate immaterial errors would have the effect of converting an error that was in and of itself immaterial into a material error through its combination with other immaterial errors. Those other errors may be unrelated and may lie in different and discrete aspects of the price control.

The CC did not rule out the possibility that there may be cases in which such aggregation was justifiable where the cumulative effect of discrete errors had a highly significant impact on the price control set by the regulator.

However, as a general approach, the CC stated it would be cautious about elevating the immaterial into the material. It observed that aggregation might encourage a scattergun approach on the part of appellants, which was not the purpose of the appeal process.¹³³

3.86 We note also that in ELMA 2021, the CMA stated, following its reference to the above principles, that it had considered, where appropriate, whether the cumulative effect of immaterial errors could have a highly significant impact on the price control.¹³⁴

Precedents

3.87 We would note that each case turns on its own facts and past decisions taken by the CMA in other regulatory appeals do not set binding precedent. This means that we are not required to ensure that our decision in the present appeal mirrors assessments made and conclusions reached by the CMA in other regulatory appeals.¹³⁵

The CMA's powers on determination of the appeal

3.88 In the event and to the extent that the CMA does not allow an appeal, the CMA is required to confirm the decision appealed against.¹³⁶

¹³³ Firmus Energy, paragraph 3.26 (citing Carphone Warehouse, paragraph 1.64), cited in ELMA 2021, paragraph 3.96.

¹³⁴ ELMA 2021, paragraph 3.97.

¹³⁵ ELMA 2021, paragraph 3.87.

¹³⁶ Section 11E(5) EA89.

3.89 If the CMA allows to any extent an appeal in relation to a price control decision,¹³⁷ it must do one or more of the following:

- (a) quash the decision (to the extent that the appeal is allowed);
- (b) remit the matter back to GEMA for reconsideration and determination in accordance with any directions given by the CMA;
- (c) substitute the CMA's decision for that of GEMA (to the extent that the appeal is allowed) and give any directions to GEMA or any other party to the appeal.¹³⁸

¹³⁷ Section 11F(7) EA89 provides that for these purposes a decision is a price control decision, in relation to the modification of a condition of a licence, if the purpose of the condition is, in the CMA's opinion, to limit or control the charges on, or the revenue of, the holder of the licence.

¹³⁸ Section 11F(2) EA89.

4. Ground 1 – Misallocation of allowances between cost categories

Introduction

- 4.1 NPG's first ground of appeal concerns GEMA's allocation of NPG's allowances between cost categories.
- 4.2 In the RIIO-ED2 Final Determinations Core Methodology Document, GEMA stated that its cost assessment produced allowances at an overall, total expenditure level. GEMA stated that the introduction of volume drivers (among other matters) and other price control mechanisms required these total allowances to be broken down at activity-level cost categories.¹³⁹ GEMA stated that it was also important to have allowances disaggregated at an activity level in order to allow comparison against DNOs' submitted costs,¹⁴⁰ and to monitor in-period performance.¹⁴¹
- 4.3 GEMA used the average of cost proportions derived from DNOs' submitted costs and its disaggregated modelling to allocate total allowances.¹⁴²
- 4.4 NPG submitted that GEMA was wrong to rely on DNOs' submitted cost proportions when allocating DNOs' efficient modelled costs because DNOs' submitted costs were based on decarbonisation planning scenarios that were manifestly different from the one that GEMA intended to fund.¹⁴³ It submitted that the effect of this approach was that some of NPG's costs that GEMA had determined to be efficient would be irrecoverable in practice.¹⁴⁴

¹³⁹ GEMA, [RIIO-ED2 Final Determinations Core Methodology Document](#), paragraph 7.634. Each DNO's total efficient modelled costs were then allocated across the 51 activity-level cost categories. [NoA](#), paragraph 9.9. Volume drivers are discussed in paragraph 4.11(a).

¹⁴⁰ Submitted costs are the costs submitted to GEMA by each DNO in its business plan. The main steps in GEMA's approach to assessing DNOs' submitted costs are described at paragraphs 4.15ff. They include GEMA making 'normalisation adjustments', which sought to ensure that GEMA was able to carry out cost benchmarking between DNOs on a comparable basis. Normalisation adjustments are explained in further detail at paragraph 4.16(b).

Unless the context otherwise requires, references in this final determination to our assessment in relation to 'submitted costs' are to submitted costs (based on a DNO's decarbonisation scenario) after GEMA had made normalisation adjustments and without any specific further adjustment for the purposes of the allocation of total efficient modelled costs. We make this point for reference only, since neither the fact that GEMA made normalisation adjustments, nor its approach in making those adjustments, is the subject of this appeal.

¹⁴¹ GEMA, [RIIO-ED2 Final Determinations Core Methodology Document](#), paragraph 7.634.

¹⁴² GEMA, [RIIO-ED2 Final Determinations Core Methodology Document](#), paragraph 7.637. We understand that submitted costs proportions were derived from the submitted costs.

¹⁴³ [NoA](#), paragraphs 3.3(i), 10.1 (which referred to 'total' efficient modelled costs), 10.5 (which referred to total 'final allowances'), and 16.3 and 18.26 (both of which referred to 'total' efficient modelled costs). See also LOI paragraph 1.

¹⁴⁴ [NoA](#), paragraphs 10.7 and 18.9. See also LOI paragraph 5(b).

4.5 NPg stated that it was not challenging the architecture of GEMA's benchmarking process and submitted that the alleged errors related to discrete stages of GEMA's cost assessment process.¹⁴⁵

4.6 In this chapter we:

- (a) give the background to GEMA's RIIO-ED2 approach to allocating allowances;
- (b) summarise the key submissions of NPg, GEMA and Citizens Advice;
- (c) set out our assessment; and
- (d) provide our determination.

Background

4.7 In this section, we cover first the uncertainty around the demand that decarbonisation will place on DNOs' networks as part of the relevant context for the appeal. We then cover the main steps of GEMA's approach to cost assessment, including its approach to allocating total allowances in the RIIO-ED2 price control.

Uncertainty around decarbonisation

4.8 GEMA stated that it developed the RIIO-ED2 price control in line with the government target of net zero carbon emissions by 2050. In the context of the energy sector, GEMA stated that the net zero target implied that network companies must enable the transition to a smart, flexible, low cost, and low carbon energy system for all consumers and network users.¹⁴⁶ This would require a significant increase in investment in new low carbon infrastructure to meet the increased demand for electricity. However, GEMA stated that there was uncertainty associated with the uptake of low carbon technologies (LCT) and the necessary level and timing of the capital investments that were needed by DNOs to enable these technologies to be supported.¹⁴⁷

4.9 GEMA stated this uncertainty during the RIIO-ED2 price control period affected GEMA's cost assessment of the DNOs' business plans, and the costs associated with decarbonisation, in particular Load Related Expenditure

¹⁴⁵ NoA, paragraphs 3.6 and 6.3 (in which NPg also stated that it was not seeking to challenge GEMA's decision to fund different categories of activity through different mechanisms, or the design of those mechanisms, among other matters).

¹⁴⁶ *McMahon 1 (GEMA)*, paragraph 17.3.

¹⁴⁷ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 2.6.

(LRE). LRE refers to the investment in electricity networks that responds to increases in demand to upgrade the capacity of networks, for example to connect LCTs or new generation.¹⁴⁸ GEMA stated that LRE can be broken down into the following categories:

- (a) Connections within price control: this refers to the LRE associated with the provision or upgrading of points of connection to the distribution network;
- (b) Primary Reinforcement: this includes the LRE associated with the reinforcement of assets on the primary networks (ie the higher voltage networks);
- (c) Secondary Reinforcement: this covers the LRE associated with the reinforcement of assets on the secondary networks (ie the lower voltage networks);
- (d) Fault Level Reinforcement: this refers to the LRE associated with work carried out to alleviate fault level issues associated with specific network assets;
- (e) New Transmission Capacity Charges: these are charges payable for projects initiated by the DNO for increased capacity at existing transmission connection points or for new transmission connection points, but carried out by transmission licensees.¹⁴⁹

4.10 GEMA stated that, given the existence of a range of possible scenarios to net zero, and in order to inform its cost assessment, it decided not to provide or prescribe a single common scenario for DNOs to use for their business planning submissions (see paragraph 4.17 for further detail).¹⁵⁰ GEMA stated that consequently, it invited DNOs to submit their business plans based on their 'best view' decarbonisation planning scenario. However, in order to avoid the risk that each DNO developed its own plan on an individual basis with no consistent points of reference between DNOs, GEMA provided a common set of forecast assumptions and net zero pathways that DNOs should apply when developing their business plans.¹⁵¹ Following the submissions of business plans, GEMA requested DNOs to provide additional data on their LCT forecasts in order to be able to compare each DNO on a more consistent basis given their varying forecasts.¹⁵²

¹⁴⁸ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 3.6.

¹⁴⁹ *McMahon 1 (GEMA)*, paragraph 72.

¹⁵⁰ *McMahon 1 (GEMA)*, paragraph 30.

¹⁵¹ *McMahon 1 (GEMA)*, paragraph 32.

¹⁵² *McMahon 1 (GEMA)*, paragraph 50.

4.11 GEMA stated that, given the uncertainty surrounding the forecasts underlying RIIO-ED2 price controls, it designed a set of uncertainty mechanisms to allow changes to DNOs' baseline allowances for efficient net zero expenditures in response to changing developments during the price control period.¹⁵³ GEMA stated that the types of uncertainty mechanisms relevant for Ground 1 were the following:¹⁵⁴

- (a) Volume drivers: used to adjust allowances in line with actual volumes where the volume of work is uncertain, but the cost of each unit is stable;
- (b) Re-opener mechanisms: used in certain limited and pre-defined circumstances, which may amend allowances, outputs and/or delivery dates within the price control period.

4.12 GEMA further stated that the type of allowances which are funded through uncertainty mechanisms are the variant allowances. These are set for those activities for which there is a greater degree of uncertainty surrounding DNOs' required expenditure, for example due to the nature and pace of decarbonisation. In contrast, non-variant allowances, which are set for those activities for which there is less uncertainty around the DNOs' expected expenditure, are not adjusted during the price control period and are thus not subject to uncertainty mechanisms (see paragraph 4.40 for further detail).¹⁵⁵

4.13 GEMA stated that the uncertainty mechanisms that are relevant to Ground 1 are:

- (a) Secondary Reinforcement volume driver: this adjusts funding in DNOs' lower voltage secondary networks to ensure that funding is equal to the volume of work carried out multiplied by the unit rates based on a median benchmark across all DNOs;¹⁵⁶
- (b) Low voltage services volume driver: this adjusts funding in DNOs' low voltage services to ensure that funding is equal to the volume of work carried out multiplied by the unit rates based on a median benchmark across all DNOs.¹⁵⁷ Low voltage services are works that are done to increase the capacity of consumers' low voltage service cables, for

¹⁵³ GEMA, RIIO-ED2 Final Determination Overview document, paragraph 6.3.

¹⁵⁴ GEMA, RIIO-ED2 Final Determination Overview document, paragraph 6.4.

¹⁵⁵ [GEMA Response](#), paragraph 69.

¹⁵⁶ *McMahon 1 (GEMA)*, paragraph 79.2 a).

¹⁵⁷ *McMahon 1 (GEMA)*, paragraph 79.2 b).

example to enable consumers to install an electric vehicle charger at their house;¹⁵⁸

- (c) Load related expenditure re-opener: this applies to the remaining LRE cost categories that are not covered by the two volume drivers described above. Re-openers allow DNOs to apply for additional funding if their expenditure on LRE exceeds the ex-ante allowances provided for LRE in these remaining cost categories;¹⁵⁹
 - (d) Clawback mechanism: this is an ex-post mechanism which allows GEMA to claw back allowances if there is DNO underspend of more than 20% (for reasons other than cost efficiency);¹⁶⁰
 - (e) Indirect scaler volume driver: this adjusts indirect operational costs (ie Closely Associated Indirects (CAIs)) to be scaled in line with the adjustments to LRE through the LRE uncertainty mechanisms.¹⁶¹
- 4.14 GEMA stated that as regards volume driver uncertainty mechanisms discussed in paragraphs 4.11(a) and 4.11(b), they would be particularly effective for the delivery of reinforcement on the secondary network and low voltage services. GEMA added that, although there is a reasonable degree of ex-ante certainty on unit cost in these two areas, there is uncertainty about how high the volume of work will be since it will be driven by LCT uptake. Consequently, volume driver uncertainty mechanisms would help DNO allowances to increase without any delay of funding and would thus ensure that RIIO-ED2 would not be a blocker to net zero.¹⁶²

The main steps of GEMA's approach in cost assessment

- 4.15 In this section we present an overview of the main steps of GEMA's approach to cost assessment, including its approach to allocating total allowances at the cost category level. It follows from the funding through uncertainty mechanisms that the total allowance (which includes variant allowances) needs to be allocated between variant (funded through uncertainty mechanisms) and non-variant allowances.

¹⁵⁸ GEMA, RIIO-ED2 Final Determination Overview document, Appendix 1.

¹⁵⁹ *McMahon 1 (GEMA)*, paragraph 79.2 c).

¹⁶⁰ *McMahon 1 (GEMA)*, paragraph 79.1.

¹⁶¹ *McMahon 1 (GEMA)*, paragraph 79.2 d).

¹⁶² *McMahon 1 (GEMA)*, paragraph 80.

- 4.16 The main steps of GEMA's approach in assessing the costs of DNOs during the price control period, which in turn determine allowances under RIIO-ED2, are the following:¹⁶³
- (a) Business plans submissions: in order to inform its cost assessment, GEMA requested DNOs to submit cost information on historical and forecast expenditure through their business plans;
 - (b) Normalisations and adjustments: to ensure that the cost benchmarking (which is covered at point (c)) is carried out on a comparable basis, GEMA made some adjustments on the data submitted by the DNOs to take account of inconsistencies and other effects;¹⁶⁴
 - (c) Benchmarking: in this step GEMA benchmarked the DNOs' submitted costs to assess their relative efficiency. In its cost assessment GEMA used two different benchmarking approaches: the total expenditure benchmarking and the disaggregated (activity-level) benchmarking;¹⁶⁵
 - (d) Demand Driven Adjustment (DDA):¹⁶⁶ GEMA stated that it developed the DDA in order to challenge DNOs' forecasts and adjust them post-modelling;¹⁶⁷
 - (e) Weighting of modelled costs: GEMA combined the total expenditure and the disaggregated benchmarking models;
 - (f) Efficiency challenge: in order to set allowances based on efficient costs and incentivise networks to become more efficient, GEMA applied both catch-up efficiency challenges to encourage less efficient DNOs to catch up on expenditure with the most efficient DNOs and ongoing efficiency challenges to encourage even the more efficient DNOs to increase their productivity during the RIIO-ED2 price control;
 - (g) Allocation: once GEMA estimated the efficient modelled costs, it had to allocate them across cost categories in order to allocate the DNOs' total allowances at an activity level.

¹⁶³ [GEMA Response](#), paragraph 61. NoA, paragraphs 9.1-9.14.

¹⁶⁴ Final Determinations Core Methodology Document, paragraph 7.21.

¹⁶⁵ *McMahon 1 (GEMA)*, paragraph 86.

¹⁶⁶ We note that NPg stated that the workload adjustments are separate post-modelling adjustments alongside the DDA. NoA, paragraph 9.4.

¹⁶⁷ *McMahon 1 (GEMA)*, paragraphs 116, 117.

Step 1: Business plans submissions

- 4.17 GEMA stated that given the existence of a range of possible scenarios to net zero, and in order to inform its cost assessment, it decided not to provide or prescribe a single common scenario for DNOs to use for their business planning submissions. Rather, in the Business Plan Guidance, GEMA set out a set of forecast assumptions and net zero pathways that DNOs should apply when developing their business plans.¹⁶⁸ This included key assumptions relevant to business planning for LRE extracted from the Electricity System Operator's Future Energy Scenarios (FES) net zero compliant scenarios and the Climate Change Committee's (CCC) 6th Carbon Budget.¹⁶⁹ These scenarios made various projections for the UK out to 2050, including the expected uptake of LCT, growth in total electricity demand (GWh), growth in network peak demand (MW) and distributed generation connections, as well as energy efficiency trends.¹⁷⁰
- 4.18 The FES covered the following net zero compliant pathways:
- (a) System transformation: based on this scenario, net zero would be met by 2050 with hydrogen playing a key role for heating, and supply side flexibility also prominent. It assumed that consumers were less inclined to change behaviour together with limited energy efficiency;
 - (b) Consumer transformation: this scenario expected to meet net zero by 2050 but with shifts in consumer behaviour driving high uptakes of energy efficiency, renewable distributed generators and demand side flexibility, as well as electrified heating and transport;
 - (c) Leading the way: this represented the fastest credible decarbonisation pathway with net zero achieved before 2050 and early electrification of transport and heating (also hydrogen). It was centred on significant lifestyle changes for consumers;¹⁷¹
- 4.19 DNOs then applied these Great Britain wide pathways to their specific networks and regions to form their own Distribution Future Electricity Scenarios (DFES). The DFES were standardised so that the four scenarios (Steady Progression, System Transformation, Consumer Transformation, Leading the Way) were common among all DNOs and shared the same names, assumptions and framework as the Energy System Operator FES.¹⁷²

¹⁶⁸ *McMahon 1 (GEMA)*, paragraph 32.

¹⁶⁹ *McMahon 1 (GEMA)*, paragraph 73.

¹⁷⁰ GEMA, clarification session slides, slides 17.

¹⁷¹ GEMA, clarification session slides, slide 18.

¹⁷² GEMA, clarification session slides, slide 17.

- 4.20 GEMA stated that the rationale behind its guidance was to ensure DNOs were forecasting likely demand and implications for network investment from a common basis, but allowing sufficient flexibility to reflect factors that may justify variation from this.¹⁷³ GEMA requested DNOs to provide additional data on their LCT forecasts in order to be able to compare DNOs on a more consistent basis given their varying forecasts.¹⁷⁴
- 4.21 When requesting business plans, GEMA communicated to DNOs that their business plans had to be based on the assumption that GEMA would apply uncertainty mechanisms to allow allowances to flex in a timely manner and closely match the efficient cost of delivering a certain level of activity or the output that DNOs in fact deliver.¹⁷⁵
- 4.22 GEMA stated that each DNO was required to submit a business plan based on a baseline scenario reflecting the DNO's best view decarbonisation planning scenario as well as to submit supplementary data relating to a high and low case scenario. This data included forecast volumes for LCTs and additional forecast costs specifically for LRE.¹⁷⁶
- 4.23 GEMA stated that in their business plans, DNOs were required to provide a breakdown of submitted costs (historical and forecast) by 51 specified cost categories.¹⁷⁷

Step 2: Normalisations and adjustments

- 4.24 GEMA stated that in order to ensure that the cost benchmarking (which is covered at Step 3 below) is carried out on a comparable basis, it performed some adjustments on the data submitted by the DNOs to take account of inconsistencies and other effects, for example in respect of regional and company-specific factors.¹⁷⁸ GEMA submitted that adjustments made for the normalisations process were not comparable to adjustments made as a result of GEMA's benchmarking and efficiency assessment.¹⁷⁹
- 4.25 Given the above, our view is that the adjustments made for the normalisation process were not seeking to address any concerns with the DNOs' LCT or LRE forecasts. Unless the context otherwise requires, references in this final determination to our assessment in relation to 'submitted costs' are to

¹⁷³ *McMahon 1 (GEMA)*, paragraph 73.

¹⁷⁴ *McMahon 1 (GEMA)*, paragraph 50.

¹⁷⁵ *McMahon 1 (GEMA)*, paragraph 95.

¹⁷⁶ *McMahon 1 (GEMA)*, paragraphs 42 and 153.

¹⁷⁷ *McMahon 1 (GEMA)*, paragraph 84. For the list of all the 51 cost activities, please see Frontier (NPg), Assessment of GEMA's Approach to Allocating Allowances at RIIO-ED2, Exhibit FE1 Tab 1, Annex B.

¹⁷⁸ Final Determinations Core Methodology Document, paragraph 7.21.

¹⁷⁹ GEMA Skeleton, paragraph 47.

submitted costs (based on a DNO's decarbonisation planning scenario) after GEMA had made normalisation adjustments and without any specific further adjustment for the purposes of the allocation of total efficient modelled costs. We make this point for the avoidance of doubt, since neither the fact that GEMA made normalisation adjustments, nor its approach in making those adjustments, is the subject of this appeal.

Step 3: Benchmarking

- 4.26 GEMA stated that in this step it benchmarked the DNOs' submitted costs to assess their relative efficiency. In its cost assessment GEMA used two different benchmarking approaches: the total expenditure benchmarking; and the disaggregated (activity-level) benchmarking.
- 4.27 In the total expenditure benchmarking exercise, GEMA compared DNOs' total costs in models to produce a set of total modelled costs for each DNO. GEMA's total expenditure benchmarking consisted of three separate regression models.¹⁸⁰
- 4.28 GEMA stated that as regards the disaggregated benchmarking, it compared DNOs' costs on a cost activity-by-activity basis, using a range of different models. The output of each of these models was then summed to produce a set of total modelled costs for each DNO. GEMA's disaggregated benchmarking consisted of 36 models covering 46 cost activities, including applying workload adjustments, as well as models to deal with separately assessed projects and sub-categories.¹⁸¹
- 4.29 GEMA stated that it performed two types of adjustments when determining efficient allowances in the benchmarking step of the cost assessment:
- (a) Cost adjustments: these are also referred to as unit cost adjustments and they are carried out when GEMA assesses the efficiency of the unit costs submitted by the DNOs;
 - (b) Workload adjustments: these are also called volume adjustments and are carried out when evaluating the efficiency of the submitted volume of activity.¹⁸²

¹⁸⁰ *McMahon 1 (GEMA)*, paragraph 86.1.

¹⁸¹ *McMahon 1 (GEMA)*, paragraph 86.2.

¹⁸² GEMA stated that workload adjustments are specifically targeted and applied directly within the disaggregated benchmarking. Its total expenditure benchmarking will capture elements of workload efficiency and adjustments to a degree, but workload adjustments are not distinctly identifiable from cost adjustments in the output of its total expenditure benchmarking. GEMA stated that workload adjustments can be thought of as

- 4.30 In the Final Determinations, GEMA implemented the workload adjustment within the Secondary Reinforcement disaggregated benchmarking model.¹⁸³ GEMA stated that this Secondary Reinforcement workload adjustment had similarities with DDA applied in the total expenditure benchmarking model (see Step 4 below) as it had a component that related to forecast demand (not efficiency).¹⁸⁴

Step 4: Demand Driven Adjustment

- 4.31 GEMA stated that given the uncertainty around the level of demand growth and LRE for the RIIO-ED2 price control period, GEMA developed a post-modelling DDA. GEMA stated that the rationale behind this adjustment was to maintain low costs in consumers' interests by setting conservative ex-ante allowances that could be flexed up if needed.¹⁸⁵ These adjustments were based on System Transformation FES. GEMA stated that it applied the DDA as a post-modelling adjustment to the totex benchmarking. It did not apply the DDA to the disaggregated benchmarking to avoid any potential issues of double counting with the demand-based workload adjustments within the Secondary Reinforcement disaggregated benchmarking model (see paragraph 4.30).¹⁸⁶

Step 5: Weighting of modelled costs

- 4.32 GEMA stated that it weighted the total expenditure and the disaggregated benchmarking costs to calculate its combined view of modelled costs. GEMA explained that totex and disaggregated benchmarking approaches were different in nature but mutually complementary since they sought to capture different characteristics of the DNOs' business plans and explore the efficiency and justification for the plans using different tools and techniques.¹⁸⁷
- 4.33 GEMA stated that total expenditure and disaggregated benchmarking approaches provided complementary views of DNOs' costs, and it did not

either: needs related where GEMA is assessing the needs case of the activity/project; or efficiency related where it is assessing whether the work is justified as being consistent with efficient delivery of the expected outputs. It stated that needs related workload adjustments in the disaggregated models are predominantly a function of GEMA's review of DNOs' EJPs. *McMahon 1 (GEMA)*, paragraphs 107-109, 128, and 143.

¹⁸³ GEMA stated that workload adjustments only form part of the disaggregated modelling and are not a specific stage in the totex modelling. In addition, workload adjustments are only made to 11 out of the 46 cost activities that are modelled. The reason for this is that workload data is not reported for all of the cost activities to which the disaggregated models relate (eg business support). Where workload data is reported, GEMA reviews the submitted workload forecasts and determines whether to make workload adjustments or accept the submitted data. [GEMA Response](#), paragraph 117, footnote 23.

¹⁸⁴ *McMahon 1 (GEMA)*, paragraph 120.

¹⁸⁵ *McMahon 1 (GEMA)*, paragraph 115.

¹⁸⁶ *McMahon 1 (GEMA)*, paragraph 117.

¹⁸⁷ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraphs 7.580, 7.581.

identify any strong reasons to assign different weights to the two approaches.¹⁸⁸ Consequently, GEMA assigned 50% weight to the total expenditure benchmarking and 50% weight to the disaggregated benchmarking total modelled costs.¹⁸⁹ The combination of these two approaches at a total expenditure level produced an overall set of total (pre-efficiency challenge) modelled costs.¹⁹⁰

Step 6: Efficiency challenge

- 4.34 GEMA stated that, in order to set allowances based on efficient costs and incentivise networks to become more efficient, it applied catch-up efficiency challenges to encourage less efficient DNOs to catch up on expenditure with the most efficient DNOs as well as ongoing efficiency challenges to encourage all the DNOs to increase their productivity during the RIIO-ED2 price control.
- 4.35 GEMA stated that it first adopted an efficiency benchmark (catch-up efficiency challenge) that included a linear glide path from the 75th to the 85th percentile over the first three years of RIIO-ED2. Then, GEMA computed the weighted average efficiency benchmark, including the linear glide path, by placing a 16.67% weight on each total expenditure model and a 50% weight on the disaggregated benchmarking. Finally, it calculated the efficiency scores for each DNO allowing it to specify the catch-up challenge for each DNO.¹⁹¹
- 4.36 GEMA stated that the efficiency scores reflected the relative efficiency of each DNO and were based on modelled costs pre-efficiency challenge. They were calculated with the purpose of determining an appropriate catch-up efficiency challenge for the entire electricity distribution networks sector.¹⁹² GEMA calculated these scores for each DNO by dividing the DNO's submitted costs by GEMA's modelled costs. An efficiency score lower than 1 would indicate that the DNO was relatively efficient (ie the submitted costs were less than the modelled costs), whereas a score higher than 1 would suggest inefficiency (ie the submitted costs were higher than the modelled costs).¹⁹³

¹⁸⁸ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 7.590.

¹⁸⁹ The disaggregated benchmarking modelled costs represent the sum of the separately modelled costs within the disaggregated benchmarking step. *McMahon 1 (GEMA)*, paragraph 90.

¹⁹⁰ *McMahon 1 (GEMA)*, paragraph 139.

¹⁹¹ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraphs 7.582-7.586.

¹⁹² *McMahon 1 (GEMA)*, paragraph 262.

¹⁹³ *McMahon 1 (GEMA)*, footnote 62.

4.37 GEMA applied an ongoing efficiency challenge of 1% per annum for all DNOs over the RIIO-ED2 period.¹⁹⁴ At this step, GEMA arrived at its overall view of total efficient modelled costs derived from steps 1 to 6 above.¹⁹⁵

Step 7: Allocation

4.38 Once GEMA had estimated each DNO's total efficient modelled costs, it proceeded to allocate them across the 51 cost categories in order to disaggregate the DNOs' total allowances at an activity level.

4.39 GEMA submitted that the main reasons behind allocating allowances by cost categories were:

- (a) to support the effective operation of different funding mechanisms for different cost categories, including uncertainty mechanisms;
- (b) to allocate allowances in a way that best reflected the way they were likely to be spent, thereby facilitating in-period performance monitoring; and
- (c) to allow comparison against submitted costs.¹⁹⁶

4.40 GEMA stated that there were two types of allowances:

- (a) Variant allowances,¹⁹⁷ which are set for those activities for which there is a higher degree of uncertainty surrounding DNOs' required expenditure, for example due to the nature and pace of decarbonisation. In order to manage this uncertainty, variant allowances are funded through uncertainty mechanisms, which imply making adjustments to ex-ante allowances (ie this uncertainty mechanism funding allow adjustments to ex-ante allowances for those activities which are implicitly included in the total efficient modelled costs, and hence the variant allowance needs to be identified and separated from non-variant allowances through the allocation process). The variant allowances are non-fungible;

¹⁹⁴ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 7.19.

¹⁹⁵ [GEMA Response](#), paragraph 67.

¹⁹⁶ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 7.634.

¹⁹⁷ We note that Frontier Economics uses the terms *contingent* allowances and *fixed* allowances. It stated allowances for LRE are contingent as spending will be heavily impacted by the nature and pace of decarbonisation and these costs will be subject to uncertainty mechanisms (Assessment of GEMA's approach to allocating allowances at RIIO-ED2, Frontier, Exhibit FE1 Tab 1, paragraph 1.7). See also footnote 220 for a further explanation of what each of NPg and GEMA understood by contingent and fixed allowances.

- (b) Non-variant allowances, which are set for those activities for which there is less uncertainty around the DNOs' future level of expenditure. They are thus not subject to adjustments and are fungible.¹⁹⁸
- 4.41 GEMA stated that to allocate allowances into the required variant and non-variant cost categories, its methodology required:
- (a) First, determining the cost proportions to assign to each of the 51 different cost activities that the DNOs reported in their business plans.
- (b) Then, multiplying the cost proportions with the modelled total expenditure to calculate the allocated costs.¹⁹⁹
- 4.42 GEMA stated that the allocation of allowances across cost categories did not impact the overall allowance for total expenditures, however it affected the proportion that is classified as variant and non-variant total expenditures.²⁰⁰
- 4.43 GEMA further stated that in its Draft Determinations it considered three options for allocating allowances:
- (a) Using the DNOs' cost shares derived from their submitted costs. This would mean that cost proportions funded with non-variant and variant allowances would differ across DNOs based on their business model or proposed spending approach;
- (b) Using the disaggregated benchmarking cost shares. This would mean that the proportion of costs funded with non-variant and variant allowances would differ across DNOs based on GEMA's disaggregated benchmarking outputs;
- (c) Using an industry average proportional split of costs by activity.²⁰¹
- 4.44 GEMA stated that it considered that using an industry average proportional split of costs by activity would provide the most consistency; however it recognised that this approach would disregard differences between the DNOs' business plans and their level of activity in each area. As regards the approach of using the disaggregated benchmarking cost shares, GEMA observed that this approach would reflect GEMA's disaggregated benchmarking modelled view of the efficient proportion of spend on each activity; however it would disregard DNOs' business plans and anticipated spending in each area. Consequently, GEMA suggested use of the

¹⁹⁸ *McMahon 1 (GEMA)*, paragraphs 141, 144, 145.

¹⁹⁹ *McMahon 1 (GEMA)*, paragraph 146.

²⁰⁰ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 7.635.

²⁰¹ *McMahon 1 (GEMA)*, paragraph 150.

proportional split of costs by activity from DNO submitted costs to reflect DNO business plans and different demand scenarios.²⁰²

- 4.45 GEMA stated that all DNOs expressed concern about the proposed approach in the Draft Determinations because they observed that the outcome of GEMA's disaggregated modelling process would not be reflected in the allowances. GEMA stated that the majority of the DNOs suggested to allocate allowances using an equal weighting between total expenditure models (split by submitted cost proportions) and disaggregated models to reflect better the overall cost assessment process. Consequently, at Final Determinations GEMA decided to use the average of DNOs' submitted cost proportions and cost proportions produced from the disaggregated modelling. This resulted in a 50-50% blended approach.²⁰³

Parties' and Intervener's submissions

- 4.46 In this section we summarise the key submissions of NPg, GEMA and Citizens Advice in relation to this ground.

NPg's submissions

- 4.47 In summary, NPg submitted that using cost proportions from DNOs' submitted costs (which were each based on decarbonisation planning scenarios that were materially different from what NPg described as GEMA's 'Common Scenario'²⁰⁴ (the Common Scenario) to inform the allocation of total efficient modelled costs (which were based on the Common Scenario) was illogical, irrational and wrong by reference to the statutory grounds.²⁰⁵
- 4.48 NPg submitted that the very substantial scenario adjustments to LRE made by GEMA rendered the cost proportions from business plans an irrational source of information on which to base the allocation of total efficient modelled costs to fund the Common Scenario. It further submitted that, in other contexts, using an essentially irrelevant source of information in allocating allowances might not result in real world prejudice to DNOs, but here the operation of uncertainty mechanisms meant that misallocation generated an effective disallowance of efficient costs, in this case a very substantial disallowance.²⁰⁶

²⁰² *McMahon 1 (GEMA)*, paragraphs 151-157.

²⁰³ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraphs 7.636-7.638, 7.640.

²⁰⁴ NPg described this as a common decarbonisation scenario for the purposes of GEMA's cost assessment process based on the 2022 'System Transformation' FES (NGESO Future Energy Scenarios) (NoA, paragraph 9.4).

²⁰⁵ NoA, paragraphs 3.3(i), 10.1, 10.5 and 16.3; NPg Skeleton, paragraph 3. See also LOI paragraph 1.

²⁰⁶ NPg Skeleton, paragraph 9.

- 4.49 NPg submitted that GEMA's allocation process was not designed or intended to involve any downward adjustment to total efficient modelled costs, rather the allocation process should be neutral in its effect on a DNO's total final allowances (subject to the operation of uncertainty mechanisms).²⁰⁷ NPg further submitted that using NPg's submitted costs to inform the allocation of total modelled costs assessed as efficient for that Common Scenario resulted in a substantial misallocation of final allowances between cost categories.²⁰⁸
- 4.50 NPg submitted that GEMA allocated the total efficient modelled costs of each DNO to various cost categories using a hybrid allocation model (which is described more fully at paragraph 4.45).²⁰⁹
- 4.51 NPg further submitted that such an approach was irrational and illogical insofar as it relied (as to 50%) on the cost proportions from a DNO's submitted costs that were based on a decarbonisation planning scenario that was manifestly different from the one that GEMA used in the cost assessment process and for setting total final allowances.²¹⁰ NPg submitted that GEMA's modelling²¹¹ materially changed the structure of DNOs' costs from those in their submitted costs. Given that DNOs' submitted costs were not prepared on the same basis as GEMA's Common Scenario, NPg submitted that the DNOs' submitted cost proportions should not play any role in the allocation of allowances that were assessed to be efficient by reference to that Common Scenario.
- 4.52 NPg disagreed with GEMA's suggestion that this was a matter of overall regulatory value judgement.²¹² NPg submitted that the question of whether or not to have regard to a proportional split of DNOs' submitted costs in the allocation process was not a matter on which a broad margin of discretion was appropriate.²¹³ NPg further submitted that the task at the allocation stage required only the identification of an appropriate method to allocate the costs that GEMA determined to be efficient for the scenario that GEMA chose to fund. In NPg's submission, the specificity of that task, and the nature of the underlying concepts, implied a relatively narrow range of rational approaches.²¹⁴

²⁰⁷ NoA, paragraphs 10.3 and 18.4.

²⁰⁸ NoA, paragraph 18.6.

²⁰⁹ NoA, paragraphs 10.4 and 17.5.

²¹⁰ NoA, paragraphs 3.3(i), 10.1, 10.5, 16.3 and 18.26.

²¹¹ The modelling is described in further detail under the sub-heading Step 2 (Benchmarking) in the Background section in this chapter.

²¹² NoA, paragraph 18.26; LOI paragraph 1.

²¹³ NoA, paragraph 18.26; NPg Skeleton, paragraph 8.

²¹⁴ NPg Response to PD, paragraph 2.6.

- 4.53 NPg further submitted that GEMA decided to reduce the weighting given to DNOs' submitted cost proportions by 50% between the Draft Determinations stage and the Final Determinations stage.²¹⁵ In NPg's submission, doing so did not make this any less of an error, as the error was a matter of principle, not degree: NPg submitted that it was an error of principle to use irrelevant cost proportions derived from submitted costs, irrespective of what weighting was then applied to those proportions in the allocation method.²¹⁶
- 4.54 NPg submitted that the effect of GEMA's approach was that whatever happened in the RIIO-ED2 price control period (i.e. regardless of whether the Common Scenario, NPg's scenario or any other decarbonisation scenario was to arise), some of the DNOs' total costs that GEMA had determined to be efficient would be irrecoverable in practice.²¹⁷ As such, NPg submitted that DNOs would under-recover relative to their assessed-as-efficient costs and final allowances.²¹⁸ NPg further submitted that this effect was particularly significant for an efficient DNO whose business plan was premised on a relatively fast pace of electrification and the accompanying relatively high network challenge, as compared to the Common Scenario.²¹⁹ This was because such DNOs inevitably allocated a higher proportion of their total costs to LRE (which receive Contingent Allowances²²⁰) and a correspondingly lower proportion to all other cost categories (most of which receive Fixed Allowances) in their business plans.²²¹ NPg further submitted that the bulk of the misallocation concerned one particular category of LRE costs known as Secondary Reinforcement costs²²², although other cost categories within LRE were also affected with similar results for NPg.²²³

²¹⁵ NoA, paragraphs 10.6, 17.5.

²¹⁶ NoA, paragraphs 10.6 and 18.28.

²¹⁷ NoA, paragraphs 10.7, 18.9, 18.10, 18.14 and 18.19. See also LOI paragraph 5(b).

²¹⁸ NoA, paragraph 10.7.

²¹⁹ NoA, paragraphs 10.8 and 19.2. See also LOI paragraph 5(a).

²²⁰ In the NoA, NPg defined the term Contingent Allowances to mean those LRE allowances where funding was subject to uncertainty mechanisms, ie funding was (wholly or partly) contingent on a DNO's LRE related activity during the price control period (NoA, paragraph 7.3(i)). NPg also defined the term Fixed Allowances to mean those allowances where funding was not subject to uncertainty mechanisms, ie funding was fixed at the outset of the price control and would not be adjusted over the price control period.

In turn, GEMA in the Response described 'variant' or 'contingent' allowances as those which were subject to conditionality and which were not fungible (GEMA Response, paragraph 10, footnote 1). It described 'Non-variant' or 'fixed' allowances as allowances which were fungible for DNOs (ibid.). See also paragraph 4.40 for a further description of the terms variant and non-variant.

In our understanding, 'variant' allowances do not include the component of the LRE subject to the LRE re-opener uncertainty mechanism, whereas Contingent Allowances include the component of the LRE subject to the LRE re-opener uncertainty mechanism.

²²¹ NoA, paragraph 10.8.

²²² NoA, paragraphs 10.8 and 18.11 to 18.15.

²²³ NoA, paragraphs 18.16 to 18.19.

Impact

4.55 NPg submitted that the errors made by GEMA were material²²⁴ with a significant adverse impact on NPg (which was affected more severely than other DNOs): GEMA's approach resulted in an effective total disallowance (that is, underfunding) of circa £157 million of funding relative to the allowances that GEMA had deemed efficient and appropriate to the Common Scenario, through:²²⁵

- (a) an over-allocation to LRE exceeding the level of expenditure appropriate to the Common Scenario, where any excess funding could in fact never be accessed and could not be used to fund other activities (because it was funded with Contingent Allowances, ie through uncertainty mechanisms;²²⁶ and
- (b) a corresponding under-allocation to other cost categories that were funded with Fixed Allowances, which resulted in efficient costs in these cost categories being irrecoverable in all circumstances.²²⁷

Legal grounds

4.56 As a result of the matters summarised above, NPg submitted that the Decision was wrong in that:²²⁸

- (a) it was based on an error of fact (section 11E(4)(c) EA89), in that GEMA used submitted cost proportions in the allocation method on the erroneous basis that such proportions were a proxy for the output of its totex modelling;
- (b) the modifications failed to achieve the effect stated by GEMA (section 11E(4)(d) EA89) in that:
 - i. GEMA stated in the Decision that allowances for LRE under the modified price control would be calibrated to the Common Scenario and that the approach taken to allocation would not impact the overall totex allowance; whereas

²²⁴ NPg submitted that the misallocation of final allowances between cost categories was 'substantial' (NoA, paragraph 18.6) and that the misallocation generated an effective disallowance of efficient costs that was 'very substantial' (NPg Skeleton, paragraph 9).

²²⁵ NoA, paragraphs 3.4(i), 10.9 and 19.2. NPg submitted that the total disallowance of circa £157 million broke down into circa £104 million for NPgY and circa £53 million for NPgN (NoA, paragraph 19.2(iii)).

²²⁶ NoA, paragraphs 10.9(i), 10.10, 19.2-19.4; NPg Skeleton, paragraphs 12 to 13.

²²⁷ NoA, paragraph 10.9 (ii); NPg Reply, paragraph 2.8; NPg Skeleton paragraphs 12 to 13. See also LOI paragraphs 5(b) and 5(c).

²²⁸ NoA, paragraphs 10.11 and 21.1.

- ii. for the reasons set out in the NoA and because of the erroneous approach taken to allocation, the price control introduced by the modifications did not achieve either of these effects as regards NPg's allowances; and

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

4.57 NPg also submitted that GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties, in particular under section 3A(2)(b) EA89 (securing that licence holders are able to finance their activities). This was because, in NPg's submission, GEMA's approach to allocation resulted in NPg being materially under-funded relative to its assessed-to-be efficient costs and the outputs that NPg was required to produce.²²⁹ NPg further submitted that GEMA failed to have regard to its financeability duty as GEMA assessed NPg's financeability based on Final Determination allowances in which GEMA assumed that all costs were fully recoverable. NPg submitted this was not the case; £157 million (the amount by which NPg considered it was underfunded)²³⁰ was stranded ie was not recoverable.²³¹

Further submissions

4.58 NPg made further submissions in relation to points arising from GEMA's Response and GEMA's further submissions. We summarise the key further submissions from NPg below.

GEMA's change in position

4.59 In summary, NPg submitted that: GEMA's position in the Final Determinations was to present the allocation step as being essentially revenue-neutral; to which NPg's position was that GEMA's misallocation had resulted in an effective disallowance of efficient costs; however, GEMA's 'new' case during the appeal was that there had been an effective disallowance, but that this outcome was justified in the interests of consumers.²³² NPg made the following submissions on the above points.

²²⁹ NoA, paragraphs 10.12 and 21.2. See also NoA, paragraph 15.9.

²³⁰ NoA, paragraph 19.2(iii).

²³¹ MPH Transcript, page 38, lines 14 to 19. See also LOI paragraph 5(b).

²³² NPg Skeleton, paragraphs 10 to 16 et seq.

- 4.60 NPg submitted that in the Final Determinations, GEMA made no attempt to justify any effective disallowance of efficient costs, presenting the allocation step as essentially revenue-neutral.²³³ NPg further submitted that, in fact, a substantial proportion of NPg's allowances were irrecoverable because notional allowances to Secondary Reinforcement were over-written to zero and funded through volume drivers.²³⁴ The ultimate outcomes, NPg submitted, were that 'Fixed cost categories'²³⁵ were underfunded and as a result, there was overall underfunding. In NPg's submission, those were irrational and unjustifiable outcomes.²³⁶
- 4.61 NPg submitted that in the GEMA Response, GEMA did not attempt to rebut the allegation that the allocation method resulted in underfunding relative to total efficient modelled costs. In NPg's submission, GEMA had thus moved away from the Final Determinations. NPg submitted that although GEMA's Response contained no express admission, the thrust of what NPg called GEMA's 'new case' was that there had indeed been an effective disallowance relative to NPg's total efficient modelled costs but that this outcome was justified in the interests of consumers.²³⁷
- 4.62 NPg submitted that what NPg called GEMA's 'new case' was that the allocation was intended not merely to allocate total efficient modelled costs between cost categories, but also to prevent the recovery of (an arbitrary proportion of) those efficient costs. The disallowance was, in NPg's submission, arbitrary in that its scale reflected (1) the degree of difference between each DNO's planning scenario²³⁸ and the Common Scenario and (2) the DNO's relative efficiency in the Fixed costs categories (with higher efficiency resulting perversely in a greater effective disallowance).²³⁹ NPg further submitted that GEMA, having abandoned the claim that the allocation was revenue-neutral, deployed various arguments intended to justify an arbitrary disallowance of total efficient modelled costs, none of which had any real merit.²⁴⁰ A summary of NPg's submissions on GEMA's arguments is set out below.

²³³ NPg Skeleton, paragraph 10.

²³⁴ NPg Skeleton, paragraph 11.

²³⁵ NPg described 'Fixed cost categories' as those which do not vary (NPg Skeleton, paragraph 12(c), referring to [NoA](#), paragraphs 19.3-19.4).

²³⁶ NPg Skeleton, paragraph 13.

²³⁷ NPg Skeleton, paragraph 14.

²³⁸ Our understanding is that NPg's reference to 'each DNO's planning scenario' is to each DNO's decarbonisation planning scenario.

²³⁹ NPg Skeleton, paragraph 15.

²⁴⁰ NPg Skeleton, paragraph 16.

Modest adjustments

- 4.63 NPg submitted that what NPg called GEMA's 'new case' was untenable on the facts. NPg submitted that contrary to the GEMA Response (in which GEMA had denied imposing a Common Scenario after the submission of business plans²⁴¹), GEMA did use a common planning scenario²⁴² and did not make only "*modest adjustments*" informed by the System Transformation FES.²⁴³ NPg submitted that DDA in the totex stream and workload adjustments in the disaggregated models were, by their characteristics and effects, plainly adjusting for differences between DNOs' planning scenarios²⁴⁴ and the Common Scenario.²⁴⁵
- 4.64 NPg further submitted that the adjustments were far from modest and that this could be demonstrated by comparing: (1) the percentages of NPg's total submitted (business plan) costs accounted for by LRE with (2) the equivalent percentages for NPg's disaggregated modelled costs. For NPgN, the comparison was between 16.8% (submitted) and 7.6% (modelled). For NPgY, the figures were 22% compared with 8.5%. After adjustment, LRE accounted for a dramatically reduced proportion of modelled costs. The basic costs profile implied by the NPg Business Plan was changed dramatically through the modelling and post-modelling adjustment.²⁴⁶

*No wholesale re-baselining*²⁴⁷

- 4.65 In reply to GEMA's Response where GEMA had stated that it did not carry out a 'wholesale re-baselining of business plans',²⁴⁸ a 'wholesale scenario adjustment'²⁴⁹ or a 'wholesale adjustment of DNO's costs'²⁵⁰ to a Common Scenario, NPg submitted that GEMA did not re-baseline all submitted costs to the Common Scenario; but as regards LRE, DNOs' planned costs were re-baselined to the Common Scenario.²⁵¹ In NPg's submission, that was exactly what GEMA had said in the Draft Determinations it was going to do. NPg

²⁴¹ [GEMA Response](#), paragraph 83.

²⁴² Our understanding is that NPg's reference to a 'common planning scenario' is to a common decarbonisation planning scenario.

²⁴³ [NPg Reply](#), paragraphs 2.2 and 2.7.

²⁴⁴ Our understanding is that NPg's reference to 'DNOs' planning scenarios' is to their decarbonisation planning scenarios.

²⁴⁵ [NPg Reply](#), paragraph 2.8.

²⁴⁶ NPg Skeleton, paragraph 18. NPg added that the absolute amounts of money involved were far from modest: Frontier Economics had put the total value of NPg's scenario adjustments in the disaggregated modelling at £398m (NPg Skeleton, paragraph 19).

²⁴⁷ LOI paragraph 3

²⁴⁸ NPg Skeleton, paragraph 20, citing [GEMA Response](#), paragraph 92.

²⁴⁹ NPg Skeleton, paragraph 20, citing [GEMA Response](#), paragraph 122.

²⁵⁰ NPg Skeleton, paragraph 20, citing [GEMA Response](#), paragraph 131.

²⁵¹ NPg Skeleton, paragraphs 20-21.

submitted that it was clear that GEMA then did in fact use the Common Scenario to re-baseline LRE.²⁵²

*Adjustments for efficiency / unjustified expenditure*²⁵³

- 4.66 NPg submitted that consistent with GEMA's case that the re-baselining was 'modest' (and so did not render business plan costs proportions essentially irrelevant), GEMA was now arguing that the very large workload adjustments in the disaggregated modelling were 'predominantly efficiency or needs-related' and 'in the case of NPgY, overwhelmingly so', rather than being 'scenario-driven'.²⁵⁴ NPg submitted that this was not a sustainable position for three reasons:
- (a) It was implausible that, had GEMA formed the view that NPg's proposed LRE was wildly inefficient, this would not have featured prominently in the Final Determinations. NPgY ranked 2nd of all DNOs in efficiency scores and there was no mention of wild inefficiency in its planned LRE;²⁵⁵
 - (b) An objective analysis of the workload adjustments for Secondary Reinforcement showed them to have none of the expected characteristics of efficiency challenge and all of the expected characteristics of scenario adjustment. NPg submitted that this was explained in detail in Annex A to NPg's Reply.²⁵⁶ NPg submitted that GEMA did not seek to explain any of the following: (i) whether, and if so on what basis, GEMA now contended there was a single LCT impact ratio applicable to all electrification scenarios;²⁵⁷ (ii) how NPgY's sophisticated business planning process could have led to two-thirds of its planned Secondary Reinforcement work being attributable to inefficiency, as opposed to being merely inappropriate to the Common Scenario GEMA chose to fund;²⁵⁸ and (iii) how NPg could, at one and the same time, be (1) wildly inefficient in relation to one aspect of Secondary Reinforcement work, namely LV overhead line reinforcement (carrying out 2,251% more work than the median firm) and (2) brilliantly efficient in relation to another aspect, HV overhead line reinforcement (carrying out 86% less work than the median firm);²⁵⁹

²⁵² NPg Skeleton, paragraph 21.

²⁵³ LOI paragraph 4

²⁵⁴ NPg Skeleton, paragraph 22, citing [GEMA Response](#), paragraph 129.

²⁵⁵ NPg Skeleton, paragraph 23

²⁵⁶ Annex A to NPg Reply was entitled "Observations in Response from Frontier Economics".

²⁵⁷ NPg Skeleton, paragraph 24(a).

²⁵⁸ NPg Skeleton, paragraph 24(b).

²⁵⁹ NPg Skeleton, paragraph 24(c).

(c) GEMA's argument invited the CMA to accept as mere coincidence that, when NPg provided its own estimate of Secondary Reinforcement costs under System Transformation FES, these were relatively close to GEMA's ultimate assessment of NPg's efficient costs to deliver that scenario.²⁶⁰

4.67 NPg submitted that given that GEMA had received costs information pertaining to System Transformation FES from NPg, it could have taken a simpler course.²⁶¹ However, the approach that GEMA chose was, in NPg's submission, logically incompatible with then turning back to the NPg business plan's cost proportions when it came to allocate the costs determined to be efficient for the Common Scenario. NPg further submitted that GEMA could not obscure that incoherence by re-characterising scenario adjustments as efficiency challenge.²⁶²

GEMA's inefficiency argument did not support its choice of allocation method

4.68 NPg further submitted that the essence of the misallocation was that NPg's notional allocations to LRE were inflated, resulting in a corresponding under-allocation to all other cost categories. NPg submitted that, for the sake of argument, even assuming that huge LRE disallowances were required to remove inefficiency, the outcome of GEMA's chosen allocation method would be perverse: under that method, NPg would receive higher notional allocations to LRE (which would raise expenditure levels, and thereby was not rational with a concern over grossly inefficient LRE), yet NPg would receive lower allocations to costs categories which funded essential business activity which was not sensitive to scenario differences (e.g. investment to maintain existing network assets) and for which funding did not vary under uncertainty mechanisms. NPg submitted that a concern over grossly inefficient LRE could not rationally justify lower allocations to cost categories in relation to which no such concern arose.²⁶³

4.69 NPg further submitted that the difficulty for GEMA was that it could not say that NPg's total efficient modelled costs were too high for the delivery of the Common Scenario, as GEMA calculated those costs. If the total was appropriate, NPg submitted that using the allocation to generate an effective

²⁶⁰ NPg Skeleton, paragraph 25 which referred to NPg Reply, Annex A, Figure 1 'Comparison of NPg submitted LRE costs to [workload adjustments] WLA'.

²⁶¹ NPg Skeleton, paragraph 26. NPg added that GEMA was entitled to use in the benchmarking process NPg's Secondary Reinforcement costs for a high electrification scenario, even if only to then reverse much of them out through workload adjustments and the DDA (ibid.).

²⁶² NPg Skeleton, paragraph 26.

²⁶³ NPg Skeleton, paragraph 27.

disallowance was irrational, even more so where it also resulted in less control over *ex hypothesi* inefficient expenditure.²⁶⁴

Arbitrary disallowances were not in consumers' interests

- 4.70 NPg submitted that GEMA's contention that a disallowance was in consumers' interests was unsustainable. It was not in consumers' interests for efficient costs to be disallowed on an arbitrary basis.²⁶⁵ NPg further submitted that the point seemed to boil down to the suggestion that NPg should not, as a matter of principle, recover in any costs category an amount higher than its business plan costs, but there was no such principle and nor should there be.²⁶⁶

What NPg called GEMA's 'new case' involved an impermissible fresh decision²⁶⁷

- 4.71 NPg submitted that as a matter of basic procedural fairness, GEMA should not be permitted to defend its allocation method on the basis that (contrary to its decision documents), the purpose and effect of the allocation was to disallow a proportion of NPg's total efficient modelled costs. NPg submitted that this would substitute a new decision for the decision taken and appealed.²⁶⁸
- 4.72 NPg submitted that GEMA was seeking to move away from clear statements it had made in the Draft Determinations and Final Determinations²⁶⁹ and recast, *ex post*, its approach to the uncertainty around the path and pace of electrification. NPg submitted that this was, in effect, GEMA defending a fundamentally different decision from that in the Final Determinations.²⁷⁰
- 4.73 NPg further submitted that GEMA was not seeking to defend a decision it took by relying on different reasoning²⁷¹ or identifying in evidence some other basis for that decision. On the contrary, NPg submitted, GEMA was seeking to

²⁶⁴ NPg Skeleton, paragraph 28.

²⁶⁵ NPg Skeleton, paragraph 29(a).

²⁶⁶ NPg Skeleton, paragraph 29(b).

²⁶⁷ LOI paragraph 7

²⁶⁸ NPg Skeleton, paragraph 31.

²⁶⁹ NPg provided examples of those statements (see NPg Reply, paragraph 2.2).

²⁷⁰ [NPg Reply](#), paragraphs 1.2 and 2.4.

²⁷¹ NPg submitted that the statement of principle which GEMA had invoked, namely that an appeal is against the decision, not the reasons for the decision (GEMA Response, paragraph 35, citing Firmus Energy) was uncontroversial, but did not apply to the present case (NPg Reply, paragraph 2.6; NPg Skeleton, paragraphs 32 to 34).

defend a different decision that it did not take, identifying grounds on which that different decision might have been lawful.²⁷²

- 4.74 NPg further submitted that GEMA had made such a profound and fundamental change that it really did cross ‘the perhaps difficult to define - but obvious when you see it – barrier’ between additional reasons to support an existing discussion, and something that was better characterised and properly characterised as a fresh decision.²⁷³

GEMA’s cross-checks

- 4.75 NPg submitted that GEMA was now seeking to rely on various cross-checks to validate its chosen hybrid allocation method: GEMA had submitted that, in general, reasonable cross-checks resulted in similar levels of non-variant totex as adopted in the final allowances in Final Determinations.²⁷⁴ In reply, NPg submitted that these cross-checks were uninformative and did nothing to refute the fundamental irrationality of using submitted cost proportions in allocating final allowances.²⁷⁵ NPg further submitted that GEMA had asserted consistency with GEMA’s approach in other RIIO price controls. NPg submitted that, in fact, the allocation approach used in the last electricity distribution price control (RIIO-ED1) was more consistent with the remedy proposed by NPg than it was with the approach adopted by GEMA for RIIO-ED2.²⁷⁶

GEMA’s submissions

General submissions

- 4.76 In relation to both of NPg’s grounds of appeal, GEMA made the following general submissions.
- 4.77 GEMA submitted that its decision-making in respect of the RIIO-ED2 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.²⁷⁷ It added that the Decision was the product of that work, and of the interaction of a broad range of factors considered by GEMA in accordance with its statutory duties. GEMA submitted that inevitably within this process there were trade-offs and careful

²⁷² Ibid.

²⁷³ MPH Transcript, page 68, lines 14 to 18.

²⁷⁴ [GEMA Response](#), paragraph 96.3. See also LOI paragraph 6(d).

²⁷⁵ [NPg Reply](#), paragraph 5.1.

²⁷⁶ Ibid.

²⁷⁷ [GEMA Response](#), paragraph 7; GEMA Skeleton, paragraph 1.

judgements to be taken to ensure a fair outcome and appropriate balance of risk for both consumers and the network companies.²⁷⁸

- 4.78 GEMA characterised NPg's complaints as amounting to no more than disagreements with the way in which GEMA had exercised its expert regulatory discretion.²⁷⁹ It added that the decisions it had reached could not be shown to be wrong or irrational, nor did they fall outside the generous scope afforded to the expert regulator's judgement. On the contrary, GEMA submitted, they were clear, compelling and in the interests of consumers.²⁸⁰

*Allocation of allowances*²⁸¹

- 4.79 With respect to the cost allocations process, GEMA submitted that there was a range of approaches which an expert regulator might choose to adopt in the exercise of its regulatory judgement, and no single 'correct' way to allocate costs between cost categories based on the information available.²⁸² It added that its blended approach (that is, to allocate costs using a 50/50 weighting between the cost proportions in DNOs' submitted business plans and the cost proportions informed by the results of the disaggregated benchmarking modelling) was both rational and logical, reflecting the advantages and disadvantages across the spectrum of choices available and, critically, maintaining consistency with GEMA's overall approach to cost assessment where no single approach was deterministic in the assessment of efficiency or in setting final allowances.²⁸³ GEMA further submitted that its approach was also consistent with established regulatory precedent, including the interpolation approach using disaggregated and submitted cost shares for RIIO-ED1.²⁸⁴ In response to the Provisional Determination, GEMA further submitted that its blended allocation methodology achieved a balanced outcome and addressed what GEMA described as a range of regulatory objectives and principles, including: (a) the need to reflect and account for GEMA's approach to cost assessment, namely the equal weighting of totex and disaggregated benchmarking in determining final total efficient modelled costs; (b) the drawbacks of solely using disaggregated cost shares for the allocation; (c) how the findings of GEMA's benchmarking could be presumed to impact the relative proportions of costs in the total efficient modelled costs, in particular the LRE component; and (d) the merits of a transparent and

²⁷⁸ Ibid.

²⁷⁹ [GEMA Response](#), paragraph 13.

²⁸⁰ GEMA Skeleton, paragraph 1.

²⁸¹ LOI paragraph 1

²⁸² [GEMA Response](#), paragraph 82; GEMA Skeleton, paragraph 3.

²⁸³ GEMA Skeleton, paragraph 3.

²⁸⁴ GEMA Skeleton, paragraphs 3 and 30 (where GEMA also referred to consistency with the approaches taken in RIIO-ED1 and RIIO-GD2 (and also in RIIO-ED2 for five out of the six DNOs)).

replicable blended approach that could be applied consistently to all DNOs and that did not rely on GEMA needing to make targeted, but potentially arbitrary and assumptions-based adjustments to each DNO's submitted cost proportions that were used in the final allocation process.²⁸⁵

4.80 GEMA submitted that taking into account only the cost proportions derived from the disaggregated benchmarking modelling (as NPg contended) would entirely ignore DNOs' business plans, which formed an important input into GEMA's costs benchmarking process.²⁸⁶ GEMA noted that in its Draft Determinations, it had initially suggested that only submitted cost proportions should be taken into account, but following representations from the DNOs, in its Final Determinations GEMA took account of both factors. None of the DNOs, apart from NPg, contended for an approach which excluded reference to DNOs' business plans.²⁸⁷ All other DNOs contended that GEMA should consider both disaggregated benchmarking modelling and DNOs' business plans.²⁸⁸

4.81 Submitted cost shares, in GEMA's view, contained valuable information related to the interaction between activities, and the allocation of costs to cost categories based on how each DNO structured its business and the use of these remained justified as part of a blended allocations approach.²⁸⁹

4.82 GEMA submitted that NPg's proposed approach of having regard only to disaggregated benchmarking shares was methodologically inappropriate (since it disregarded submitted costs, a key input into the costs benchmarking process),²⁹⁰ was not in the interests of consumers and nor was it likely to accelerate the achievement of net zero objectives over a longer-term trajectory.²⁹¹ It was not in the interests of consumers, according to GEMA, for the following reasons:²⁹²

(a) there were inherent limitations of a disaggregated benchmarking cost assessment premised on a combination of separately modelled costs that meant the distribution of allowed totex resulting from the allocation may not necessarily reflect an efficient split of totex across DNO activities (or

²⁸⁵ GEMA Response to PD, paragraph 17.

²⁸⁶ GEMA Response, paragraphs 8 and 101.

²⁸⁷ GEMA Response, paragraphs 9 and 88 (noting that all DNOs had opposed GEMA's proposed approach of relying solely on submitted cost shares).

²⁸⁸ GEMA Response, paragraphs 9 and 88. GEMA Skeleton, paragraph 27. See also LOI paragraph 6(a).

²⁸⁹ GEMA Skeleton, paragraph 20.

²⁹⁰ GEMA Response, paragraph 95.

²⁹¹ GEMA Skeleton, paragraph 4.

²⁹² GEMA Response, paragraph 94. See also LOI, paragraphs 6(b) and 6(c).

at least, the disaggregated benchmarking cost shares were only one view of the cost splits of an efficient DNO);²⁹³

- (b) 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 have resulted in an allocation to non-variant totex that was disproportionate, given other elements of a DNO's cost base;
- (c) a comparison to non-variant totex allowances calculated using GEMA's cost models and NPg's submitted forecasts of LCT uptake clearly showed that using only disaggregated benchmarking cost shares would have resulted in a non-variant totex allowance which was higher than could be justified from the outputs of GEMA's (uncontested) cost modelling.

4.83 GEMA further submitted that NPg failed to advance any case at all why its approach would be in consumers' interests; in fact it would be contrary to those interests.²⁹⁴

4.84 GEMA submitted that an outcome which led to an excessive or disproportionate non-variant totex allowance could lead to DNOs reaping excessive rewards, which were unconnected to specific outputs or other tangible benefits for consumers ²⁹⁵, and that 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.²⁹⁶ GEMA added that while it did 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-ED2.²⁹⁷ GEMA further submitted that its chosen methodology was more reflective of the cost assessment approach, and it generated balanced and appropriate outcomes which were consistent with a range of reasonable cross-checks.²⁹⁸

²⁹³ GEMA further submitted that the CMA should consider whether the distribution of total efficient modelled costs resulting from a cost allocation using disaggregated cost shares was methodologically inappropriate ' (GEMA Response to PD, paragraph 19).

²⁹⁴ [GEMA Response](#), paragraph 101; GEMA Skeleton, paragraph 27.

²⁹⁵ [GEMA Response](#), paragraphs 10, 94.2, 94.3 and 95. GEMA Skeleton, paragraph 27.

²⁹⁶ [GEMA Response](#), paragraph 10. See also LOI paragraph 6(b).

²⁹⁷ [GEMA Response](#), paragraph 95. See also LOI paragraph 6(c).

²⁹⁸ [GEMA Response](#), paragraph 10.

4.85 GEMA submitted that it undertook significant analysis to cross-check the outcomes of the different allocations options and provide reassurance that the approach produced reasonable results ensuring that DNOs were not materially disadvantaged.²⁹⁹ GEMA submitted that its analysis found that NPg's preferred allocations approach would predominantly allocate costs to CAIs and Business Support Costs (BSC) at the expense of LRE, and that the impact of this would be to provide NPg with allowances for CAIs and BSCs significantly in excess of their business plan submission with no tangible increase in outputs to be delivered.³⁰⁰ It submitted that, in contrast, GEMA's blended approach provided NPg with allowances consistent with their submitted costs for CAIs and BSCs.³⁰¹

Materiality

4.86 As regards NPg's submission that a material disallowance had resulted given that NPg's business plan had assumed a much faster pace of LCT uptake and higher levels of electrification (and therefore required a correspondingly higher amount of LRE) than envisaged by National Grid's System Transformation FES,³⁰² GEMA submitted that the relevant adjustment was much more minor than NPg suggested. That was because FES Transformation data was used only in a limited way in the context of: (1) the DDA following Step 2a³⁰³ of the cost assessment process for the totex benchmarking exercise; and (2) in the demand-driven workload adjustments to the Secondary Reinforcement model (which was one of the 46 cost activities modelled in the disaggregated benchmarking).³⁰⁴ The impact of GEMA's demand-based adjustments (which it described as relatively small and targeted) amounted to £116 million or circa 3.6% of NPg's totex.³⁰⁵ GEMA submitted that this did not amount to a wholesale re-baselining of business plans³⁰⁶ or re-baselining to a common scenario and GEMA did not change its position on this.³⁰⁷ GEMA further submitted that it did not accept there was an effective disallowance against total efficient costs.³⁰⁸

4.87 GEMA further submitted that NPg's contention that GEMA's allocation methodology resulted in NPg being underfunded by £157 million was a

²⁹⁹ GEMA Skeleton, paragraphs 24 and 29.

³⁰⁰ GEMA Skeleton, paragraph 24.

³⁰¹ GEMA Skeleton, paragraph 24. See also LOI paragraph 6(d).

³⁰² [GEMA Response](#), paragraph 91, referring to [NoA](#), paragraph 18.5. See also LOI paragraph 2.

³⁰³ Step 2a was the step at which the totex benchmarking was conducted prior to the DDA, which was step 3 (GEMA Response, paragraph 61).

³⁰⁴ [GEMA Response](#), paragraph 92.

³⁰⁵ GEMA further submitted that its relatively small modelling adjustment in the totex benchmarking represented 2.4% of normalised submitted costs (GEMA Response to PD, paragraph 14).

³⁰⁶ [GEMA Response](#), paragraph 92; GEMA Skeleton, paragraph 18. See also LOI paragraph 3.

³⁰⁷ MPH Transcript, page 88, lines 11 to 12.

³⁰⁸ MPH Transcript, page 160, lines 1 to 2.

simplification: it confused LRE and non-LRE allowances with variant and non-variant allowances and the indirect costs provided to support LRE allowances. GEMA submitted that the correct figure was no higher than £130 million (which was the difference between the non-variant allowance under GEMA's approach and the non-variant allowance under NPg's proposed approach), and even the £130 million figure far overstated the materiality of any risk of underfunding.³⁰⁹ At the Main Party Hearing, GEMA further submitted, by way of clarification, that in its submissions on the £130 million figure, it was not detracting from its position that there was no effective disallowance, rather its submission was that even if one took NPg's case 'at its highest' and using NPg's logic, GEMA came up with a different number, but that was not a suggestion that it accepted NPg's premise.³¹⁰ GEMA further submitted that if it was wrong on the point that there was no effective disallowance, it did not take a separate materiality point.³¹¹

- 4.88 GEMA submitted that it fundamentally disagreed with NPg that demand-based adjustments within the cost assessment, ie the post-modelling DDA and the workload adjustments within the Secondary Reinforcement disaggregated benchmarking model, represented a re-baselining of DNO business plans to a Common Scenario.³¹² GEMA submitted that these were targeted and proportionate adjustments introduced specifically to account for insufficient justification for DNOs' forecasts of LCT uptake and demand.³¹³ GEMA further submitted that while its approach evolved, the specific drivers and justification for the inclusion of the demand-based adjustments did not change through Draft Determinations and Final Determinations and it was plainly wrong to suggest that GEMA was seeking to defend a different decision.³¹⁴
- 4.89 GEMA further submitted that it was not its intention to provide or prescribe a single Common Scenario for DNOs to use for their business planning submissions and, similarly, GEMA did not intend to or, in practice, apply a single Common Scenario across the allowances that were set.³¹⁵ For RII0-ED2, GEMA submitted that it set a package of *ex ante* allowances along with uncertainty mechanisms.³¹⁶ This did not fix allowances to a Common Scenario or a single view of future demand at the beginning of the price control period but instead enabled DNOs' allowances to flex to meet evolving

³⁰⁹ [GEMA Response](#), paragraph 93; GEMA Skeleton, paragraph 21.

³¹⁰ MPH Transcript, page 162, lines 2 to 12 and page 162, lines 24 to 25 to page 163, lines 1 to 9.

³¹¹ MPH Transcript, page 162, lines 15 to 16 and page 163, lines 15 to 16.

³¹² GEMA Skeleton, paragraph 5. See also LOI paragraph 3.

³¹³ GEMA Skeleton, paragraphs 16 and 19.

³¹⁴ GEMA Skeleton, paragraph 5.

³¹⁵ GEMA Skeleton, paragraph 12.

³¹⁶ GEMA Skeleton, paragraphs 13 and 23.

demand on the networks, while applying appropriate safeguards to allow GEMA to satisfy itself that consumers' money was invested appropriately.³¹⁷ GEMA submitted that this was consistent with the Business Plan guidance that GEMA provided DNOs.³¹⁸

- 4.90 As regards the cross-checks it conducted, GEMA submitted that in its analysis, cross-check 3³¹⁹ took DNOs' submitted costs as the level of totex allowances and then used DNOs' submitted cost shares to allocate allowances. GEMA submitted that this provided a measure of the allowances for non-variant activities that DNOs indicated they required under their business plans.³²⁰ GEMA further submitted that this cross-check showed that if GEMA had simply accepted NPg's submitted costs, without any efficiency benchmarking, their non-variant allowances, for which they claimed to be underfunded, would be only £67 million higher (NPgN: £66 million; NPgY: £1 million) than the allowances set at Final Determinations.³²¹ GEMA submitted that for NPgN, it could not be concluded that this was evidence of underfunding, rather the outcome of a fair and reasonable cost assessment exercise.³²²

*Underfunding*³²³

- 4.91 GEMA submitted it was wrong for NPg to contend that the consequences of GEMA's approach was that NPg would be starting from a position of underfunding of their non-variant totex allowances, and that GEMA's approach would not permit them to recover their efficient costs under any scenario.³²⁴ GEMA further submitted that the comparator against which the alleged underfunding was measured was the level of non-variant totex allowance produced by the sole use of disaggregated benchmarking cost shares. However, that was not an objectively correct approach. It was only one view of the of the appropriate level of non-variant totex allowance, and did not take account of other reasonable approaches. Further:

- (a) NPg's non-variant totex allowance for RIIO-ED2 was still a significant increase on their non-variant totex allowance compared to the actual

³¹⁷ Ibid.

³¹⁸ GEMA Skeleton, paragraph 14.

³¹⁹ Cross-check 1 consisted of using 100% disaggregated benchmarking cost shares to allocate allowances. Cross-check 2 consisted of removing demand-based adjustments and using both submitted cost shares and disaggregated benchmarking cost shares (50:50 blend) to allocate allowances. Cross-check 3 consisted of taking DNOs' submitted totex from 'Business Plan Data Templates' (after exclusions and normalisations so as to be consistent with modelled totex, but with no benchmarking applied) as the level of totex allowances, and using their submitted cost shares to allocate allowances (McMahon 1 (GEMA), paragraph 327).

³²⁰ GEMA Skeleton, paragraph 25.

³²¹ Ibid.

³²² Ibid.

³²³ LOI paragraphs 5(b) and 5(c).

³²⁴ [GEMA Response](#), paragraph 96.

costs that NPg incurred for the same non-variant cost activities in RIIO-ED1;

- (b) 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 was just £21 million for NPgN and £30 million for NPgY; and
- (c) in general, reasonable cross-checks resulted in similar levels of non-variant totex as adopted in the final allowances in Final Determinations.³²⁵

4.92 GEMA submitted that whilst it was a statement of fact that NPg received less in non-variant allowances using the blended allocation methodology than they would using 100% disaggregated benchmarking cost shares, that did not automatically equate to underfunding. GEMA considered that 'underfunding' referred to a situation where a DNO had insufficient allowances to deliver their outputs. However, from the evidence presented, it was not clear what outputs NPg was alleging they were underfunded for.³²⁶

4.93 GEMA submitted that it was not correct to characterise its allocation methodology, as NPg had done, as an 'unjustified discriminatory ratchet on final allowances'. In GEMA's submission, that was a restatement of NPg's disagreement with the outcome; GEMA's blended approach was a reasonable judgement which was open to the expert regulator to take.³²⁷

4.94 GEMA further submitted that it was not the case that GEMA had mechanically capped the allowance for each activity at the lower of submitted and modelled efficient costs. On the contrary, GEMA submitted that it had conducted a number of comparisons and cross-checks to ascertain that the allocation approach was reasonable across the sector and did not unfairly reward or penalise any DNO. GEMA submitted that it had reasonably concluded that the outcomes produced by this methodology were appropriate, and allowed DNOs to recover their efficient costs, while protecting the interests of consumers.³²⁸

4.95 GEMA submitted that an alternative volume driver 'cross-check', as proposed by Frontier Economics³²⁹, would not take NPg any further because that cross-check was based on unit costs and corresponding volumes which were

³²⁵ GEMA Response, paragraph 96; NPg Skeleton, paragraph 21.

³²⁶ GEMA Skeleton, paragraph 22 and 4.

³²⁷ GEMA Response, paragraph 98.

³²⁸ GEMA Response, paragraph 99.

³²⁹ Frontier (NPg) paragraph 4.67(c); see also NoA, paragraph 20.2(iii).

derived from disaggregated modelling so it was, GEMA submitted, wholly unsurprising that the results it produced conformed to the results of the disaggregated benchmarking cost shares.³³⁰

- 4.96 GEMA further submitted that for substantially the same reasons, GEMA's choice of allocation methodology could not be considered an error of fact or that the licence modifications had failed to achieve their stated effect.³³¹ GEMA's allocation methodology, it submitted, reflected a balanced regulatory judgement which took into account both major sources of data used in the cost assessment process, and which yielded outcomes which were reasonable when measured against a wide range of cross-checks.³³²

Financeability and other duties

- 4.97 GEMA submitted that it was only if all of NPg's previous arguments (as summarised elsewhere in this section) were accepted that there would be any consequence at all for NPg's bottom lines, but in that case, GEMA's duty in section 3A(2b) EA89 to have regard to the ability of licence holders to finance their activities added nothing to NPg's arguments.³³³
- 4.98 GEMA submitted that this duty did not impose an obligation of result, that is the duty did not require GEMA to have regard to securing the actual financeability of particular licence holders. Furthermore, the use of a notional company approach did properly have regard to the financeability duty.³³⁴
- 4.99 GEMA also submitted that it had 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. It 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.³³⁵
- 4.100 GEMA further submitted that when considering its financeability duty, GEMA had its baseline case, which tested a couple of parameters around ongoing efficiency. On top of that, GEMA submitted that it did high case 1 and high case 2 tests, flexing a number of different factors. That financeability assessment was also done at a point of time, so it always had to be fixed on model specifications at that point, which imposed limitations on what GEMA

³³⁰ [GEMA Response](#), paragraph 100.

³³¹ [GEMA Response](#), paragraph 101.

³³² *Ibid.*

³³³ [GEMA Response](#), paragraph 102.

³³⁴ [GEMA Response](#), paragraph 102, citing the CMA's Final Determination in ELMA 2021, paragraphs 14.74 and 14.81.

³³⁵ [GEMA Response](#), paragraph 103, which in turn referenced paragraphs 77 to 80.

could do. GEMA did not re-run the financeability assessment after that. GEMA submitted that it considered that any underfunding figure (although GEMA did not confirm whether £157m or £130m was within its range of scenarios) was small relative to the range of scenarios GEMA was testing.³³⁶

*New/fresh decision*³³⁷

4.101 In response to NPg's submission that GEMA was advancing in its Response a substantially new decision, GEMA submitted that NPg was really challenging GEMA's decision to use submitted cost shares in addition to the disaggregated cost shares for the purposes of cost allocation, and GEMA's decision on that had not changed.³³⁸ To the extent that there had been a change in reasoning about an effective disallowance, and GEMA submitted there was no change in reasoning, such a change fell firmly on the side of the line of a change in rationale surrounding a decision; and according to Firmus Energy,³³⁹ this did not matter for the purposes of the CMA's task in the appeal.³⁴⁰

Stated effect

4.102 GEMA submitted that it did not accept that the stated effect of the Final Determinations was as characterised by NPg in its NoA.³⁴¹ GEMA submitted that looking at its Final Determinations there was a series of individual decisions where GEMA set out what it had done; it added that alongside its licence modifications, GEMA published a 'reasons and effect' document and accepted that the modifications and explanations for them were more likely to be the combined source for the stated effect.³⁴²

Intervener's submissions

4.103 Citizens Advice submitted that allowing the appeal would cause consumer detriment both in the short term and the long term, because any unjustified returns for network companies would add unfair cost to consumers' bills and would also erode the credibility of the regulatory regime and so damage consumer trust, which was vital to net zero delivery.³⁴³

³³⁶ MPH Transcript, page 131, lines 10 to 18.

³³⁷ LOI paragraph 7

³³⁸ MPH Transcript, page 164, lines 12 to 18.

³³⁹ In this context, GEMA was referring to the principle, set out in Firmus Energy, that an appeal is against the decision, not the reasons for the decision (MPH Transcript, page 164, lines 19 to 22; see also [GEMA Response](#), paragraph 35).

³⁴⁰ MPH Transcript, page 164, lines 23 to 24.

³⁴¹ MPH Transcript, page 159, lines 17 to 19 referring to [NoA](#), paragraph 21.1(ii).

³⁴² MPH Transcript, page 161, lines 4 to 9.

³⁴³ CA Skeleton, paragraph 4.

*No evidence of underfunding*³⁴⁴

4.104 Citizens Advice submitted that it did not believe that NPg would be underfunded. NPg had chosen to define underfunding by comparing to the results of GEMA's disaggregated benchmarking. This was wrong as it relied upon having confidence that the disaggregated modelling could be taken as a reliable view of efficient costs (at an activity level).³⁴⁵ Citizens Advice further submitted that, from a consumer perspective, underfunding should simply be where funding was below expenditure; and NPg had not presented evidence that it would spend in excess of its total expenditure allowance or that it would be unable to complete the necessary work.³⁴⁶ Citizens Advice further submitted that NPg should be required to provide compelling evidence that its best view of actual spending required to deliver the required outputs exceeded its allowances.³⁴⁷

4.105 Citizens Advice submitted that the effect of using NPg's preferred allocation method was to move allowances from LRE to Closely Associated Indirects (CAI) and BSC, which gave values for CAI and BSC that were higher than those included in NPg's business plan submission.³⁴⁸ This was despite the reduction in scope of activity, reflected in the lower LRE baseline, which would be expected to lead to a corresponding reduction in CAI and BSC. Citizens Advice added that this did not appear to be in consumers' interests. Combining these high values for CAI and BSC, with the potential for additional funding through the Indirects Scaler, and a value for LRE that would move with actual activity, was likely to lead to an overall value that was too high, which further reinforced that NPg had not been underfunded.³⁴⁹

Choice of allocation methodology

4.106 Citizens Advice submitted that using the results of disaggregated benchmarking for totex allocation, an outcome which it described as 'strange', demonstrated that GEMA could not reasonably have been expected to have relied on this methodology. GEMA would have been failing in its duty to protect consumers if it had only used disaggregated benchmarking. Therefore, it submitted, a different method of allocating totex was required instead of, or in addition to, using disaggregated benchmarking. Using

³⁴⁴ LOI paragraph 5(c).

³⁴⁵ CA intervention, paragraphs 18-19; CA Skeleton, paragraphs 7 and 9.

³⁴⁶ CA Intervention, paragraph 20; CA Skeleton, paragraph 8. We understand 'necessary work' to refer to the work/activities which RIIO-ED2 seeks to fund.

³⁴⁷ CA Skeleton, paragraph 11.

³⁴⁸ CA Intervention, paragraphs 21-23.

³⁴⁹ Ibid.

companies' business plans provided an alternative approach that was required. Citizens Advice was not aware of other approaches.³⁵⁰

- 4.107 Citizens Advice further submitted that it had called for more extensive use of uncertainty mechanisms as more protection for consumers was required due to the increased uncertainty over future energy scenarios. Citizens Advice submitted that GEMA was right to be cautious about how non-variant allowances were set.³⁵¹

*Value of cross-checks*³⁵²

- 4.108 Citizens Advice submitted that, in general, cross-checks were an important safeguard for consumers (and companies) within the regulatory framework.³⁵³
- 4.109 Citizens Advice disagreed with NPg's view that cross-check 3 was irrelevant; it submitted that cross-check 3, by referring back to business plan submissions, was most instructive as the check closest to reflecting reality.³⁵⁴
- 4.110 Citizens Advice submitted that cross-check 2 addressed the concerns raised by NPg directly by removing demand-based adjustments from the totex and disaggregated benchmarking. Whilst it was very likely to produce non-variant allowances that were too high, Citizens Advice submitted, it was useful in establishing an upper bound on the materiality of any error. Citizens Advice submitted that it did not consider that any error had taken place.³⁵⁵

Impact of regulatory regime on risk of underfunding

- 4.111 Citizens Advice submitted that the context of the RIIO regulatory regime was relevant context to understanding the likelihood of NPg being underfunded.³⁵⁶ Within the RIIO-1 price controls, underspending against allowances was routine with few instances of overspending, which Citizens Advice submitted that the CMA had previously acknowledged.³⁵⁷ Citizens Advice further submitted that there was strong evidence of structural outperformance in RIIO-1 and previous price controls.³⁵⁸ It added that current expectations were

³⁵⁰ CA Intervention, paragraphs 24-25; CA Skeleton, paragraphs 13-15.

³⁵¹ CA Skeleton, paragraph 16.

³⁵² LOI paragraph 6(d).

³⁵³ CA Skeleton, paragraph 17.

³⁵⁴ CA Skeleton, paragraph 18.

³⁵⁵ CA Skeleton, paragraph 21. Citizens Advice submitted that cross-check 2 established an upper bound of £51m on the materiality of any error. However, after taking into account the Totex Incentive Mechanism (TIM), which meant that underspends/overspends against non-variant allowances were shared equally between companies and consumers, the share of impact on NPg would be around £25 million - Citizens Advice questioned whether this sum remained material (CA Skeleton, paragraph 22).

³⁵⁶ CA Intervention, paragraphs 26-27; CA Skeleton, paragraphs 23 to 25; CA Response to PD, paragraphs 4-6.

³⁵⁷ CA Intervention, paragraph 28.

³⁵⁸ CA Intervention, paragraph 29.

that nearly all companies would outperform compared to their allowed Cost of Equity, and that in a well-calibrated price control settlement, one would expect to see companies' performance distributed around the allowed Cost of Equity.³⁵⁹

ED2 should be expected to be generous to NPg

4.112 Citizens Advice submitted that the cost of capital and incentive returns in GEMA's RIIO-ED2 Determinations were over-generous to the sector.³⁶⁰ Citizens Advice did not consider that there was a material risk that NPg would be underfunded (despite their claim) and unable to achieve returns above the allowed costs of capital.³⁶¹ Citizens Advice also submitted that the incentive mechanisms in RIIO-ED2 were not sufficiently stretching for DNOs.³⁶²

Our assessment of Ground 1

4.113 In this section we set out our assessment of Ground 1.

4.114 In summary, in relation to the alleged misallocation of allowances, NPg submitted that the Decision was 'wrong' within the meaning of section 11E(4) EA89, in that GEMA had relied on the cost proportions derived from DNOs' submitted costs when allocating, post benchmarking, DNOs' total efficient modelled costs to different cost categories.³⁶³ NPg submitted that GEMA's decision to do so was irrational and illogical because DNOs' submitted costs were based on decarbonisation planning scenarios that were 'manifestly'³⁶⁴ different from the one that GEMA intended to fund and had used in the cost assessment process and for setting total final allowances (namely, the Common Scenario, a term used by NPg).³⁶⁵

4.115 GEMA stated that it made modest adjustments that were not a wholesale re-baselining of NPg's business plan such as would render it irrational for GEMA to have any regard to the cost proportions derived from that plan.³⁶⁶ It stated that there was a range of approaches for allocation which an expert regulator might choose to adopt, in the exercise of regulatory judgement.³⁶⁷

³⁵⁹ CA Intervention, paragraphs 29-30.

³⁶⁰ CA Intervention, paragraph 31.

³⁶¹ Ibid.

³⁶² CA Intervention, paragraph 34.

³⁶³ NoA, paragraphs 3.3(i), 10.1, 10.5, 16.3, 18.26 and 18.28.

³⁶⁴ At NoA, paragraph 16.3, NPg referred to the decarbonisation planning scenarios being 'materially' different from GEMA's Common Scenario.

³⁶⁵ NoA, paragraphs 3.3(i), 10.5, 16.3, 18.7 and 18.26.

³⁶⁶ GEMA Response, paragraph 83. See also LOI paragraph 3.

³⁶⁷ GEMA Response, paragraph 82.

- 4.116 NPg submitted that the error was a matter of principle, not degree:³⁶⁸ it was an error of principle to use irrelevant cost proportions derived from submitted costs, irrespective of what weighting was then applied to those proportions in the allocation method.³⁶⁹
- 4.117 In our interpretation, NPg's formulation of its challenge under Ground 1 is that the differences in NPg's submitted costs (based on decarbonisation planning scenarios) and NPg's total efficient modelled costs were such that no weight should be attached to the cost proportions derived from NPg's submitted costs, as in effect those cost proportions were not appropriate for the purpose of GEMA's allocation of NPg's total efficient modelled costs to cost categories. We see this 'no weight' argument as presenting a binary decision as to whether or not GEMA should have used NPg's submitted cost proportions for its allocation of NPg's total efficient modelled costs.³⁷⁰ In the ensuing paragraphs, for ease of presentation, references to NPg's submitted costs are to NPg's submitted costs based on its decarbonisation planning scenario, after the normalisations applied by GEMA³⁷¹ and without any specific further adjustment for the purposes of the allocation of NPg's total efficient modelled costs.
- 4.118 NPg submitted that DNOs' submitted costs were based on decarbonisation planning scenarios that were manifestly different from the one that GEMA intended to fund, whereas GEMA submitted that it made modest demand-based adjustments (to reflect the differences between NPg's forecasts of LCT uptake and the forecast yielded by the System Transformation FES) and that workload adjustments applied in the disaggregated benchmarking were overwhelmingly reflective of efficiency rather than demand.³⁷²

³⁶⁸ [NoA](#), paragraphs 10.6 and 18.28.

³⁶⁹ [NoA](#), paragraph 18.28.

³⁷⁰ GEMA submitted that the suggestion that no weight should be attached to submitted cost shares was unreasonable and indeed a practical impossibility. It explained that in the case of reliance on 100% disaggregated benchmarking cost shares, it would be required to consider submitted cost shares for the purposes of cost allocation. This was because disaggregated benchmarking cost shares, for some cost activity areas (eg CAIs and BSCs), were insufficiently disaggregated. Therefore, submitted cost shares provided the only information available regarding the relative allocation of cost categories. (GEMA Response to PD, paragraph 8.10 and footnote 2). We acknowledge this submission, but we note that it does not impact the relative proportions of LRE and non-LRE cost categories within disaggregated benchmarking as the LRE cost categories were assessed separately from non-LRE cost categories by GEMA in this benchmarking. In other words, if some of the non-LRE cost categories were assessed together within disaggregated benchmarking, that does not impact the relative proportions of LRE and non-LRE cost categories in the disaggregated benchmarking proportions. Therefore, we consider that the 'no weight' characterisation is appropriate for the purposes of this appeal. Information derived from NPg's business plan submission could be used for cost activities which were insufficiently disaggregated.

³⁷¹ See paragraph 4.16(b) for further information about the normalisations.

³⁷² [NoA](#), paragraphs 3.3(i). [GEMA Response](#), paragraph 83. [GEMA Skeleton](#), paragraph 16.

- 4.119 In our view, the question whether the workload adjustments were scenario or efficiency related is irrelevant to our assessment of the alleged error in Ground 1. That is because both scenario and efficiency adjustments have an impact on the validity of the submitted cost proportions for the purposes of the allocation of total efficient modelled costs.³⁷³
- 4.120 Therefore, in our assessment of Ground 1, our starting point is to consider (a) the intrinsic nature and (b) the magnitude of adjustments to LRE (including the workload related adjustments) in order to determine the impact (if any) of these adjustments on the appropriateness of using the proportions derived from NPg's submitted costs for the purposes of GEMA's allocation of NPg's total efficient modelled costs.
- 4.121 We then consider GEMA's submission on the drawbacks of disaggregated benchmarking proportions as (a) submitted cost proportions were used in conjunction with (b) the disaggregated benchmarking proportions, and GEMA stated that these methods (that is (a) and (b)) controlled for the respective flaws of each other.³⁷⁴

The adjustments to LRE

- 4.122 Within GEMA's cost assessment, workload adjustments were applied in the disaggregated benchmarking and the DDA was applied in the totex benchmarking alongside implicit volume adjustments within the totex models.
- 4.123 The workload adjustments within disaggregated benchmarking and the DDA within totex benchmarking are primarily concerned with DNOs' planned levels of decarbonisation related expenditure. NPg submitted that it considered its submitted costs to be based on decarbonisation planning scenarios that were 'manifestly'³⁷⁵ different from the one that GEMA intended to fund and had used in the cost assessment process and for setting total final allowances. GEMA's view was that NPg's higher levels of planned LRE lacked justification. In particular, GEMA was critical of NPg's lack of explanation around how it would utilise existing headroom on NPgY's network and around the lack of

³⁷³ LOI paragraph 4.

³⁷⁴ MPH Transcript, page 83, lines 23 to 25 and page 84, line 1. GEMA stated: '... we have made clear that every approach has advantages, but also has a number of disadvantages or flaws that push you into different directions. By taking the 50-50 hybrid approach, we are controlling for these flaws, making sure no single benchmarking approach is deterministic in our assessment of efficient expenditure, and making sure the outcomes are less likely to be biased or distorted in any way' (MPH Transcript, page 83, lines 21 to 25 to page 84, line 1) and 'Regardless of the sort of size of the adjustment happening, that one in our modelling, I think there is still a key challenge or issue or flaw with disag, which I think means it is one of the reasons why we use Totex, and it is one of the reasons why we think submitted cost shares do still contain valuable information' (MPH Transcript, page 106, lines 21 to 25).

³⁷⁵ NoA, paragraphs 3.3(i) and 10.5. At NoA, paragraph 16.3, NPg referred to the decarbonisation planning scenarios being 'materially' different from GEMA's Common Scenario.

justification or explanation on the role of flexibility to temper load-related expenditures.³⁷⁶ GEMA also stated that whilst NPg's level of proposed LRE and network reinforcement was greater than the rest of the sector, this was not correlated with a relatively higher assumed rate of electrification.³⁷⁷ In addition, GEMA stated that its independent challenge group, which reviewed the business plans, was highly critical of NPg's draft business plan, particularly in relation to LRE.³⁷⁸ Furthermore, GEMA submitted that the large variation for NPgY (no other DNO's efficiency score changed by more than 5%) reflected what GEMA described as NPgY's extremely high (and in GEMA's view inefficient) workload volumes relating to secondary network reinforcement.³⁷⁹

- 4.124 In terms of the intrinsic nature of the adjustments, our view is that GEMA's use of the cost proportions derived from NPg's submitted costs (for the purposes of allocating NPg's total efficient modelled costs) is inconsistent with GEMA's rejection of NPg's LRE which was included in its submitted costs. It is inconsistent that these cost proportions were used for the allocation of NPg's total efficient modelled costs when GEMA had determined the levels of submitted LRE to be inefficient and it had also made demand adjustments to the submitted LRE.
- 4.125 In its response to the Provisional Determination, GEMA disagreed with the provisional findings that its use of submitted cost shares, as part of a blended approach to allocate NPg's total efficient modelled costs, was wrong.³⁸⁰ In GEMA's submission, the CMA had erred in suggesting that 'the LRE workload embedded in NPg's total efficient modelled costs was materially reduced relative to that embedded in its submitted costs'.³⁸¹ GEMA submitted that, whilst this was correct in the context of the disaggregated modelling (which only contributed to 50% of the total efficient modelled costs), it could not be presumed from the results of the totex benchmarking.³⁸²
- 4.126 GEMA submitted that it might expect some of the adjustments it made within totex benchmarking to be focused on LRE-related components of NPg's plan, but not to such an extent that the balance between LRE and non-LRE categories in the total efficient modelled costs rendered GEMA's 50% use of submitted cost shares in the allocation process irrelevant.³⁸³ In our view, GEMA's submission disregards our finding that the use of the cost proportions

³⁷⁶ MPH Transcript, page 145, lines 18 to 25 to page 146, lines 1 to 3-

³⁷⁷ McMahon 1 (GEMA), paragraph 345.

³⁷⁸ [GEMA Response](#), paragraph 57.

³⁷⁹ [GEMA Response](#), paragraph 137.2.

³⁸⁰ GEMA Response to PD, paragraph 1.

³⁸¹ GEMA Response to PD, paragraph 18.

³⁸² Ibid.

³⁸³ GEMA Response to PD, paragraph 8.7.

derived from NPg's submitted costs was inconsistent with GEMA's rejection of NPg's submitted LRE in the first place. Moreover, as explained below, we infer from the evidence that the adjustments which GEMA made to LRE within totex benchmarking were sizeable and proportionately larger than the adjustments applied to other major cost categories. Therefore, in our view, GEMA effectively rejected NPg's submitted LRE in its totex benchmarking (and disaggregated benchmarking). This is further supported by GEMA's statements referred to in paragraph 4.123.

- 4.127 In its response to the Provisional Determination, GEMA discussed how the adjustments in totex benchmarking could be assumed to impact the relative proportions of LRE and non-LRE categories in the total efficient modelled costs, and on the degree to which adjustments to LRE were reflected in its blended approach.³⁸⁴ We consider these points below.
- 4.128 In addition to our finding that GEMA's use of the cost proportions derived from NPg's submitted costs was inconsistent with its rejection of NPg's submitted LRE, our view is that, in the case of NPg, the adjustments discussed in paragraph 4.122 were sizeable and the adjustments made to the LRE cost categories were proportionately larger than those applied to other major cost categories. Effectively, therefore, GEMA rejected not only the absolute level of the submitted LRE costs but also the share of NPg's overall submitted costs accounted for by LRE.
- 4.129 The impact of the adjustments applied by GEMA on LRE cost categories within disaggregated benchmarking (on which GEMA placed 50% reliance when it set total efficient modelled costs) is shown by comparing the percentage of expenditure on LRE within total expenditure both in NPg's submitted costs and in GEMA's disaggregated benchmarking. Specifically, within NPg's submitted costs, LRE accounted for 22% of NPgY's and 16.8% of NPgN's total costs, compared with 8.5% for NPgY and 7.6% for NPgN within GEMA's disaggregated benchmarking models.³⁸⁵ We note that these adjustments are captured in GEMA's blended approach by virtue of the 50% weight attached to the disaggregated benchmarking produced modelled costs, and the 50% weight attached to the allocation based on the disaggregated benchmarking proportions.³⁸⁶ We discuss GEMA's adjustments made in relation to the totex benchmarking below.³⁸⁷

³⁸⁴ GEMA Response to PD, paragraph 8.1; see also paragraph 15.

³⁸⁵ Frontier (NPg), Assessment of GEMA's approach to allocating allowances at RIIO-ED2, Table 3.

³⁸⁶ GEMA Response to PD, paragraph 15.

³⁸⁷ GEMA submitted that the CMA's reasoning was flawed in presuming that the DDA, as well as any implicit volume adjustments applied within the totex benchmarking, were equivalent in magnitude to the explicit volume

4.130 Although GEMA's adjustments to LRE within totex benchmarking cannot be estimated precisely as its three totex models produced a set of total modelled costs (rather than a more granular breakdown of different cost categories such as the five LRE cost categories), we infer from the evidence discussed in this paragraph and in paragraphs 4.131 to 4.133 that in the case of NPg, these adjustments to LRE were sizeable and proportionately larger than the adjustments applied to other major cost categories (as we note in paragraph 4.128). GEMA stated that within the totex benchmarking models, the adjustment made by the DDA aimed to reflect the differences between NPg's higher forecasts of LCT uptake and the lower forecast yielded by System Transformation FES and that the value of the DDA was £84 million for NPg (amounting to 2.6% of NPg's submitted costs).³⁸⁸ However, this £84 million already reflects the 50% contribution of totex benchmarking in setting total efficient modelled costs. The size of the totex DDA as applied to the totex benchmarking component of modelled costs is £167 million.³⁸⁹ In comparison, NPg's submitted LRE is £680 million.³⁹⁰

4.131 Although we agree with GEMA that it cannot be assumed that the DDA solely impacts LRE, GEMA's initial assumption, namely that the DDA predominantly impacts LRE cost categories,³⁹¹ appears to be appropriate in our view on the basis that an explicit DDA adjustment can be more directly attributed as a reduction in LRE in the composition of NPg's modelled costs.³⁹² In its response to the Provisional Determination, GEMA submitted that it could not definitively be said, and that NPg had not demonstrated, that the explicit [DDA] and implicit adjustments to NPg's submitted costs (as part of totex benchmarking) produced a materially lower share of LRE in the modelled costs compared to NPg's submitted costs.³⁹³ However, we note that GEMA also stated that '[g]iven the nature of the composite growth variables used in totex models 2 and 3, and the way in which the DDA was derived and applied, [it] might expect that adjustments to NPg's totex would be focused on LRE'.³⁹⁴

adjustments made to LRE (mainly in secondary reinforcement) in the disaggregated benchmarking (GEMA Response to PD, paragraph 13). In paragraph 4.129 we discuss the adjustments made to disaggregated benchmarking and in paragraphs 4.130 to 4.133 we discuss the adjustments made to totex benchmarking separately. Therefore, we do not assume that, or assess whether, such adjustments (as referred to by GEMA) were equivalent in magnitude.

³⁸⁸ GEMA clarification session, slides 34 and 37. [GEMA Response](#), paragraph 83. GEMA Response to PD, paragraph 12.

³⁸⁹ GEMA Response to PD, footnote 19.

³⁹⁰ GEMA Response to PD, Figure 7.

³⁹¹ GEMA Response to PD, paragraph 49 and Figure 7.

³⁹² GEMA Response to PD, paragraphs 12 and 49. GEMA made this initial assumption when discussing one remedy option in its response to the Provisional Determination.

³⁹³ GEMA Response to PD, paragraph 8.6. GEMA made a related point at paragraph 15: 'This suggests that the share of LRE in the efficient total modelled costs from the totex benchmarking was not reduced to anywhere near the same extent as it had been in the disaggregated benchmarking'.

³⁹⁴ GEMA Response to PD, paragraphs 15 and 49.

- 4.132 GEMA submitted that the demand-based adjustments (ie the DDA applied to the totex benchmarking models and some of the workload adjustments within the Secondary Reinforcement disaggregated benchmarking model) that were made within the GEMA's assessment of total efficient modelled costs were relatively small and targeted, amounting to 3.6% of totex for NPg.³⁹⁵ However, we note that this figure does not take into account the implicit volume adjustments within totex benchmarking and a sizeable part (ie 84%) of the Secondary Reinforcement workload adjustment made to LRE.³⁹⁶ In addition, in its reference to 3.6%, GEMA calculated the size of the adjustments as a proportion of NPg's total costs and took no account of the impact on the relative proportions of LRE and non-LRE cost categories.
- 4.133 In response to the Provisional Determination, GEMA also submitted that the contribution of the modelling adjustments (including the DDA) made within the totex benchmarking to NPg's total efficient modelled costs was £77 million (2.4% of totex for NPg).³⁹⁷ It submitted that it cannot be the case that submitted cost shares are deemed irrelevant for NPg simply because of a relatively small modelling adjustment in the totex benchmarking that represents 2.4% of submitted costs.³⁹⁸ However, in our view, this figure (£77 million or 2.4% of totex) does not tell us the magnitude of the adjustment to LRE within totex benchmarking, just the size of the overall modelling adjustment contributions from the three totex models and the DDA to total efficient modelled costs (ie the sum of the positive and negative adjustments and reflecting the 50% share of totex benchmarking in setting allowances).³⁹⁹
- 4.134 Based on the above, we consider that the size, purpose and specification of the adjustments made by GEMA show that the share of LRE in GEMA's assessment of NPg's total efficient modelled costs (both in totex and disaggregated benchmarking) was materially lower than that in NPg's submitted costs. We consider this to be a material deficiency of the proportions derived from NPg's submitted costs as these proportions are not in accordance with the objectives of allocating total efficient modelled costs as discussed in paragraph 4.39.
- 4.135 In particular, we think that GEMA's reliance on the proportions derived from NPg's submitted costs is likely to have the effect of materially distorting the effective allocation of allowances to different cost categories that are required

³⁹⁵ GEMA Skeleton, paragraph 16.

³⁹⁶ McMahon 1 (GEMA), Appendix C, Table 3.

³⁹⁷ GEMA Response to PD, paragraph 13. GEMA also stated that the contribution from the disaggregated benchmarking on total efficient modelled costs is almost twice as large at £149m. We discussed the adjustments within disaggregated benchmarking in paragraph 4.129.

³⁹⁸ GEMA Response to PD, paragraph 14.

³⁹⁹ GEMA Response to PD, footnote 4.

for the operation of the LRE uncertainty mechanisms.⁴⁰⁰ This is because the effective allocation of costs for these purposes requires GEMA to identify the proportion of total efficient modelled costs to be funded through uncertainty mechanisms and, in turn, the remaining proportion of total efficient modelled costs to be funded by fixed allowances. As such, we consider that as the LRE workload embedded in NPg's total efficient modelled costs was materially reduced relative to that embedded in its submitted costs, the proportions derived from NPg's submitted costs were not relevant for the purposes of GEMA's allocation of NPg's total efficient modelled costs. In particular, the result would be a reduction in funding for NPg to non-LRE cost categories relative to what was determined by GEMA in its cost assessment. Therefore, our view is that GEMA was wrong to rely on the cost proportions derived from NPg's submitted costs for the purposes of allocating NPg's total efficient modelled costs across different cost categories.

GEMA's submission on the disaggregated benchmarking proportions

4.136 GEMA stated that the submitted cost proportions and the disaggregated benchmarking proportions controlled for the respective flaws of each other.⁴⁰¹ In relation to the disaggregated benchmarking proportions, GEMA stated that they have the below drawbacks:

- (a) there are inherent limitations of a disaggregated benchmarking 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;
- (b) 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 (disaggregated benchmarking costs shares produce a relative over-allocation to Closely Associated Indirects (CAIs), which are primarily funded through non-variant allowances); and
- (c) a comparison to non-variant totex allowances calculated using GEMA's cost models and NPg's submitted forecasts of LCT uptake clearly shows that using only disaggregated benchmarking cost shares would have

⁴⁰⁰ See also [NoA](#), paragraph 9.11

⁴⁰¹ MPH Transcript, page 83, lines 21 to 25.

resulted in a non-variant totex allowance which is higher than can be justified from the outputs of GEMA's cost modelling.⁴⁰²

4.137 In our view, there is no need for us to assess GEMA's view on the drawbacks of the disaggregated benchmarking proportions. Even if we were to accept GEMA's view that there are such drawbacks, the error we have found in relation to NPg's submitted cost proportions means that these proportions are not relevant for the purposes of GEMA allocating NPg's total efficient modelled costs and therefore cannot be used to correct the drawbacks of the disaggregated benchmarking proportions noted by GEMA.⁴⁰³

4.138 In GEMA's response to the Provisional Determination, GEMA further submitted that the CMA had failed to consider either the outcomes or the inherent merits of the blended approach to the cost allocations process that GEMA adopted in its Final Determinations.⁴⁰⁴ GEMA submitted that the judicial review ground of irrelevant considerations, to which the CMA's provisional findings referred, did not entail any lower threshold than irrationality.⁴⁰⁵ It added that it was for GEMA to determine what was relevant to its decision and to afford it such weight as it considered in all the circumstances to be appropriate.⁴⁰⁶ GEMA further submitted that given what it described as the 'formidable threshold' associated with irrationality, it was not open to the CMA to consider only the relevance of the submitted costs shares without also considering the drawbacks or appropriateness of the alternative sources of information available to GEMA for the purposes of cost allocation.⁴⁰⁷ It added that the CMA had to consider all the relevant circumstances, including the alternative sources of information open to GEMA for the purposes of the cost allocation exercise and that any other finding would involve an error of approach or a misdirection as to the applicable legal principles.⁴⁰⁸

4.139 In its response to the Provisional Determination, Citizens Advice expressed concern that the CMA had relied upon a comparison to the results of GEMA's disaggregated benchmarking, whilst also stating that it did not need to assess

⁴⁰² McMahon 1 (GEMA), paragraph 201.3. GEMA referred to its cross-check 2 presented in McMahon 1 (GEMA), Appendix C.

⁴⁰³ See paragraph 3.37 and footnote 79 for the principle that we may find that GEMA's decision was 'wrong' in circumstances where the appellant succeeds in so undermining the foundations of a decision that it cannot stand, without establishing what the alternative should be.

⁴⁰⁴ GEMA Response to PD, paragraphs 8.9, 9 and 29.

⁴⁰⁵ GEMA Response to PD, paragraph 27.

⁴⁰⁶ *Ibid.*, citing *R (Khatun) v London Borough of Newham* [2004] QB 37, paragraph 35.

⁴⁰⁷ GEMA Response to PD, paragraph 29.

⁴⁰⁸ GEMA Response to PD, paragraphs 29 and 31.

GEMA's view on the drawbacks of the disaggregated benchmarking proportions.⁴⁰⁹

- 4.140 As noted in paragraph 4.124, the CMA has determined that GEMA's use of the cost proportions derived from NPg's submitted costs was inconsistent with GEMA's rejection of NPg's LRE (within its submitted costs), as inefficient and the fact that it had also made demand adjustments to those submitted costs. Moreover, as noted in paragraph 4.128, in the case of NPg, the adjustments discussed in paragraph 4.122 were sizeable and the adjustments made to the LRE cost categories were proportionately larger than those applied to other major cost categories. The resulting material deficiency of the proportions derived from NPg's submitted costs meant that they were not relevant for the purposes of GEMA's allocation of NPg's total efficient modelled costs.
- 4.141 In addition, and without prejudice to paragraph 4.137 above, we consider that there were rational alternative options open to GEMA, avoiding an error of the type we have found in the present case. We note that in our assessment of the challenge brought by NPg, we do not take issue with GEMA's use of a blended approach (that is, an approach that blends differently derived cost proportions), nor in principle with the use of information derived from NPg's business plan submission; rather the error we have identified is in respect of the use of the proportions derived from NPg's submitted costs as one part of the blended approach that it adopted. As noted in chapter 6 (Remedies), some of the information derived from NPg's business plan submission would be informative for the purposes of allocating NPg's total efficient modelled costs (see paragraph 6.13).
- 4.142 In light of the above, our view is that GEMA's error was of a fundamental nature: put simply, the error produced a wrong input (for the purposes in question) to one part of the blended approach adopted by GEMA. As GEMA has recognised,⁴¹⁰ its entitlement to determine what information was relevant for the purposes of its cost allocation was subject to the requirement of rationality. For the reasons given above, we consider that the cost proportions derived from NPg's submitted costs were irrelevant for this purpose. Therefore, we conclude that it was wrong for GEMA to use the proportions derived from NPg's submitted costs for the purposes of GEMA's allocation of NPg's total efficient modelled costs.

⁴⁰⁹ CA Response to PD, paragraphs 3 and 7 to 9.

⁴¹⁰ GEMA Response to PD, paragraph 27.

Summary of our assessment

- 4.143 GEMA submitted that the Decision remained firmly within its margin of appreciation.⁴¹¹ However, given the material deficiency of the cost proportions derived from NPg's submitted costs identified in paragraph 4.135, our view is that GEMA's decision was not within its margin of appreciation.⁴¹²
- 4.144 Based on the above, we consider that GEMA was wrong to rely on the cost proportions derived from NPg's submitted costs for the purposes of allocating NPg's total efficient modelled costs.⁴¹³ That is because, in circumstances in which GEMA rejected NPg's LRE in its submitted costs and the share of LRE in NPg's submitted costs was materially higher than the share of LRE within NPg's total efficient modelled costs, the cost proportions that were derived by GEMA from NPg's submitted costs were not relevant, and could not legitimately be relied on at all, for the purposes of GEMA's allocation of NPg's total efficient modelled costs. In these circumstances, given the importance of GEMA's allocation of total efficient modelled costs for the purposes of the price control and the fact that the error was one of economic or regulatory principle (namely, it was an error to use an inappropriate input for those purposes), the error was material.
- 4.145 Given that we have decided that the use of the proportions derived from NPg's submitted costs was wrong for the purposes of the allocation of NPg's total efficient modelled costs, we do not need to assess:
- (a) NPg's argument (4.55) or GEMA's cross-checks (4.91) on whether GEMA's decision will lead to NPg being underfunded;⁴¹⁴
 - (b) Whether NPg's total efficient modelled costs have been re-baselined to a so-called Common Scenario;⁴¹⁵
 - (c) whether GEMA's allocation of NPg's total efficient modelled costs was revenue-neutral;⁴¹⁶ or
 - (d) any other issue raised within the LOI and/or as part of the statutory grounds of appeal relied on by NPg.⁴¹⁷

⁴¹¹ GEMA Skeleton, paragraphs 1, 10, 26 and 30; see also [GEMA Response](#), paragraphs 98, 101 and 139.3.

⁴¹² LOI paragraph 1.

⁴¹³ LOI paragraph 1.

⁴¹⁴ LOI paragraph 5.

⁴¹⁵ LOI paragraph 3.

⁴¹⁶ [NoA](#), paragraph 18.14. See also LOI paragraphs 5(b), 5(c) and 6(d).

⁴¹⁷ [NoA](#), paragraphs 21.1 and 21.2. See also paragraph 4.150 of this final determination.

- 4.146 We note that Citizens Advice submitted that RIIO-ED2 was already generous,⁴¹⁸ however as that is a point about the overall price control, which is not being challenged in this appeal, it does not assist us to determine the appeal on the narrow point of challenge raised by NPg under Ground 1 of its appeal.
- 4.147 In its response to the Provisional Determination, Citizens Advice submitted, in relation to consumer interests, that although the CMA may not need to assess whether NPg would be underfunded, Citizens Advice believed that it was important and it would be helpful for the CMA to do so.⁴¹⁹ Our view is that it would not be appropriate to make such an assessment. That is because, as set out in further detail in chapter 6 (Remedies), as a result of our determination that GEMA's decision was 'wrong', we are remitting the matter to GEMA for reconsideration and determination. The question of whether NPg will be under-funded as a result of the decision that we have determined to be 'wrong' is therefore not apt for present purposes.

Statutory appeal grounds

- 4.148 For the reasons given above, we conclude that the cost proportions derived from NPg's submitted costs were an irrelevant consideration, and/or it was otherwise irrational for GEMA to rely on those submitted cost proportions, when allocating NPg's total efficient modelled costs to different cost categories. That is because, in circumstances in which GEMA rejected NPg's LRE in its submitted costs and the share of LRE in NPg's submitted costs was materially higher than the share of LRE within NPg's total efficient modelled costs, the cost proportions that were derived by GEMA from NPg's submitted costs were not relevant, and could not legitimately be relied on at all, for the purposes of GEMA's allocation of NPg's total efficient modelled costs. Given the importance of the allocation of total efficient modelled costs for the purposes of the price control and the fact that the error was one of economic or regulatory principle (namely, it was an error to use an inappropriate input for those purposes), the error was material. In view of the above, it was 'wrong in law' (section 11E(4)(e) EA89) for GEMA to use those cost proportions when allocating NPg's total efficient modelled costs.
- 4.149 Given that, for the purposes of section 11E(4) EA89, we may allow an appeal on one or more of the statutory appeal grounds, in the interests of the

⁴¹⁸ MPH Transcript, page 75, lines 23 to 25 where Citizens Advice stated 'we are of the view that this is a relatively generous price control package ... upholding the appeal would upset the balance of what we view as an already generous deal'; see also page 79, lines 22-25 to similar effect.

⁴¹⁹ CA Response to PD, paragraphs 4 to 6.

overriding objective,⁴²⁰ we do not consider and determine whether any of the other statutory grounds relied on by NPg (in section 11E(4)(a) to (d) EA89) has also been met.

4.150 In its response to the Provisional Determination, GEMA submitted that the CMA's (then provisional) conclusion would constitute a damaging precedent in relation to the use of submitted costs shares for the purposes of cost allocations in future price controls. GEMA submitted that this was because adjustments consistent with the magnitude of the adjustments made through its totex benchmarking for RIIO-ED2 were an entirely probable outcome of any robust cost assessment process.⁴²¹ We disagree with GEMA's submission that the outcome of the present appeal would set a damaging precedent. The error that we have found in the present case (that is, in respect of the nature and scale of GEMA's adjustments to NPg's submitted costs) is an error of economic or regulatory principle and we have clarified that the error in question in this case is 'wrong in law' within the meaning of section 11E(4)(e) EA89. In any event, CMA determinations do not set binding precedent and each case needs to be assessed on its facts.

Our determination on Ground 1

4.151 For the reasons given above, we conclude that the Decision was 'wrong in law' (section 11E(4)(e) EA89), as set out above, and we allow the appeal to that extent.⁴²²

4.152 Chapter 6 (Remedies) sets out the next steps in relation to remedies.

⁴²⁰ In particular, the considerations in the overriding objective to dispose of appeals efficiently and at proportionate cost (ELMA Rules, Rule 4.1).

⁴²¹ GEMA Response to PD, paragraph 10.

⁴²² Section 11E(4) EA89 provides that the CMA may allow an appeal only 'to the extent that' it is satisfied that the decision appealed against was 'wrong' on one or more of the statutory appeal grounds.

5. Ground 2 – BPI Stage 4 reward

Introduction

- 5.1 NPg’s second ground of appeal concerns GEMA’s failure to grant NPgY a Business Plan Incentive (BPI) Stage 4 reward when it should have done.⁴²³
- 5.2 NPg submitted that the BPI Stage 4 reward is designed to reward DNOs that provide information about their projected costs that aids GEMA in setting accurate price controls for the sector based on efficient allowances.⁴²⁴ GEMA described the BPI as an incentive mechanism designed to encourage DNOs to submit high quality business plans. It added that 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. 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.⁴²⁵
- 5.3 NPg submitted that GEMA was wrong to compare submitted costs to modelled costs after workload adjustments in the disaggregated modelling⁴²⁶ as this approach was at odds with the logic of the process as well as inconsistent with the approach taken elsewhere by GEMA in the cost assessment process.⁴²⁷ NPg further submitted that GEMA’s approach also created an arbitrary difference in treatment between DNOs to the detriment of DNOs in the position of NPg.⁴²⁸
- 5.4 NPg stated that it was not challenging the architecture of GEMA’s benchmarking process or the basic features of the BPI Stage 4 reward assessment and submitted that the alleged errors related to discrete stages of GEMA’s cost assessment process.⁴²⁹
- 5.5 In this chapter we:

⁴²³ NoA, paragraphs 3.3(ii) and 11.1.

⁴²⁴ NoA, paragraphs 11.2 and 11.8(i).

⁴²⁵ GEMA Response, paragraph 106 and NoA paragraph 11.3; see also GEMA, [RIIO-ED2 Final Determinations Overview Document](#), paragraphs 9.54 and 9.55.

⁴²⁶ NoA, paragraph 11.6.

⁴²⁷ NoA, paragraphs 23.3 and 11.8(v).

⁴²⁸ NoA, paragraphs 11.1 and 23.3.

⁴²⁹ NoA, paragraphs 3.6, 6.3 and 11.6.

- (a) give the background to GEMA's RIIO-ED2 approach to the BPI Stage 4 reward;
- (b) summarise the key submissions of NPg and GEMA;
- (c) set out our assessment; and
- (d) provide our determination.

Background

- 5.6 In this section we provide background on GEMA's approach to BPI Stage 4 reward in the RIIO-ED2 Decision.
- 5.7 GEMA said that in order to undertake the RIIO-ED2 process, it needed information from the DNOs on the activities that they intended to undertake in RIIO-ED2, and their associated costs and outputs. Companies provided this information to GEMA in the form of business plans, which GEMA then assessed.⁴³⁰
- 5.8 GEMA developed the Business Plan Incentive (BPI) mechanism to encourage network companies to submit ambitious business plans that contained the information GEMA required to undertake a robust assessment of the DNOs' business plans.⁴³¹
- 5.9 The BPI comprises four stages of rewards and penalties:
- (a) Stage 1: GEMA carried out a qualitative assessment of business plans in order to ensure that they contained all of the information set out in the minimum requirements.⁴³² Business plans either passed or failed Stage 1, and GEMA imposed an upfront penalty of 0.5% of allowed baseline total expenditure for failing Stage 1.⁴³³ All DNOs passed the whole system minimum requirements under this stage in RIIO-ED2;⁴³⁴
 - (b) Stage 2: GEMA carried out a qualitative assessment of what additional value the business plans offered to consumers. Companies could bid for a reward on the quality aspects of their plans, as revealed through the

⁴³⁰ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 4.5.

⁴³¹ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 9.7.

⁴³² GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 9.12.

⁴³³ GEMA, RIIO-ED2 Final Determinations Overview document, Figure 4.

⁴³⁴ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 9.13.

Consumer Value Proposition.⁴³⁵ Under this stage of the BPI, NGED and SSEN received a reward of £4.6 million and £3.5 million respectively,⁴³⁶

- (c) Stage 3: GEMA reviewed the forecasts for costs assessed by GEMA to be lower-confidence baseline costs included in companies' plans. Any costs deemed to be poorly justified and removed by GEMA from the companies' forecasts through this cost assessment process were subject to a penalty.⁴³⁷ No DNOs received a penalty under this stage in RIIO-ED2;⁴³⁸
- (d) Stage 4: in this stage DNOs were eligible for a reward if their submitted costs were lower than their efficient modelled costs.⁴³⁹ At Final Determinations, UKPN received a BPI 4 Stage reward.⁴⁴⁰

5.10 GEMA stated that the aim of the BPI Stage 4 reward is to incentivise DNOs to reveal their true costs information in their business plan submissions. Through the BPI Stage 4, DNOs can receive an upfront reward for revealing cost savings at the time of setting the price control, compared to a counterfactual where GEMA sets allowances based on a cost benchmark and the DNO is able to beat that benchmark through the price control, by spending in line with its original forecast.⁴⁴¹

5.11 A DNO will receive a Stage 4 reward if its high confidence costs (in practice submitted costs) beat the independent benchmark set by GEMA⁴⁴² (ie the total efficient modelled costs). In order to calculate it, GEMA subtracted the submitted costs from the modelled costs and multiplied the difference by the DNO Totex Incentive Mechanism (TIM) rate:

- (a) The modelled costs used for the BPI calculations were weighted costs without the DDA applied and with all workload adjustments included;⁴⁴³
- (b) The TIM rate is designed to encourage network companies to improve their efficiency in delivery and ensures that the benefits of these

⁴³⁵ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 9.22.

⁴³⁶ GEMA, RIIO-ED2 Final Determinations Overview document, Table 10 and Table 11.

⁴³⁷ [GEMA Response](#), paragraph 112.3.

⁴³⁸ GEMA, RIIO-ED2 Final Determinations Overview document, paragraph 9.55.

⁴³⁹ [GEMA Response](#), paragraph 106.

⁴⁴⁰ GEMA, RIIO-ED2 Final Determinations Overview Document, Table 13.

⁴⁴¹ *McMahon 1 (GEMA)*, paragraphs 238-240.

⁴⁴² [GEMA Response](#), paragraph 112.4. GEMA stated that it arrived at the benchmark through its cost modelling process. It stated that the independent benchmark was intended to represent GEMA's final estimate of modelled costs ([GEMA Response](#), paragraph 114).

⁴⁴³ GEMA weighted the total expenditure and the disaggregated benchmarking streams to calculate its combined view of modelled costs. See paragraph 4.32 on weighted costs and paragraphs 4.29 to 4.31 on DDA and workload adjustments for more detail. Also, these modelled costs are post-reversal of regional and company specific factor adjustments (please see paragraph 4.24) and post catch-up efficiency challenge. The submitted costs were normalised post-reversal of regional and company specific factor adjustments.

efficiencies are shared with consumers. It also provides some protection to consumers from any company overspend of their allowances as the cost of these overspends are shared with consumers.⁴⁴⁴ In RIIO-ED2 the TIM rate was between 48-50% for all DNOs.⁴⁴⁵

Parties' submissions

5.12 In this section we summarise the key submissions of NPg and GEMA in relation to this ground. Citizens Advice did not make any submissions on this ground of appeal.

NPg's submissions

5.13 In summary, NPg submitted that GEMA was wrong to use disaggregated modelled costs after the application of workload adjustments as the basis to calculate the BPI Stage 4 reward.⁴⁴⁶ This approach, in NPg's submission, was at odds with the logic of the process as well as inconsistent with the approach taken elsewhere by GEMA in the cost assessment process. In NPg's submission, it also created an arbitrary difference in treatment between DNOs to the detriment of DNOs in the position of NPg.⁴⁴⁷ Accordingly, NPg submitted that GEMA's Decision not to grant any BPI Stage 4 reward to NPgY was wrong by reference to the statutory grounds.⁴⁴⁸ A summary of NPg's more detailed submissions is set out below.

5.14 NPg submitted that GEMA's approach to calculating the BPI Stage 4 reward was wrong on the following basis:

- (a) By comparing submitted costs to modelled costs after workload adjustments,⁴⁴⁹ GEMA had failed to compare like with like. That was because workload adjustments were driven overwhelmingly not by efficiency assessments, but by the differences between GEMA's chosen Common Scenario and the planning scenario⁴⁵⁰ used in a DNO's business plan.⁴⁵¹ NPg submitted that GEMA was wrong to assert that NPgY's workload adjustments for 'Secondary Reinforcement' were

⁴⁴⁴ GEMA, RIIO-ED2 Final Determinations Overview Document, paragraph 9.2.

⁴⁴⁵ GEMA, clarification session slides 12 May 2023, slide 33.

⁴⁴⁶ NoA, paragraphs 11.6 and 23.3.

⁴⁴⁷ NoA, paragraphs 23.3 and 11.1.

⁴⁴⁸ NoA, paragraph 23.4.

⁴⁴⁹ NoA, paragraphs 11.6 and 11.8; NPg Skeleton, paragraph 38; LOI, paragraph 9

⁴⁵⁰ For the avoidance of doubt, the CMA understands that NPg's reference here to a 'planning scenario' is to a decarbonisation planning scenario.

⁴⁵¹ NoA, paragraphs 11.8(i), 25.1, 25.2 and 25.7; NPg Reply paragraph 3.1 to 3.5; NPg Skeleton paragraph 46, LOI, paragraph 10.

overwhelmingly efficiency related (rather than adjusting for scenario differences) for the following reasons: (i) it is implausible that if GEMA had considered that NPg's proposed LRE was 'wildly inefficient', this would not have featured prominently in the Final Determinations (in fact, NPgY was ranked second of all DNOs in efficiency scores and there was no mention of 'wild inefficiency' in NPgY's planned LRE); (ii) an objective analysis of the workload adjustments for 'Secondary Reinforcement' showed them to have all of the expected characteristics of scenario adjustment and none of the expected characteristics of efficiency challenge; and (iii) GEMA's position invited the CMA to accept as 'mere coincidence' the fact that NPg's own estimate of 'Secondary Reinforcement' costs under System Transformation FES showed that these costs were relatively close to GEMA's ultimate assessment of NPg's efficient costs to deliver that scenario; but if NPg's planning process was 'grossly inefficient', its costs for System Transformation FES would also have reflected this inefficiency – in fact, they demonstrated the scale, according to NPg's planning tools, of scenario differences and that scale matched the workload adjustments;⁴⁵²

(b) NPg also made submissions on the inconsistency of GEMA's approach:

- (i) NPg submitted that the illogic of GEMA's approach was evident from the approach it had taken to totex modelled costs: the latter were taken before the application of the DDA; however disaggregated costs were taken after the application of workload adjustments. NPg submitted that the workload adjustments applied to disaggregated modelled costs were in main part functionally equivalent to the DDA, so GEMA should have used disaggregated modelled costs before the application of workload adjustments, in order to be consistent with the use of totex modelled costs before the application of the DDA;⁴⁵³
- (ii) NPg submitted that GEMA's approach to assessing the BPI Stage 4 reward was inconsistent with the approach it took to the efficiency rankings of the DNOs elsewhere in the RIIO-ED2 process: NPg explained that, in another stage of the price control, GEMA had calculated efficiency scores before any workload adjustments to disaggregated modelled costs and then used those scores to set the 'catch-up' efficiency challenge for all DNOs. In that scenario, NPgY was ranked the second-most efficient DNO, but did not receive a BPI

⁴⁵² NPg Skeleton, paragraph 46, referring to paragraphs 22-26 and the Frontier BPI Report, Annex A and NPg Reply, Annex A, paragraphs 1.1-1.28.

⁴⁵³ NoA, paragraph 11.8(ii) and 26.1; NPg Skeleton, paragraphs 37 to 42; LOI, paragraph 11.

Stage 4 reward.⁴⁵⁴ NPg submitted that this showed that GEMA's approach did not achieve its aim, was irrational and created an arbitrary difference in treatment.⁴⁵⁵

- (c) In its response to the Provisional Determination, NPg submitted that the costs in its business plan contributed to setting the 'glide path' and were in effect used by GEMA to set lower allowances for other DNOs. NPg contended that its submitted costs therefore helped GEMA set a better price control, in accordance with the stated aim of the BPI Stage 4 reward.⁴⁵⁶
- (d) NPg also made submissions on procedural points:
- (i) It submitted that GEMA gave no notice that DNOs with more conservative decarbonisation planning scenarios would receive preferential treatment when assessing eligibility for a BPI Stage 4 reward;⁴⁵⁷
 - (ii) It also submitted that GEMA issued no guidance before the submission of DNOs' business plans that would have enabled a DNO to calibrate its planning to the Common Scenario.⁴⁵⁸
 - (iii) In its response to the Provisional Determination, NPg raised a concern in relation to what it described as 'procedural difficulties, which are inherent in a "focused" appeal regime': namely that a defence raised by GEMA during the appeal process reveals inconsistencies with, and thereby an error in relation to, some other, separate, aspect of its price control decision-making which an appellant is time-barred from challenging by the time this defence is raised.⁴⁵⁹

Impact

5.15 NPg submitted that using disaggregated modelled costs after the application of workload adjustments had a particularly severe (and discriminatory) effect on DNOs, such as NPgY, that had assumed a relatively higher pace of electrification than GEMA's Common Scenario. That was because NPg's

⁴⁵⁴ NoA, paragraphs 11.8(v), 25.4, 25.5 and 25.8; NPg Skeleton, paragraphs 43 to 45.

⁴⁵⁵ NoA, paragraph 25.5.

⁴⁵⁶ NPg Response to PD, paragraph 3.2.

⁴⁵⁷ NoA, paragraph 11.8(iii). NPg added that such preference was in any event arbitrary in light of GEMA's stated policy aims for the reward.

⁴⁵⁸ NoA, paragraph 11.8(iv).

⁴⁵⁹ NPg Response to PD, paragraphs 3.10 and 3.13.

relatively high electrification planning scenario⁴⁶⁰ inevitably resulted (all else being equal) in higher submitted costs, and the disaggregated modelled costs for NPg were accordingly subject to larger workload adjustments. Therefore, if the comparison to submitted costs was done after workload adjustments were applied to modelled costs, NPg's submitted costs would appear high by comparison to modelled costs, thereby making it harder for NPg to achieve a BPI Stage 4 reward.⁴⁶¹

- 5.16 NPg submitted that the errors made by GEMA were material with significant adverse impact on NPg: GEMA's approach resulted in NPgY not being awarded a BPI Stage 4 reward of £15 million.⁴⁶²

Legal grounds

- 5.17 As a result of the matters summarised above, NPg submitted that the Decision was wrong in that:⁴⁶³

- (a) it was based on errors of fact (section 11E(4)(c) EA89), in that GEMA erroneously proceeded on the basis that workload adjustments in the disaggregated modelling were (or were predominantly) reflective of efficiency, as opposed to adjusting for differences between scenarios;
- (b) the modifications failed to achieve GEMA's stated effect (section 11E(4)(d) EA89) in that:
 - (i) GEMA stated in the Final Determinations Overview Document that the BPI Stage 4 reward would be provided to any DNO whose high confidence costs beat GEMA's independent benchmark;⁴⁶⁴ whereas
 - (ii) for the reasons set out in the NoA, NPgY's high confidence costs did beat the appropriate independent benchmark (modelled costs prior to Scenario Adjustments), yet it wrongly did not receive any reward; and
- (c) GEMA erred in law (section 11E(4)(e) EA89) by acting irrationally in its calculation of the BPI Stage 4 reward.

- 5.18 NPg also submitted that GEMA failed under sections 11E(4)(a) and (b) EA89 properly to have regard to and/or to give appropriate weight to the carrying out of its principal objective and the performance of its duties. This was because

⁴⁶⁰ For the avoidance of doubt, the CMA understands that NPg's reference here to a 'high electrification planning scenario' is to a high electrification decarbonisation planning scenario.

⁴⁶¹ NoA, paragraphs 11.8(iii) and 25.3.

⁴⁶² NoA, paragraphs 3.4(ii) and 27.2.

⁴⁶³ NoA, paragraphs 11.10 and 28.1.

⁴⁶⁴ That benchmark was set by GEMA ([GEMA Response](#), paragraph 112.4).

GEMA's approach to calculating the BPI Stage 4 reward resulted in NPgY not receiving a material BPI Stage 4 reward, which, but for GEMA's error, it would have received.⁴⁶⁵ At the Main Party Hearing, NPg clarified that its submissions referred to GEMA's other duties generally, rather than to any specific duty.⁴⁶⁶

Further submissions

- 5.19 NPg made further submissions in relation to points arising from GEMA's Response and GEMA's further submissions. We summarise the key further submissions from NPg below.
- 5.20 As regards GEMA's alleged inefficiency of the NPg business plan, NPg submitted that its planning assumptions did not become objectively inefficient just because GEMA chose to fund a more conservative baseline scenario, in particular in circumstances where GEMA had not concluded that System Transformation FES was the most likely scenario. NPg added that it was not credible that, had GEMA identified significant inefficiency in LRE, it would then undermine the logic of its funding mechanism by allocating deliberately excessive notional allowances to those cost categories.⁴⁶⁷
- 5.21 In response to GEMA's submission that NPgY's workload volumes relating to Secondary Reinforcement were 'extremely high' and 'inefficient',⁴⁶⁸ NPg submitted that GEMA did not give any examples of having criticised the final NPg business plan on the basis of inefficient LRE forecasts; and its decision documents did not state that adjustments to NPg's planned LRE were required to correct for extreme inefficiency.⁴⁶⁹
- 5.22 In response to GEMA's submission that NPg's planned LRE was not premised on a substantially different path and pace of electrification, NPg submitted that DNOs' levels of planned LRE were not attributable entirely to differences between their assumptions as to LCT uptake in the period 2023-2028. While the number of new LCTs in that period was an important driver for increases in LRE, the impact on a DNO's network of increases in LCTs varied dramatically depending on local network design, existing demand profile, the location, timing and demand profiles of the new technologies and assumptions on how demand would increase after 2028. NPg added that it was untenable to suggest that there was or should be a linear relationship between LCT uptake in 2023-2028 and the efficient LRE required to

⁴⁶⁵ NoA, paragraphs 11.1 and 28.2.

⁴⁶⁶ MPH Transcript page 65, lines 16-18 and page 66 lines 18-24.

⁴⁶⁷ NPg Reply paragraphs 3.1, 3.3 and 3.4.

⁴⁶⁸ GEMA Response, paragraph 137.2.

⁴⁶⁹ NPg Reply paragraphs 3.2 and 3.3.

accommodate network demand increases and that this relationship would be the same across dramatically different electrification scenarios.⁴⁷⁰

- 5.23 As regards GEMA's claim that efficiency scores and the BPI Stage 4 calculation were not comparable, NPg submitted that it was incoherent and inconsistent with the price control as a whole for GEMA to say that the catch-up efficiency challenge measured the efficiency of delivery whereas the BPI Stage 4 reward calculation measured the efficiency of business plans in terms of DNOs' approaches to running their businesses: a DNO's plan and the delivery of the plan were indivisible parts of a whole. This distinction was not explained during the decision-making process.⁴⁷¹
- 5.24 NPg also made a number of submissions, which are relevant to the question of the extent (if any) to which GEMA's Response constituted a fresh decision.⁴⁷² In particular, NPg submitted that:
- (a) GEMA was 'rewriting history' by submitting in its Response that it concluded that the Secondary Reinforcement costs in NPg's business plan were hugely inefficient;⁴⁷³
 - (b) GEMA made a 'new contention' by submitting in its Response that NPg's planned LRE was not premised on a substantially different path and pace of electrification;⁴⁷⁴ and
 - (c) GEMA's explanation for taking different approaches to efficiency in calculating the BPI Stage 4 reward and the efficiency scores (ie that the two calculations served separate and distinct purposes) was new.⁴⁷⁵

GEMA's submissions

- 5.25 GEMA made a number of general introductory submissions about its decision-making in the RIIO-ED2 price controls. Those submissions are set out at paragraphs 4.76-4.78 above and are not repeated here.

The purpose of the BPI and Stage 4

- 5.26 GEMA explained that the BPI is an incentive mechanism designed to encourage DNOs to submit high quality business plans that represent additional value for money compared to business-as-usual and provide high

⁴⁷⁰ NPg Reply paragraph 3.5.

⁴⁷¹ NPg Reply paragraph 4.1.

⁴⁷² LOI, paragraph 12.

⁴⁷³ NPg Reply, paragraph 3.4.

⁴⁷⁴ NPg Reply, paragraph 3.5.

⁴⁷⁵ NPg Reply paragraph 4.1; NPg Skeleton, paragraph 43.

quality and high confidence information that was useful to GEMA in setting the price control. The purpose of Stage 4 was to incentivise DNOs to reveal the best information through their business plan to enable GEMA to conduct a more robust cost assessment. At Stage 4, GEMA provided financial rewards to those DNOs whose high-confidence baseline costs were lower than an independent benchmark set by GEMA.⁴⁷⁶

The nature of workload adjustments: efficiency, not scenario

- 5.27 GEMA submitted that NPg's challenge (on the basis that the workload adjustments included in the disaggregated modelled costs were driven overwhelmingly not by efficiency, but by the differences between GEMA's chosen 'Common Scenario' and the decarbonisation planning scenario that was used for the purpose of a DNO's business plan) was misleading: GEMA did not rebase costs to any 'Common Scenario'.⁴⁷⁷ GEMA stated that it was not GEMA's intention to provide or prescribe a single Common Scenario for DNOs to use for their business planning submissions and similarly, GEMA did not intend to or, in practice, apply a single Common Scenario across the allowances that were set.⁴⁷⁸
- 5.28 GEMA's position was that it was not wrong to include workload adjustments for the purpose of considering the efficiency of NPgY's business plan at BPI Stage 4. Workload adjustments were predominantly reflective of GEMA's view of efficient volumes.⁴⁷⁹ GEMA added that in relation to NPgY, 86% of the overall workload adjustment within the Secondary Reinforcement disaggregated benchmarking model arose from efficiency-related adjustments, not demand-based adjustments.⁴⁸⁰ In response to the Provisional Determination, GEMA submitted that NPg had failed to provide the necessary evidence or information to prove that workload adjustments are not predominantly reflective of (in)efficiency.⁴⁸¹
- 5.29 GEMA also submitted that NPg's contention that its high Secondary Reinforcement volumes were purely driven by its decarbonisation planning scenario assumptions, and so could not be viewed as inefficient, was incorrect: there were comparable levels of LCT uptake forecast for the period 2023-2028 across the sector and NPg had not provided any specific evidence on precisely how different NPg's assumptions were from other DNOs in respect of LCT impact, network design and demand growth beyond RIIO-

⁴⁷⁶ GEMA Response, paragraphs 106, 111, 112.4 and 113.

⁴⁷⁷ GEMA Response, paragraph 107 and GEMA Skeleton, paragraph 43.

⁴⁷⁸ GEMA Skeleton, paragraph 12.

⁴⁷⁹ GEMA Response, paragraphs 11, 110.1 and 126-129; GEMA Skeleton, paragraphs 6, 32 and 34-40.

⁴⁸⁰ GEMA Response, paragraphs 124 and 128; GEMA Skeleton, paragraph 40.

⁴⁸¹ GEMA Response to PD, paragraph 81.

ED2.⁴⁸² GEMA added that NPg's submission on the network impact of LCTs included evidence and assumptions that were broadly in line with those of other DNOs and that differences in network topology between NPg's network and the rest of the sector was not so significant as to explain the need for different scenario assumptions and associated LRE. Furthermore, all DNOs had submitted LRE proposals that considered the demand increases (and associated network requirements) beyond 2028, so GEMA considered this was adequately captured in the benchmarking and that all DNOs were benchmarked on a comparable basis.⁴⁸³

- 5.30 As such, GEMA submits that it is not the case that NPg's high costs removed in the ratio benchmarking step in the Secondary Reinforcement disaggregated benchmarking model were attributable to differences in the assumptions in the decarbonisation planning scenarios of NPg and those of other DNOs. NPg's Secondary Reinforcement expenditure (which was five times higher than that of UKPN) could not be explained by the small differences in scenario assumptions and should not be viewed as entirely efficient beyond the forecast uptake of LCTs.⁴⁸⁴

No inconsistency with the application of the DDA

- 5.31 GEMA submitted that it was not inconsistent to include workload adjustments, but exclude the DDA. Unlike workload adjustments, the DDA was a post-modelling adjustment which reflected the difference between the DNOs' submitted scenarios and a particular projection of LCT uptake contained in the System Transformation FES.⁴⁸⁵ In any event, the value of the adjustment was relatively minor in the case of NPgY and even if it were excluded for the purposes of the BPI Stage 4 reward, NPgY would still not have received a reward.⁴⁸⁶

No inconsistency with the catch-up efficiency challenge

- 5.32 GEMA submitted that it was not wrong or inconsistent for GEMA to have included workload adjustments in its assessment of the BPI Stage 4 reward, but not in the catch-up efficiency challenge: the catch-up efficiency challenge focused on the efficiency of the delivery of DNOs' business plans, whereas

⁴⁸² GEMA Skeleton, paragraph 51.

⁴⁸³ GEMA Skeleton, paragraphs 52 and 53.

⁴⁸⁴ GEMA Skeleton, paragraph 54.

⁴⁸⁵ [GEMA Response](#), paragraphs 12, 110.2 and 130-131; GEMA Skeleton, paragraph 42.

⁴⁸⁶ [GEMA Response](#), paragraph 12.

the BPI Stage 4 reward entailed an assessment of the efficiency of DNOs' business plans themselves.⁴⁸⁷

Materiality

- 5.33 In relation to materiality, GEMA noted that NPg had contended that if the BPI Stage 4 reward had been calculated before (all or only the Secondary Reinforcement) adjustments, NPgY would have received a reward. In response, GEMA submitted that if NPgY were to establish that GEMA should have included the limited component of the Secondary Reinforcement workload readjustment (which was scenario related) in its determination of the BPI Stage 4 reward, NPgY's submitted costs would still not have beaten GEMA's benchmark and NPgY would not have received a BPI Stage 4 reward.⁴⁸⁸ At the Main Party Hearing, GEMA submitted, by way of clarification, that it had considered a range of alternative approaches and, in all of the credible alternatives, including and excluding elements of workload adjustments, NPgY would not have received a reward.⁴⁸⁹
- 5.34 At the Main Party Hearing, GEMA further submitted, by way of clarification, that as regards materiality it was not making an independent point that taking NPg's case at its highest was an immaterial error.⁴⁹⁰

Legal grounds

- 5.35 In view of the above, GEMA submitted that each of the appeal grounds was without merit, in that:
- (a) The Decision was not based on any error of fact (section 11E(4)(c) EA89): workload adjustments were predominantly reflective of efficiency; they were not scenario adjustments;⁴⁹¹
 - (b) The relevant modifications achieved GEMA's stated effect (section 11E(4)(d) EA89): NPgY's high confidence costs did not beat the appropriate independent benchmark so NPgY rightly did not receive a BPI Stage 4 reward;⁴⁹²
 - (c) GEMA did not err in law by acting irrationally (section 11E(4)(e) EA89): the judicial review standard of irrationality invoked by NPgY is 'extremely

⁴⁸⁷ [GEMA Response](#), paragraphs 110.3 and 132-138; GEMA Skeleton, paragraphs 6 and 42-.

⁴⁸⁸ [GEMA Response](#), paragraph 145.

⁴⁸⁹ MPH Transcript, page 84, lines 22 to 25 and page 85, line 1.

⁴⁹⁰ MPH Transcript, page 162, lines 15 to 16 and page 163, lines 15 to 16.

⁴⁹¹ [GEMA Response](#), paragraph 139.1.

⁴⁹² [GEMA Response](#), paragraph 139.2.

high' in the regulatory context and was not met in this case, as GEMA's decision fell within the enhanced margin of appreciation afforded to a regulator in an expert field;⁴⁹³

- (d) NPgY had not explained how GEMA had failed to pursue the principal objective of protecting consumer interests. NPgY failing to receive a BPI Stage 4 reward was consistent with the objective of the BPI Stage 4 reward in incentivising and rewarding the most ambitious business plans and this objective was in the interests of consumers.⁴⁹⁴

Our assessment of Ground 2

5.36 In this section we set out our assessment of Ground 2.

5.37 In summary, in relation to the BPI Stage 4 reward, NPg submitted that the Decision was 'wrong' within the meaning of section 11E(4) EA89, in that, when determining eligibility for a BPI Stage 4 reward, GEMA had failed to compare costs on a rational and consistent basis, in particular by comparing submitted costs to modelled costs after the application of workload adjustments in the disaggregated modelling.⁴⁹⁵

5.38 In the case of NPg, the workload adjustments are sizeable downward adjustments to the modelled costs. As a result, when comparing submitted costs to modelled costs after the application of workload adjustments, NPg did not receive a BPI Stage 4 reward; however, when comparing submitted costs to modelled costs before the application of workload adjustments, NPg would have received a reward.⁴⁹⁶

5.39 Both parties agreed that:

- (a) if workload adjustments were related to efficiency (rather than scenario) then GEMA should have applied them when determining eligibility for the BPI Stage 4 reward and, if not, then it should not have applied them;⁴⁹⁷
- (b) Secondary Reinforcement workload adjustment was the only workload adjustment that at least partly related to a scenario.⁴⁹⁸

⁴⁹³ [GEMA Response](#), paragraph 139.3.

⁴⁹⁴ [GEMA Response](#), paragraph 140.

⁴⁹⁵ [NoA](#), paragraphs 3.3(ii), 11.1, 11.6 and 23.3; LOI paragraph 9

⁴⁹⁶ [NoA](#), paragraph 23.5 summarised this point by stating that the impact of GEMA's error was that NPgY did not receive a BPI Stage 4 reward, which, but for GEMA's error, it would have received.

⁴⁹⁷ MPH Transcript, pages 46 to 47 and 145 to 146.

⁴⁹⁸ [NoA](#), paragraph 25.7. [GEMA Response](#), paragraph 12.

- 5.40 Therefore, we first address GEMA's argument that the Secondary Reinforcement workload adjustment is predominantly an efficiency rather than a scenario adjustment.
- 5.41 We then consider GEMA's stated aim of the BPI Stage 4 reward, NPg's submissions that GEMA's approach was inconsistent, whether GEMA's Response constituted a fresh decision and then the procedural points raised by NPg.

Secondary Reinforcement workload adjustment

- 5.42 In this section we address NPg's submission that the Decision as regards the BPI Stage 4 reward was based on errors of fact in that GEMA erroneously proceeded on the basis that workload adjustments in the disaggregated model were (or were predominantly) reflective of efficiency judgements, as opposed to adjusting for differences between scenarios.⁴⁹⁹ As such, we consider whether the Secondary Reinforcement workload adjustments were related (or related predominantly) to efficiency (or scenarios).
- 5.43 In relation to the Secondary Reinforcement workload adjustment, NPg stated that it adjusted predominantly for scenarios (ie it stripped out costs that would not be required under the Common Scenario)⁵⁰⁰, whereas GEMA stated that it adjusted predominantly for efficiency (ie reflected GEMA's view of efficient volumes).⁵⁰¹
- 5.44 Our understanding of NPg's position is that in circumstances where GEMA had not concluded that System Transformation FES was the most likely scenario, it could not rationally conclude that LRE planning assumptions appropriate to higher electrification scenarios were objectively inefficient.⁵⁰² In other words, NPg's chosen assumptions in relation to the level of investment required to be able to meet demand and, importantly, the timing of the investment required (eg NPg's assessment of the contribution that smart and flexible technologies could make to supporting net zero in its planning process) by default must be regarded as predominantly related to scenario rather than efficiency. NPg also noted that GEMA found NPg to have performed well on unit cost benchmarking for Secondary Reinforcement.
- 5.45 GEMA's position was that DNOs' LRE forecasts of how they planned to respond to an increase in LCT uptake could be subject to an efficiency

⁴⁹⁹ NoA, paragraph 28.1(i); LOI, paragraph 10.

⁵⁰⁰ NoA, paragraph 11.7.

⁵⁰¹ GEMA Response, paragraphs 11 and 127.

⁵⁰² NoA, paragraphs 11.8(i), 25.1, 25.2, 25.6, 25.7 and 25.8; NPg Reply, paragraph 3.1 to 3.5; NPg Skeleton, paragraph 46.

assessment (and in this respect were no different from any other investment decisions).⁵⁰³ In other words, it was appropriate for LRE to be subject to the same benchmarking exercises as other cost categories and for GEMA to interpret outlier LRE forecasts on top of what is explained by LCT uptake in 2023-2028 as related predominantly to (in)efficiency.⁵⁰⁴

5.46 In the next part, we assess whether GEMA's approach was 'wrong'.

5.47 NPg stated that:

- (a) GEMA was wrong to interpret NPg's high LRE forecast as related to inefficiency (see paragraph 5.14(a)). For example, Frontier presented a waterfall chart which according to NPg showed that 'the same team, using the same planning assumptions, came up with a system transformation cost that we [NPg] would be fine with, because it happens to sit right on top of the number Ofgem came up with';⁵⁰⁵
- (b) there was a high level of uncertainty around the decarbonisation planning scenarios, and in circumstances where GEMA did not provide guidance⁵⁰⁶ and had not concluded that System Transformation FES was the most likely scenario, it could not rationally conclude that LRE planning assumptions appropriate to higher electrification scenarios were somehow objectively inefficient;⁵⁰⁷ and
- (c) it had submitted a 100-page engineering justification document to GEMA, which described, in detail, all of the different assumptions from the modelling that NPg had made.⁵⁰⁸

5.48 GEMA's view was that DNO submissions on how they planned to respond to increased LCT take-up should be subject to an efficiency assessment, and therefore it was appropriate for GEMA to subject DNOs' LRE forecasts to the same benchmarking as other cost categories and to interpret differences across DNOs as related to efficiency except those explained by DNOs' forecasted LCT uptake between 2023 and 2028. GEMA stated that this position was supported by the fact that all the DNOs received the same guidance and that GEMA supplemented that guidance by further

⁵⁰³ GEMA Skeleton, paragraphs 39, 40 and 54.

⁵⁰⁴ GEMA Skeleton, paragraphs 38, 39, 40, 51 and 54. MPH Transcript, page 88, lines 1 to 8.

⁵⁰⁵ MPH Transcript, page 44, line 25 to page 45, lines 1 to 3.

⁵⁰⁶ NoA, paragraphs 7.1, 7.2; and 11.8(iv) where NPg submitted that GEMA had issued no guidance before the submission of DNOs' business plans that would have enabled a DNO to calibrate its planning to the 'Common Scenario'.

⁵⁰⁷ NPg Reply, paragraph 3.3.

⁵⁰⁸ MPH Transcript, page 49, lines 6 to 8 and page 52, lines 21-23, referring to the 'Engineering Justification Papers' that were sent to GEMA.

communication and by giving the opportunity for DNOs to submit adjusted LRE forecasts.⁵⁰⁹

- 5.49 Our view is that the key issue in considering these different positions is whether the approach taken by GEMA is consistent with the purpose of the BPI Stage 4 reward which was to reward DNOs that provided information about their projected costs that aided GEMA in setting accurate price controls for the sector based on efficient allowances.⁵¹⁰ In addition, we consider that GEMA's aim in this price control to support the networks in preparing for decarbonisation at the lowest cost to the consumer, while maintaining world-class levels of system reliability is relevant and important context.⁵¹¹
- 5.50 NPg submitted that the justification for its LRE forecast was provided by a detailed supporting engineering assessment.⁵¹² GEMA's view was that NPg's planning lacked sufficient justification. In particular, GEMA was critical of NPg's lack of explanation around how it would utilise existing headroom on NPgY's network and around the lack of justification or explanation on the role of flexibility to temper load-related expenditures.⁵¹³ GEMA stated that its view was supported by GEMA's independent challenge group which reviewed the business plans. GEMA conducted benchmarking in circumstances in which all the DNOs received the same guidance.⁵¹⁴ In this benchmarking GEMA assessed NPg's LRE forecast and it took into account the differences across DNOs' LCT uptake forecasts between 2023-2028. We note from the above that GEMA responded to NPg's engineering assessment, its independent challenge group reviewed the business plans and GEMA carried out benchmarking.
- 5.51 In response to the Provisional Determination, NPg submitted that the difference between NPg's submitted LRE for a low scenario and its submitted costs for its planning scenario closely matched the size of the workload adjustments.⁵¹⁵ It submitted that, therefore, it was implausible that workload adjustments (in the case of NPg) were predominantly for inefficiency as it was common ground that LRE for the RIIO-ED2 price control period would differ substantially between low and high scenarios.⁵¹⁶ GEMA submitted that it was untenable that NPg's submitted secondary reinforcement expenditure for

⁵⁰⁹ GEMA Skeleton, paragraph 14. MPH Transcript, page 155 lines 11 to 23.

⁵¹⁰ [NoA](#), paragraph 11.2; [GEMA Response](#), paragraph 113.

⁵¹¹ GEMA, RIIO-ED2 Final Determinations Core Methodology Document, paragraph 3.5. Also MPH Transcript, page 24, lines 11 to 13 and pages 81, lines 16 to 25 to page 82, lines 1 to 6.

⁵¹² MPH Transcript, page 49, lines 6 to 8, page 52, lines 21 to 23, referring to the 'Engineering Justification Papers' that were sent to GEMA.

⁵¹³ MPH Transcript, page 145, lines 24 to 25 to page 146, lines 1 to 3.

⁵¹⁴ See paragraphs 4.17 and 4.26.

⁵¹⁵ NPg Response to PD, paragraph 3.7(i).

⁵¹⁶ NPg Response to PD, paragraph 3.7(ii)(a).

RIIO-ED2, which was 5 times that of UKPN, should be entirely efficient and explained by minor differences in scenario assumptions, beyond the forecast uptake of LCTs.⁵¹⁷

- 5.52 In our assessment of the Parties' opposing submissions, we have placed weight on the fact that GEMA conducted benchmarking in which it took into account the differences across DNOs' LCT uptake forecasts between 2023-2028, and that GEMA's view of NPg's business plan was supported by the work of GEMA's independent challenge group in reviewing business plans. In these circumstances, in our view, NPg has not demonstrated that it was wrong for GEMA to have interpreted differences across DNOs' LCT uptake forecasts between 2023-2028 as being related to demand and to have interpreted the other parts of the benchmarking in relation to the Secondary Reinforcement workload adjustments as being related to (in)efficiency for the purposes of the BPI Stage 4 reward.
- 5.53 Based on this assessment, our view is that GEMA was not wrong to conclude that in the case of NPg the Secondary Reinforcement workload adjustment related predominantly to (in)efficiency and, therefore, to apply workload adjustments when determining eligibility for a BPI Stage 4 reward.

GEMA's stated aim of the BPI Stage 4 reward

- 5.54 In this section we consider NPg's submission that GEMA's approach to the BPI Stage 4 reward ran contrary to GEMA's stated aim of the reward⁵¹⁸ and the related submission that the licence modifications failed to achieve the effect stated by GEMA.⁵¹⁹
- 5.55 In the introduction to its criticism of GEMA's approach to calculating the BPI Stage 4 reward, NPg submitted that GEMA had stated that DNOs would be eligible for a reward where 'their high-confidence costs meet [GEMA's] benchmark';⁵²⁰ and that the stated principal aim of the reward was to 'reflect the added value [GEMA] may get from information revealed in setting more accurate price controls for other companies' – in other words, to reward DNOs for providing information that enabled GEMA to set efficient allowances.⁵²¹ In response to the Provisional Determination, NPg submitted that the costs in its business plan contributed to setting the 'glide path' and were used by GEMA to set lower allowances for other DNOs. NPg therefore contended that its

⁵¹⁷ GEMA Skeleton, paragraph 54.

⁵¹⁸ NoA, paragraph 11.8(i).

⁵¹⁹ NoA, paragraph 28.1(ii).

⁵²⁰ NoA, paragraph 24.2, citing the RIIO-ED2 Final Determinations Overview Document, paragraph 9.54.

⁵²¹ NoA, paragraph 24.2 (and also paragraph 11.3, footnote 43), citing the RIIO-ED2 Sector Methodology Decision, Annex 2 Keeping bills low for consumers, paragraph 10.59.

submitted costs helped GEMA set a better price control, in accordance with the stated aim of the BPI Stage 4 reward.⁵²²

- 5.56 However, NPg submitted that GEMA's approach was not achieving its aim in that, despite NPgY ranking as the second-most efficient DNO in GEMA's efficiency rankings (resulting from the calculation of efficiency scores before any workload adjustments to disaggregated modelled costs), NPgY did not receive a BPI Stage 4 reward due to the erroneous inclusion of workload adjustments in the disaggregated modelled costs used for the comparison with a DNO's submitted costs.⁵²³
- 5.57 As regards its contention that the licence modifications failed to achieve the effect stated by GEMA (for the purposes of section 11E(4)(d) EA89),⁵²⁴ NPg submitted that the failure was because:
- (a) GEMA had stated that a BPI Stage 4 reward would be provided to any DNO whose high confidence costs beat an independent benchmark;⁵²⁵ whereas
 - (b) NPgY's high confidence costs did beat the appropriate independent benchmark (modelled costs prior to 'Scenario Adjustments'), yet it wrongly did not receive any reward.⁵²⁶
- 5.58 In response to the above points, GEMA stated that it agreed that it had intended that the BPI Stage 4 reward would be provided to any DNOs whose plans beat the independent benchmark,⁵²⁷ but the dispute here was really about how that benchmark was set.⁵²⁸ GEMA submitted that its approach was both rational and logical and ensured an outcome which was consistent with the objective of the BPI 'to encourage complete, ambitious, high quality and efficiently costed plans' – NPg's approach would not be consistent with that objective.⁵²⁹ GEMA further submitted that NPgY's high confidence costs did not beat the benchmark that GEMA had set.⁵³⁰

⁵²² NPg Response to PD, paragraph 3.2.

⁵²³ NoA, paragraphs 25.4 and 25.5.

⁵²⁴ NPg submitted that, in the Decision, GEMA had stated that the reasons and effects for making the modifications was to be found in its consultation documents (NoA, paragraph 15.14).

⁵²⁵ NoA, paragraph 28.1(ii)(a).

⁵²⁶ NoA, paragraph 28.1(ii)(b).

⁵²⁷ MPH Transcript, page 84, line 12 to 17 and 161, lines 20 to 23; see also the statement to this effect in the Final Determinations Overview Document (to which NPg made reference at NoA, paragraph 24.2, footnote 101) in which GEMA had stated that 'the approach we have taken on Stage 4 is mechanistic in that DNOs are rewarded where their high-confidence costs beat our benchmark ...' (Final Determinations Overview Document, paragraph 9.54).

⁵²⁸ MPH Transcript, page 161, lines 20 to 22.

⁵²⁹ GEMA Skeleton, paragraph 6; GEMA Response, paragraphs 136 and 140.

⁵³⁰ GEMA Response, paragraph 139.2 and MPH Transcript, page 162, lines 24 to 25.

5.59 In response to a question to identify the location of GEMA's stated effect of the licence modifications (for the purposes of section 11E(4)(d) EA89), GEMA referred to a framework of published documents which it stated set out the stated effect of the licence modifications for the applicable statutory purposes.⁵³¹ In relation to Ground 2 in particular, GEMA referred to the following paragraphs in the Final Determinations Overview Document, which GEMA stated set out the purpose of the BPI:

9.7 The BPI was developed to encourage network companies to submit ambitious business plans that contain the information Ofgem requires to undertake a robust assessment of the business plans. High-quality business plans are essential to enable us to have sufficient high-quality information to set the price control that delivers for consumers at a reasonable cost.

9.8 [...].⁵³²

9.9 The BPI rewards companies where, in our view, their business plan represents genuine additional value for money compared to business-as-usual and provides information that helps us to set a better price control. In contrast, inefficient, lower quality business plans are subject to financial penalties.

9.10 In this chapter we provide an overview of our BPI decisions for each company and set out some of the key points raised by stakeholders on the BPI and our responses to those points. Further details on our BPI decisions for each company are set out in Company Annexes.

(emphasis added)

5.60 Our assessment of the Parties' submissions is as follows.

5.61 As regards NPG's submission that GEMA's approach to the BPI Stage 4 reward ran contrary to GEMA's stated aim of the reward, we note that we have found (in the previous section) that GEMA was not wrong to apply workload adjustments when determining eligibility for a BPI Stage 4 reward.

⁵³¹ Letter dated 20 June 2023 from Ofgem (for GEMA), response to question 1 of the CMA's letter dated 16 June 2023. GEMA referred to: the document entitled 'Statutory consultation on the RIIO-ED2 licence drafting modifications – reasons and effect' (the "Reasons and Effect Document"), published on 14 December 2022; the documents entitled 'RIIO-ED2 Statutory Licence Modification Notice – Standard Conditions' and 'RIIO-ED2 Statutory Licence Modification Notice – Special Conditions' (the Modification Notices) dated 3 February 2023 which gave effect to GEMA's decision to modify the Standard and Special Conditions of NPG's licences; and the RIIO-ED2 Final Determinations (including the various subsidiary documents).

⁵³² Text omitted. In this paragraph, GEMA referred to the four stages of its assessment under the BPI and noted that for each company rewards and penalties (aggregated across all four stages of the BPI) were capped at 2% of GEMA's proposed totex allowances.

Moreover, the fact that the Secondary Reinforcement workload adjustments for NPgY predominantly related to (in)efficiency was consistent with the stated aim in the Final Determinations Overview Document. Given that NPgY's high confidence costs did not beat the appropriate independent benchmark, NPgY did not receive a BPI Stage 4 reward. In those circumstances, our view is that GEMA's approach to the BPI Stage 4 reward was not contrary to GEMA's stated aim of the reward, as contended by NPg. That is the case notwithstanding any contribution made by NPg's submitted costs to setting the 'glide path' (in relation to the catch-up efficiency challenge) or the use of those costs by GEMA to set lower allowances for other DNOs as NPgY's high confidence costs did not beat the appropriate independent benchmark. We address in the next section NPg's submission on the alleged inconsistency between the BPI Stage 4 reward and the catch-up efficiency challenge.

- 5.62 NPg has not provided any persuasive additional reasons to support its submission that the licence modifications failed to achieve the effect stated by GEMA. Therefore, our view is that NPg has not demonstrated that the licence modifications failed to achieve the effect stated by GEMA for the purposes of section 11E(4)(d) EA89.

Alleged inconsistencies in GEMA's approach

- 5.63 NPg made submissions in relation to two inconsistencies, which, in its view, showed that GEMA had erred in applying workload adjustments when determining eligibility for a BPI Stage 4 reward. In summary, NPg submitted that:
- (a) GEMA's approach to including workload adjustments in the BPI Stage 4 reward was illogical and inconsistent with the approach it had taken to totex modelled costs: NPg submitted that the workload adjustments applied to disaggregated modelled costs were in main part functionally equivalent to the DDA, so GEMA should have used disaggregated modelled costs *before* the application of workload adjustments, in order to be consistent with the use of totex modelled costs before the application of the DDA;⁵³³
 - (b) GEMA's approach to assessing the BPI Stage 4 reward was inconsistent with its approach to calculating efficiency catch-up scores, which were based on a comparison of submitted costs to modelled costs in which disaggregated modelled costs were used *before* the application of workload adjustments. In that scenario, NPgY was ranked the second-

⁵³³ NoA, paragraphs 11.8(ii) and 26.1; NPg Skeleton, paragraphs 37 to 42; LOI, paragraph 11(a).

most efficient DNO (by efficiency score), yet it did not receive a BPI Stage 4 reward.⁵³⁴

5.64 In summary, GEMA's response to these points was as follows:

- (a) GEMA submitted that it was not inconsistent to include workload adjustments, but exclude 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.⁵³⁵ In any event, the value of the adjustment (ie the component of the Secondary Reinforcement workload adjustment which is reflective of demand) was relatively minor in the case of NPgY and even if it were excluded for the purposes of the BPI Stage 4 reward, NPgY would still not have received a reward;⁵³⁶
- (b) It was not wrong or inconsistent for GEMA to have included workload adjustments in its assessment of the BPI Stage 4 reward but not in the catch-up efficiency challenge: the catch-up efficiency challenge was a sector-wide challenge which focused on the efficiency of the delivery of DNOs' business plans, whereas the BPI Stage 4 reward entailed an assessment of the efficiency of DNOs' business plans themselves.⁵³⁷

5.65 In our view, for the reasons given below, the points raised by NPg regarding the alleged inconsistencies do not assist NPg's challenge under Ground 2 of the appeal.

5.66 We note that in our assessment of the Secondary Reinforcement workload adjustment above, we have concluded that it was not wrong for GEMA, in the case of NPg, to treat Secondary Reinforcement workload adjustment as being related predominantly to (in)efficiency and, therefore, to apply workload adjustments when determining eligibility for a BPI Stage 4 reward. Therefore, the issue of whether there was any inconsistency with GEMA's approach in relation to other aspects of its assessment in the price control, would not affect the outcome given the specific purpose of the BPI Stage 4 reward.

5.67 Moreover, and separately, we note that the correction for any inconsistency as contended by NPg would logically involve modification of the efficiency scores calculation or the inclusion of DDA within the BPI Stage 4 assessment, neither of which is the subject of a challenge by NPg in this appeal.

⁵³⁴ NoA, paragraphs 11.8(v), 25.4 and 25.5; NPg Skeleton, paragraphs 43 to 45; LOI, paragraph 11(b).

⁵³⁵ GEMA Response, paragraphs 12, 110.2 and 130-131; GEMA Skeleton, paragraph 42.

⁵³⁶ GEMA Response, paragraph 12.

⁵³⁷ GEMA Response, paragraphs 110.3 and 132-138; GEMA Skeleton, paragraphs 6 and 42.

5.68 In view of the above, our view is that GEMA was not wrong, on the basis of any inconsistency as contended by NPg, to include workload adjustments or to take the approach it did in making its BPI Stage 4 assessment.

Whether GEMA's Response constituted a fresh decision⁵³⁸

5.69 NPg submitted that GEMA was 'rewriting history' by submitting in its Response that it concluded that the Secondary Reinforcement costs in NPg's Business Plan were hugely inefficient.⁵³⁹ NPg also submitted that GEMA had made a 'new contention' by submitting in its Response that NPg's planned LRE was not premised on a substantially different path and pace of electrification.⁵⁴⁰ NPg further submitted that GEMA's explanation for taking different approaches to efficiency in calculating the BPI Stage 4 reward and the efficiency scores (ie that the two calculations served separate and distinct purposes) was new.⁵⁴¹

5.70 In its representations on the Provisional Determination, NPg submitted that in the context of 'focused' appeals, it was concerned that the application of the principles in Firmus Energy (summarised at paragraph 3.69) so as to allow a regulator to justify a decision with a new characterisation of its decision, supported by new reasoning, would give rise to issues of procedural fairness.⁵⁴²

5.71 In our view, the various statements to which NPg has referred (at paragraph 5.68) do not demonstrate that the points made by GEMA constitute a fresh or new decision, nor do they amount to a new characterisation of GEMA's decision. Rather they are points made in GEMA's defence of specific points of challenge brought by NPg by way of further elaboration of its approach in calculating the BPI Stage 4 reward. Accordingly, our view is that GEMA's Response does not amount to a fresh or new decision, nor does it amount to a new characterisation of GEMA's decision.

Procedural points

5.72 NPg also raised the following procedural points in relation to GEMA's approach leading up to the Final Determinations:

⁵³⁸ LOI, paragraph 12.

⁵³⁹ NPg Reply, paragraph 3.4.

⁵⁴⁰ NPg Reply, paragraph 3.5

⁵⁴¹ NPg Reply, paragraph 4.1; NPg Skeleton, paragraph 43.

⁵⁴² NPg Response to PD, paragraphs 3.10 and 3.15.

- (a) It submitted that GEMA gave no notice that DNOs with more conservative decarbonisation planning scenarios would receive preferential treatment when assessing eligibility for a BPI Stage 4 reward;⁵⁴³
- (b) It also submitted that GEMA issued no guidance before the submission of DNOs' business plans that would have enabled a DNO to calibrate its planning to the Common Scenario.⁵⁴⁴

5.73 In response to GEMA's submission that NPgY's workload volumes relating to Secondary Reinforcement were 'extremely high' and 'inefficient',⁵⁴⁵ NPg submitted that GEMA did not give any examples of having criticised the final NPg Business Plan on the basis of inefficient LRE forecasts; and its decision documents did not state that adjustments to NPg's planned LRE were required to correct for extreme inefficiency.⁵⁴⁶

5.74 In summary, GEMA's response to these points was as follows:

- (a) GEMA consulted DNOs on their assumptions for energy requirements for LCT such as Electric Vehicles (EVs) and heat pumps as these were a key cost driver of the costs into LRE. NPg's information was broadly in line with other DNOs;⁵⁴⁷
- (b) GEMA also considered, together with DNOs' assumptions, other data that might imply why a DNO might need to do more reinforcement in terms of network utilisation and there was nothing that suggested that NPg would need to do more because of higher levels of network utilisation – in fact, the opposite was the case;⁵⁴⁸
- (c) GEMA had made it clear that if a DNO had brought forward strategic investment proposals, it needed to justify its approach.⁵⁴⁹ The DNOs had received individual feedback on their plans from GEMA's independent challenge group and their own customer engagement groups, as well as informal feedback from GEMA and a letter from GEMA to the DNOs dated 8 October 2022 which specifically stated '[i]f you are bringing full strategic investment, you need to really clearly justify it'. GEMA submitted that there was not much more that it could have done;⁵⁵⁰

⁵⁴³ NoA, paragraph 11.8(iii). NPg added that such preference was in any event arbitrary in light of GEMA's stated policy aims for the reward.

⁵⁴⁴ NoA, paragraph 11.8(iv).

⁵⁴⁵ GEMA Response, paragraph 137.2.

⁵⁴⁶ NPg Reply, paragraphs 3.2 and 3.3.

⁵⁴⁷ MPH Transcript page 152 lines 6 to 19.

⁵⁴⁸ MPH Transcript page 153 lines 2 to 7.

⁵⁴⁹ MPH Transcript page 154 lines 2 to 5.

⁵⁵⁰ MPH Transcript page 155 lines 17 to 23; see also page 145, lines 23 to 24.

(d) The BPI Stage 4 reward was intended as a ‘truth-telling incentive ... for DNOs to put their best foot forward’ and give ‘really good’ plans. If GEMA had actively helped DNOs to improve their business plans, it would have taken months and dampened the truth-telling incentive which was intended to overcome the information asymmetry between the DNOs and GEMA;⁵⁵¹

(e) GEMA did not detail its view on NPg’s business plan being inefficient in the Final Determinations as those documents were not intended to be used for ‘calling out’ individual companies.⁵⁵²

5.75 We note that all the DNOs received the same guidance. While the initial guidance was not detailed, we also note that GEMA had further communication with the DNOs which re-submitted their business plans with updated LRE forecasts.⁵⁵³ We also note that the DNOs received feedback from their own customer engagement groups and GEMA’s independent challenge group. Moreover, the purpose of the Final Determinations was not to provide further feedback to DNOs on their business plans.

5.76 In our view, GEMA’s consultation process was not inadequate, nor do we consider it was necessary for GEMA to have stated in its decision documents, as contended by NPg, that adjustments to NPg’s planned LRE were required to correct for extreme inefficiency.

5.77 In view of the above, our view is that GEMA’s consultation process did not present any deficiency in nature or scale such as to lead us to conclude that the Decision was ‘wrong in law’.⁵⁵⁴

5.78 In its representations on the Provisional Determination, NPg raised an additional concern in relation to what it described as ‘procedural difficulties, which are inherent in a “focused” appeal regime’: namely, that a defence raised by GEMA during the appeal process reveals inconsistencies with other aspects of its price control and that it ‘must logically have erred’ in some other, separate, aspect of its price control decision-making which an appellant is time-barred from challenging by the time this defence is raised.⁵⁵⁵ In our view, as noted at paragraph 5.70, GEMA’s Response does not amount to a new decision, as the points it made in defence of specific points of challenge brought by NPg were by way of further elaboration of its approach in

⁵⁵¹ MPH Transcript page 156 lines 4 to 13.

⁵⁵² MPH Transcript page 154 lines 20 to 25.

⁵⁵³ The DNOs submitted Draft and Final business plans (see paragraph 2.19). See also paragraph 5.73(c).

⁵⁵⁴ See paragraph 3.65 above, on the statement of principle that the regulator’s decision will be ‘wrong in law’ only where a procedural deficiency (including a flawed consultation process) was so serious that we cannot be assured that the decision was not ‘wrong’.

⁵⁵⁵ NPg Response to PD, paragraphs 3.10 and 3.13.

calculating the BPI Stage 4 reward. It is not necessary for us to address NPg's submission on a potential error in another part of the price control, as that is not the subject of the present appeal.

Statutory appeal grounds

5.79 For the reasons given above, we conclude that the Decision was not 'wrong' on any of the appeal grounds as pleaded by NPg in relation to Ground 2:

- (a) GEMA did not make an error of fact (section 11E(4)(c) EA89) by proceeding on the basis that workload adjustments in the disaggregated modelling were (or were predominantly) reflective of efficiency judgements, as opposed to adjusting for differences between scenarios. Our conclusion is that GEMA was not wrong to take the view that DNO submissions on how they planned to respond to increased LCT take-up could be subject to an efficiency assessment, and to use benchmarking in its assessment of NPg's LRE forecast, and to determine that its high LRE forecast related predominantly to (in)efficiency;
- (b) As regards NPg's submission that GEMA's licence modifications failed to achieve the effect stated by GEMA (section 11E(4)(d) EA89): we have found that GEMA's approach to the BPI Stage 4 reward was not contrary to GEMA's stated aim of the reward; NPg has not provided any persuasive additional reasons to support its submission that the licence modifications failed to achieve the effect stated by GEMA. Therefore, our conclusion is that NPg has not demonstrated that the licence modifications failed to achieve the effect stated by GEMA for the purposes of section 11E(4)(d) EA89;
- (c) GEMA did not err in law (section 11E(4)(e) EA89) in its calculation of the BPI Stage 4 reward. GEMA was neither wrong to treat Secondary Reinforcement workload adjustments differently for the efficiency scores and BPI Stage 4 calculations as the two stages had different objectives, nor was GEMA wrong to use benchmarking and conclude that high LRE forecast related predominantly to (in)efficiency. NPg has not demonstrated that GEMA's Response, on the points of challenge raised by NPg, constitutes a fresh or new decision. Nor did we find any deficiency in GEMA's consultation process that would lead us to conclude that the Decision was 'wrong in law';
- (d) NPg had also submitted that GEMA had failed to have regard and/or give appropriate weight to its principal objective and the performance of its duties (section 11(E)(4)(a) and (b) EA89) because GEMA's approach to calculating the BPI Stage 4 reward had resulted in NPgY not receiving a

material BPI Stage 4 reward, which, but for GEMA's error, it would have received.⁵⁵⁶ In view of our conclusions above, that GEMA did not err in fact or in law, in its approach to calculating the BPI Stage 4 reward, in particular that it was not wrong for GEMA to determine that NPg's high LRE forecast related predominantly to (in)efficiency, our conclusion is that this ground of appeal is also not met.

Our determination on Ground 2

- 5.80 For the reasons given above, in summary, we determine that GEMA was not 'wrong' to apply workload adjustments when determining eligibility for a BPI Stage 4 reward. In particular, GEMA was not 'wrong', in the case of NPg, to treat Secondary Reinforcement workload adjustments as related to (in)efficiency.
- 5.81 Therefore, we do not allow the appeal, and accordingly confirm the Decision, to the extent that⁵⁵⁷ we have determined that GEMA was not 'wrong' on the basis contended by NPg.

⁵⁵⁶ NoA, paragraph 28.2. At the Main Party Hearing, NPg explained that, at paragraph 28.2 of the NoA, it had referred to the principal objective and then more generally to 'other duties', so it did not specifically refer to financeability (MPH Transcript, page 65, lines 16 to 18). NPg added that it was not an oversight that it had not referred to financeability; it had only invoked it where it thought it was properly relied on (MPH Transcript, page 66, lines 20 to 22).

⁵⁵⁷ Section 11E(5) EA89 provides that to the extent that the CMA does not allow an appeal, it must confirm the decision appealed against.

6. Remedies

Introduction

- 6.1 We have found GEMA to be ‘wrong in law’ in respect of Ground 1 of the appeal. In respect of Ground 1, in summary, we have concluded that the Decision was ‘wrong in law’ (section 11E(4)(e) EA89) to the extent that GEMA relied on the cost proportions derived from NPg’s submitted costs (based on its decarbonisation planning scenarios without any specific adjustment for the purpose of ensuring that they were appropriate) when allocating, post-benchmarking, NPg’s total efficient modelled costs to different cost categories (see paragraph 4.150 for further details).
- 6.2 Where the CMA allows, to any extent, an appeal in relation to a price control decision, it must do one or more of the following:
- (a) Quash the decision (to the extent that the appeal is allowed);
 - (b) Remit the matter back to GEMA for reconsideration and determination in accordance with any directions given by the CMA;
 - (c) Substitute the CMA’s decision for that of GEMA (to the extent that the appeal is allowed) and give any directions to GEMA or any other party to the appeal;⁵⁵⁸
- 6.3 We set out below the CMA’s approach to the design and implementation of the remedies required to correct the error we have found.

Responses to the Provisional Determination

- 6.4 In response to the Provisional Determination both Parties made representations on remedy options in the event that the CMA were to uphold its Provisional Determination in relation to Ground 1.
- 6.5 Both NPg and GEMA expressed concerns about the consequences of an order to quash GEMA’s decision to proceed with the modification to the distribution licences of NPgN and NPgY in respect of the error we have found on the allocation of total efficient modelled costs. In summary:
- (a) NPg expressed serious concerns including in relation to various practical difficulties and prejudice to NPg in connection with the detailed operation of the licence conditions and the impact of any significant delay in

⁵⁵⁸ Section 11F(2) EA89.

redetermining the allocation methodology.⁵⁵⁹ More specifically, NPg submitted that a quashing order would undo the licence modifications to NPg's special conditions that are contingent on the quashed decision which would mean that NPg would not be subject to various essential parameters of the current price control machinery.⁵⁶⁰ In turn, this would likely lead to various serious problems arising over time and the detrimental impact of the ensuing regulatory uncertainty could affect NPg's customers (who are suppliers) and could also flow through to consumers.⁵⁶¹

- (b) GEMA identified what it described as a range of serious and significant consequences, direct and indirect, that would result from a quashing order in the above terms.⁵⁶² GEMA submitted that the effect of such a quashing order would create significant regulatory uncertainties as well as practical and operational challenges for both GEMA and NPg.⁵⁶³ Specifically, GEMA submitted that such a quashing order might have one of at least two effects: (a) to disapply GEMA's cost allocation in its entirety, which, given that the process of allocating total efficient modelled costs could not be isolated or detached from the remainder of the price control, would effectively render NPg's price control inoperable until GEMA had made a new decision on cost allocation;⁵⁶⁴ and (b) to disapply GEMA's cost allocation but only insofar as it used NPg's unadjusted submitted cost shares, which would create significant uncertainty regarding which elements of the licence remained in force.⁵⁶⁵ GEMA added that certainty around financial values was important for the Annual Iteration Process (AIP) for ED2 licensees under the RIIO-ED2 network price control, which GEMA would conduct later this year and that a quashing order would disrupt the AIP.⁵⁶⁶

6.6 As regards remitting to GEMA the matter (of the allocation of NPgN's and NPgY's total efficient modelled costs) for reconsideration and determination:

- (a) NPg was concerned that GEMA would be required to undertake a statutory consultation which would cause further delay. However, NPg recognised that the applicable statutory consultation periods were

⁵⁵⁹ NPg Response to PD, paragraphs 1.2(iii) and 4.2 to 4.8.

⁵⁶⁰ NPg Response to PD, paragraphs 4.2 to 4.4.

⁵⁶¹ NPg Response to PD, paragraphs 4.5 and 4.6.

⁵⁶² GEMA Response to PD, paragraphs 53 to 73.

⁵⁶³ GEMA Response to PD, paragraph 54.

⁵⁶⁴ GEMA Response to PD, paragraphs 58.1 and 60 to 65. GEMA also identified a risk that a quashing order would effectively quash other aspects of the price control which were not challenged (at paragraph 65).

⁵⁶⁵ GEMA Response to PD, paragraphs 58.2 and 66 to 69.

⁵⁶⁶ GEMA Response to PD, paragraph 70.

important safeguards.⁵⁶⁷ NPg's preferred route was that the CMA determine the appropriate allocation methodology itself and substitute GEMA's decision with its own; NPg submitted that the CMA was as well-placed as GEMA to take such action.⁵⁶⁸ NPg further submitted that if the CMA were to remit the matter back to GEMA, it should set a short time limit for GEMA's redetermination of the allocation method and provide guidance on the appropriate method GEMA may select.⁵⁶⁹ NPg submitted that the CMA should direct that within four weeks of the publication of the Final Determination (a period which NPg submitted was reasonable), GEMA must complete its redetermination, start the statutory consultation period and identify all necessary implementing and consequential modifications to NPg's licences.⁵⁷⁰ NPg further submitted that the CMA should also direct (or, if it considered it sufficient, indicate to GEMA) that the consultation and implementation periods must not exceed the statutory minima.⁵⁷¹

- (b) GEMA submitted that the CMA should remit to GEMA the matter of the allocation of NPg's total efficient modelled costs for reconsideration and determination and direct it to reach an alternative decision consistently with the CMA's findings.⁵⁷² GEMA further submitted that the complexity of the cost allocation meant that GEMA was best placed to take any necessary corrective action and highlighted that consideration and corrective action would not necessarily be a simple process, and that it would take time to consider the relevant issues and to follow the statutory modification process in section 11A Electricity Act 1989.⁵⁷³

6.7 Further to a request made by NPg in its response to the Provisional Determination⁵⁷⁴, we invited the Parties to engage with each other, without prejudice to the outcome of the appeal to see if a potential remedy could be agreed upon. The Parties subsequently reported to us that although they did engage in discussions on the topic, a remedy could not be agreed upon.⁵⁷⁵

⁵⁶⁷ NPg Response to PD, paragraph 4.9.

⁵⁶⁸ NPg Response to PD, paragraphs 4.11 to 4.20.

⁵⁶⁹ NPg Response to PD, paragraph 4.23. NPg further submitted that the CMA should direct that GEMA make use of one or both: (a) the outputs of disaggregated benchmarking; and (b) NPg's submitted costs for a low scenario (ibid.).

⁵⁷⁰ NPg Response to PD, paragraphs 4.24 and 4.25.

⁵⁷¹ NPg Response to PD, paragraph 4.25.

⁵⁷² GEMA Response to PD, paragraphs 55, 72 and 75.

⁵⁷³ GEMA Response to PD, paragraph 74.

⁵⁷⁴ NPg Response to PD, paragraphs 4.10(ii) and 4.21.

⁵⁷⁵ GEMA further submissions on remedies dated 31 August 2023 and NPg further submissions on remedies dated 1 September 2023.

Design and implementation of the remedies⁵⁷⁶

- 6.8 Having considered the Parties' representations on remedies, we set out below the remedies we have decided in respect of Ground 1.
- 6.9 In view of the serious concerns expressed by the Parties in respect of a quashing order, we have decided not to quash the Decision but to remit back to GEMA the matter of the allocation of NPgN's and NPgY's total efficient modelled costs, in respect of which we have found that GEMA was 'wrong in law', for reconsideration and determination. We do not give any directions.
- 6.10 For the reasons set out below, our view is that it would not be appropriate for us to substitute our decision for that of GEMA (to the extent that the appeal is allowed).

Our assessment

- 6.11 As identified in our assessment of Ground 1, the error lay in GEMA's reliance on the proportions derived from NPg's submitted costs for the purposes of allocating NPg's total efficient modelled costs to different cost categories.
- 6.12 We have decided to remit back to GEMA, for reconsideration and determination, the matter of its allocation of NPgN's and NPgY's total efficient modelled costs, in respect of which we have found that GEMA was 'wrong in law'. Given the complexity of the matter, in particular the need for GEMA to determine and implement an appropriate methodology for its allocation of NPg's total efficient modelled costs to different cost categories, we do not give any directions in relation to the approach that GEMA should take to determining the proportions to be used in the allocation of NPg's total efficient modelled costs to different cost categories. Nor do we give any directions as to the time period in which GEMA should reconsider and determine the matter: we acknowledge that the complexity of the matter will require time for a proper consideration and implementation of the necessary corrective action, however our expectation is that in view of the importance of the matter (including the need for NPg to have timely clarity for planning and following year charges⁵⁷⁷) GEMA will proceed expeditiously, including in relation to the applicable statutory consultation periods.
- 6.13 In case it may assist GEMA in its reconsideration and determination of the matter, we do not envisage that GEMA would necessarily rely solely on the cost proportions derived from the disaggregated benchmarking. Rather, it may

⁵⁷⁶ LOI paragraph 8.

⁵⁷⁷ NPg Response to PD, paragraphs 4.20 and 4.23.

be the case that, as the disaggregated benchmarking was used by GEMA in association with totex benchmarking to determine total efficient modelled costs, it would be appropriate for GEMA to use other sources of information on cost proportions alongside the disaggregated benchmarking proportions for the purposes of the allocation of NPg's total efficient modelled costs. In particular, it may be the case that some of the information derived from NPg's business plan submission would be informative given that the DNOs' submitted costs are an important input to GEMA's benchmarking. As such, GEMA may wish to consider using one or a combination of the following sources in allocating NPg's total efficient modelled costs alongside the disaggregated benchmarking proportions:

- (a) the low scenario costs submitted by NPg (ie based on System Transformation FES) (see paragraph 4.22),⁵⁷⁸ and/or
- (b) NPg's submitted costs based on its decarbonisation planning scenario to be modified by GEMA by applying adjustments that are aligned with those applied in GEMA's benchmarking.

6.14 In response to the Provisional Determination (which included the points made in paragraph 6.13), both Parties referred to alternative remedy options.⁵⁷⁹ In summary: NPg submitted that ultimately the choice was between (a) a hybrid allocation method using 50% of NPg's submitted costs for a low scenario and 50% disaggregated modelled costs, and (b) a fully disaggregated cost proportions allocation method;⁵⁸⁰ GEMA submitted that the alternative options available to it had serious drawbacks and none could be said to be better than the approach which GEMA had preferred and taken.⁵⁸¹ Following subsequent engagement between them to see if they could agree an appropriate remedy (see paragraph 6.7), the Parties reported to us that there remained a disparity between them and they had not reached an agreement.⁵⁸² As we have noted at paragraph 4.141, in our assessment of the challenge brought by NPg, we do not take issue with GEMA's use of a blended approach (that is, an approach that blends differently derived cost proportions), nor in principle with the use of information derived from NPg's business plan submission. We refer also to the points we have made in paragraph 6.13. In our view, an appropriate remedy should comprise inputs that are relevant to the purpose in question and avoid the inconsistency of using the cost proportions that were derived by GEMA from NPg's submitted costs given that GEMA had rejected

⁵⁷⁹ NPg Response to PD, paragraphs 4.10 to 4.20. GEMA Response to PD, paragraphs 41 to 52.

⁵⁸⁰ NPg Response to PD, paragraphs 4.17 and 4.18.

⁵⁸¹ GEMA Response to PD, paragraph 52.

⁵⁸² GEMA further submissions on remedies dated 31 August 2023. NPg further submissions on remedies dated 1 September 2023.

NPg's LRE which was included in its submitted costs. As we have noted at paragraph 4.124, it is inconsistent that the submitted cost proportions were used for the allocation of NPg's total efficient modelled costs when GEMA had determined the levels of submitted LRE to be inefficient and it had also made demand adjustments to submitted LRE.

- 6.15 Given the complexity of the matter, and the fact that GEMA has been through the price control process with the industry, our view is that GEMA is better placed to take the necessary remedial action. Therefore, our view is that it would not be appropriate for us to substitute our decision for that of GEMA (to the extent that the appeal is allowed).