Competition and Mergers Authority final determinations on electricity distribution appeals

A BRIEFING NOTE FOR CLIENTS

The CMA has published its final determination in respect of two appeals relating to RIIO-ED1, the electricity distribution price control covering 2015 – 2023[1]. One appeal was brought by Northern Powergrid (NPg) and a second by British Gas Trading (BGT).

Focused appeals regime

The NPg and BGT appeals were the first regulatory appeals to be heard under the new, focused appeals regime that is now applied to energy networks.

Under the previous appeals regime, a GB DNO had the right to reject Ofgem's Final Determination. Ofgem would then refer the matter to the CMA and the CMA would then re-determine all elements of the price control.

Under the new appeals regime, DNOs do not accept or reject Ofgem's Final Proposals, but appeal against the resulting modifications to their licence. DNOs are now entitled (indeed, encouraged) to bring focused appeals on specific elements of Ofgem's decision.

For an appeal to be successful, it is necessary for the appellant to demonstrate that the relevant decision was wrong on one or more of the prescribed statutory grounds. Under section 11E(4) of the Electricity Act 1989 the specified grounds are:

- that GEMA failed properly to have regard to the matters to which GEMA must have regard in carrying out its principle objective and its duties;
- that GEMA failed to give appropriate weight to any of those matters;
- that the decision was based, wholly or partly, on an error of fact;
- that the modifications fail to achieve, in whole or in part, the effect stated by GEMA by virtue of Section 11A(7)(b); and/or

1 https://www.gov.uk/government/news/cma-publishes-final-determinations-on-electricity-distribution-appeals

- that the decision is wrong in law.

In addition to introducing focused appeals on specific grounds, the new regime also confers rights of appeals on other licenced entities whose interests are materially affected by the decision. BGT was able to appeal the modification of DNOs licences on this basis.

It was understood that the intention in implementing focused appeals was that they would enable the appeal body to take account of the merits of the case. This point was confirmed explicitly by the CMA, and it has conducted its inquiry on this basis.

Summary of NPg decision

NPg appealed against Ofgem's proposed licence modifications on three separate grounds, in respect of:

- an adjustment made to cost allowances for smart grid benefits (SGBs);
- the setting of allowances for real price effects (RPEs) in respect of labour using a benchmark derived from external data for the base year, rather than GB DNO actuals; and
- the calculation of regional labour adjustments (RLAs) for the purposes of benchmarking.

NPg's appeal was upheld on the SGBs disallowance, but dismissed on RPEs and RLAs.

SGBs

In its Final Determination, Ofgem made a deduction from allowed costs of all the slow-tracked DNOs (including NPg) to account for its view that a higher level of SGBs was likely to emerge than NPg had factored into its business plan. NPg argued that this deduction was not justified by the available evidence.

The CMA upheld NPg's appeal in respect of SGBs. In reaching its view, the CMA decided that, notwithstanding the potential importance of SGBs, the evidence and reasons put forward by Ofgem in support of its decision were inadequate. Since the evidential support put forward lacked robustness, Ofgem's discretion was not sufficient to justify the adjustment it made to NPg's totex.

The decision, in our view, has clear consequences for infrastructure regulators, at least those facing focused appeals. First and foremost, sector regulators can expect that any analysis they put forward in support of their specific conclusions must be robust. If their evidence base is inadequate, licensed companies can anticipate bringing a successful appeal, even if the regulator also appeals to reliance on its discretion in support of its decision.

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What is arguably less clear is whether regulatory decisions can legitimately rely **solely** on discretion and judgement. For example, could Ofgem have simply added an additional stretch factor to its assessment of the DNO business plans, based on a general view the quantum of SGBs that had been underestimated by the industry? Or would this also have been wrong? While this point has not been tested in the recent appeals, the CMA did point out that robust evidence-based decision-making is itself central to protecting the interests of customers. This may suggest that largely unsubstantiated decisions may also be quashed.

In our view then, the implications of the CMA's decision are that regulators in general must support their decisions with reasonable, relevant and objective evidence.

RPEs

In its Final Determination, Ofgem set base year labour RPEs by reference to an external (to the DNO sector) benchmark. NPg argued that Ofgem's benchmark did not accurately capture the labour costs of the DNOs, and that Ofgem should have instead made use of readily available data on actual GB DNO pay settlements for the relevant year.

The CMA dismissed NPg's appeal in respect of RPEs and decided that Ofgem was not wrong (as formulated in the legislation) to rely on a benchmark for base year RPEs. The use of external evidence to set base year RPEs was found to be within Ofgem's margin of appreciation and, in particular, the observed difference between actual outturn DNO pay settlements and the basket of indices chosen by Ofgem did not in and of itself imply that Ofgem had made an error.

The CMA's decision on this ground supports this narrow element of Ofgem's regulatory practice in respect of RPEs, a methodological step which it has also adopted at previous price controls. The CMA judged that Ofgem had made a reasonable assumption that the DNOs should be able to set pay settlements and incur efficient RPEs consistent with benchmarks from comparable industries.

RLAs

In its Final Determination, Ofgem estimated RLAs on the basis of relatively aggregated data on regional pay from the ASHE[2] survey (2-digit occupational codes). NPg argued that Ofgem's method gave rise to RLAs that were too high for London and the South East, owing to a compositional bias inherent in the ASHE data[3]. This resulted in NPg receiving a lower level of allowed totex than

2 Annual Survey of Hours and Earnings.

3 For example, within a given occupational code in the ASHE data, the skill-levels of persons in London are potentially higher than elsewhere owing to, for example, a head office effect. This would

NPg argued was appropriate. NPg argued that Ofgem should have been aware of the risk of compositional bias confounding its analysis and taken steps to mitigate it, whereas in practice it took none.

The CMA dismissed NPg's appeal in respect of RLAs and decided that Ofgem was not wrong to rely on 2 digit data. The CMA did acknowledge that NPg had demonstrated a compositional bias in the data relied on by Ofgem. However, the CMA considered that Ofgem's concerns over the statistical reliability of the alternative (more granular) ASHE data, on which it may have otherwise relied, were also an important consideration. NPg had therefore not established that Ofgem was wrong to trade off addressing compositional bias with its other concerns over the potential statistical weaknesses of alternative methods.

This element of the CMAs decision is likely to have relevance in future price controls where regional variation in prices may influence efficiency assessments. The CMA's findings on Ofgem's method may persuade regulators to adopt a similar approach. However, our view is that the CMA's decision leaves open the scope to argue for a strictly superior approach that both:

- addresses compositional bias better than Ofgem's method; and
- is demonstrably statistically robust, notwithstanding the uncertainty intrinsic in using survey evidence.

Detailed analysis is likely to be required to find such a method and evidence its properties.

Summary of BGT decision

BGT appealed on five separate grounds. The CMA upheld in part BGT's appeal on one ground, but dismissed the other four.

- **Double recovery of certain revenues**: this ground of appeal related to the alleged double recovery of revenue by the GB DNOs in respect of a specific Excluded Service (i.e. an activity considered outside the price control, where costs are directly remunerated by other means). This was a DPCR5 legacy issue, in respect of which an adjustment to RAV had been made at ED1. The CMA determined that while there was some ambiguity over what had been intended at DPCR5, GEMA's approach at RIIO-ED1 was not wrong. This element of BGT's appeal is in our view highly case specific, and is unlikely to have any significant read across to other regulatory determinations.

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imply that any higher salary observed in London relative to other regions might be caused not only by regional variation in salaries for the same skill set (which is what RLAs should seek to measure); but also by differences in the composition of persons across the regions captured by the data.

- **Output incentives:** BGT's second ground of appeal was that GEMA had set targets in relation to its interruptions incentive scheme and its Broad Measure of Customer Satisfaction that would lead to rewards that were not justified by any substantive improvements in performance. However, the CMA found that Ofgem's calibration was not flawed and therefore not wrong on any of the prescribed statutory grounds.

- **Information Quality Incentive**: BGT's third ground of appeal was that Ofgem had erred by amending the calibration of its Incentive Quality Incentive (IQI) after the DNOs had submitted their business plans. The CMA did not accept that it was wrong in principle for Ofgem to have acted as it did. However, the CMA did judge that Ofgem's adjustment to the IQI did not have the effect that it had indicated it was seeking to achieve in its earlier consultation documents. The CMA has therefore decided to substitute its own calibration of the IQI in place of that taken by Ofgem. BGT's appeal on this ground has therefore been upheld in part.

- **Transitional arrangements for changes in asset lives:** BGT argued that transitional arrangements put in place by Ofgem to smooth the effect of a change in assumed depreciation lifetimes was wrong. Having identified the correct level of economic depreciation, Ofgem should have implemented it as quickly as possible. The CMA dismissed this element of BGT's appeal. Ofgem's transitional arrangements were not wrong and the regulators choices around the speed of money are within its margin of appreciation.

- **Cost of debt index:** At RIIO-ED1 Ofgem decided to extend the averaging period of its rolling mechanism for calculating the cost of debt, and to do so progressively over the ED1 period, a proposal that has become known as the "trombone index" for cost of debt. BGT's final ground of appeal was that Ofgem's decision to adopt the trombone index (rather than retain its previous fixed averaging period) was wrong, as it lead to an increased debt allowance that was unjustified. The CMA dismissed this ground of BGT's appeal. The CMA noted that under Ofgem's proposal, industry-wide embedded debt costs are expected to be recovered, even if some specific DNOs might be under-funded. It also notes that in general a benchmarked approach to setting the cost of debt (for example, by using an external index as Ofgem has done) has good incentive properties. Overall, the CMA considered that Ofgem had made the case that the trombone index would lead to regulatory consistency and the promotion of a low cost of capital environment.

In summary, the CMA has largely supported Ofgem's approach in respect of the grounds of appeal brought by BGT. In respect of these items, most of which

cover the calibration of specific regulatory instruments, Ofgem has not strayed outside of its margin of appreciation.

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