Blow by Blow

Commentary on recent energy and water appeals – and the need for reform

A compilation of articles written by Maxine Frerk (2017-2023)

The author

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The articles in this pack were written by Maxine in an independent capacity but have informed the position that Sustainability First has taken on reform of the appeals process.

Acknowledgments

Many of these articles were originally published in Utility Week and we are grateful to them for agreeing that they can be republished together in this pack to underpin Sustainability First's arguments for reform of the appeals process.

Introduction

One of the issues that government is considering as part of its Review of Economic Regulation is reform of the appeals process for regulated utilities[1]. The Review highlights the difference in the appeals models across sectors with water and rail being subject to full re-determination and other sectors providing for a merits-based appeal limited to the issues raised by the appealing party. Government highlights the benefits to investors of a more consistent approach and also raises concerns about the uncertainty created under a full re-determination and the time and costs involved. For targeted appeals there is a concern that companies can cherry-pick issues on which to appeal.

Sustainability First strongly supports the case for a review of the appeals mechanism but cautions against simply adopting the energy model in water. The energy regime has flaws and this review should be used to look at ways to improve appeals across all sectors.

This collection of articles written over a five-year period provides a "blow by blow" commentary on the various appeals that have taken place across energy and water – drawing out lessons and hopefully bringing to life the issues that government has raised.

While in general the articles support the view that the energy regime is to be preferred to the water on, they do also highlight a number of weaknesses in the energy regime compared to water which we should be addressed as a part of the review:

- An energy appeal is positioned very much as a legal dispute between two parties rather than as resolution of a matter of public interest. We would like to see more transparency and scope for consumer / stakeholder input (as exists on water) – including funding of any Citizens Advice costs;
- An energy appeal is effectively a one-way bet with companies able to pick issues where their case is strongest. The CMA has addressed this in part through setting the bar suitably high for appeals to succeed and in its handling of costs but we would like to see government explore whether there is more that could be done to create some downside risk for companies in appealing, as exists now in water.

We would also note the particular importance in relation to appeals of the long overdue Strategy and Policy Statement for energy (to which the CMA would have to have regard in reaching its decisions). With the CMA distant from wider policy debates the SPS becomes a key document.

There are also wider questions about the CMA's ways of working in its use of panels and its clear line that it is not bound by its past decisions. Regulatory consistency is important to investors in the utility sector. The government guidance to the CMA could be used to highlight the importance of consistency in this strand of the CMA's work.

Finally, through its wider work on the regulatory regime Sustainability First has also explored changes to the underlying price control process itself that could make it less adversarial, supporting wider system changes that are needed but also mitigating the need for appeals. In particular, on cost of capital the articles included here reinforce the argument for consistency across sectors – but this would not be addressed by simply aligning the approach to appeals (ie Ofwat and Ofgem could reach

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1051261/economic-regulation-policy-paper.pdf

different views on the cost of capital with neither being “wrong”). We have instead proposed a Commission to look at the cost of capital across sectors which regulators and the CMA would agree to follow, subject to any clearly justified sectoral differences.

We have also suggested more reliance be placed on a “negotiated settlement” type approach for local social and environmental deliverables as well as a more adaptive approach to major infrastructure investment (which Ofwat and Ofgem are both now exploring).

Sustainability First’s Viewpoint which explains the differences in the appeal regimes between sectors and what is needed to support purposeful regulation, can be found here:

https://sustainabilityfirst.org.uk/images/publications/expert_viewpoints/Purposeful_Regulation_and_CMA_Appeals.pdf

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An unappealing prospect (17/11/2017)

The CMA has recently published its conclusions on the appeal by SONI (the Northern Ireland system operator) against the Utility Regulator's decision on its price control. This might seem an inconsequential decision for those playing on the bigger GB stage but it's an important reminder of the unappealing prospect that at the end of the upcoming RIIO2, the CMA could be trying to deal with half a dozen appeals.

Looking back at the RIIO ED1 appeals it's worth remembering, in the context of debates about the level of network returns, that the CMA actually rejected Ofgem's effort to tighten the price control on the grounds that smart grids technology would in future allow the companies to reduce costs. Ofgem failed because it couldn't prove that costs would come down. Talking tough isn't enough. Ofgem in developing its RIIO2 proposals will need to be on top of both the economic theory and the real-world practicalities. Ofgem has lost a lot of expertise and will need to rebuild it quickly if it is to face off against the companies at the CMA.

Turning back to Northern Ireland, the SONI appeal is the second one that the Utility Regulator (URegNI) has faced under the new appeals regime in energy where companies can appeal on individual issues rather than the settlement as a whole.

Although there is the facility for third party appeals – such as that by British Gas on RIIO ED1 – it is inevitable that the network companies themselves will have more resources and more motivation to mount appeals. Indeed, the experience of having found themselves on the wrong end of an appeal in RIIO ED1 will only increase the motivation for networks to get their own appeals in, just in case.

SONI appealed on 3 grounds with a total of 11 alleged errors. Out of such a long list it was unsurprising that a few points hit home, with the CMA ultimately supporting SONI on 5. In particular they were able to secure an addition to their cost of capital to take account of particular risks they face as an asset light business, some procedural clarifications around arrangements for additional costs to be allowed in period, and additional cost allowances on pensions and information systems. The CMA estimate the gain to SONI as being £5.4m over the 5 years. This is good news for SONI, with benefits arguably running beyond this particular control, but less good for customers. It supports the sense that an appeal is now a one way bet for companies.

The only risk companies face is on costs. Earlier this year the CMA ruled on the price control for Firmus Energy, one of the gas distribution companies in Northern Ireland. In this case URegNI lost on 3 points out of 12 but the points which Firmus won on were a small (£850k) adjustment to its opex and improvements in its connections incentive. The CMA have just published their cost decision which sees Firmus picking up two thirds (£437k) of the CMA's costs and having to bear all their own costs. On that basis it can hardly have been worth their while appealing – though for the GB networks with more money at play, costs will be less of a barrier.

For regulatory afficionados these CMA reports make crucial reading on how the CMA might view similar points on appeal in RIIO2. In Firmus, for example, the CMA built on its RIIO-ED1 decision, making clear that the test was not whether there was a better alternative but whether the original decision was wrong, a relatively high hurdle.

Where it's helping shape the regulatory framework and providing an expert appeal the CMA plays an important role – and does a thorough and professional job. However, if it becomes an automatic stage in the process where companies can be confident of getting back at least some of what the regulator has taken away, then we will be in a sorry place.

Mixing energy and water (9/3/20)

Perversely, the most significant event in energy regulation last month was the decision by four water companies to appeal Ofwat's PR19 price control decision.

Energy networks have been waiting with anticipation to see whether water company appeals might help them in pushing back against what is seen in both sectors as a focus on short term politically-driven price cuts at the expense of future consumer interests. But how much of a read across is there?

At this stage it is still not totally clear where the battle lines lie in water. When presented with the price control decision in water all the companies have to do is say "no" and it is then over to Ofwat to refer the matter to the CMA setting outs its arguments as to why its proposals are in consumers' interests. It is only then that the companies have to reveal their hands and to set out what their concerns are.

The CMA's job is then, in effect, to re-determine the whole price control for each of these four companies although in practice they will tend to focus on the more contentious areas. As past experience shows this sort of appeal can lead to the company being worse off than they were before - but no doubt they will be hoping that in the current context this is unlikely.

The companies' press releases (and subsequent interviews and comments) give some flavour of the range of issues that will be raised.

Anglian had the biggest gap between its proposed investment and its allowance and said that customers want them to invest now. Northumbria argue their settlement is contrary to the best interests of customers and does not provide for sustainable investment, including for what customers say are priorities around reducing the impacts of climate change in the region. Yorkshire talk about the risks to long term resilience and to customers, with the incentive structure forcing them to focus on short term performance at the expense of long-term investment. And finally for Bristol the main issue is how they finance their business.

These are all issues that are very live in the RIIO2 debates which is why there is significant interest in the water appeals from those in the energy sector.

But will any findings from the water appeals read across into energy? The first point is that - again somewhat perversely - a decision by the CMA on the cost of capital in these appeals would be potentially more helpful to the energy sector than it would be for the other water companies who have accepted the control and now must live with it for the next 5 years.

In RIIO ED1 Ofgem shifted late in the process to take on board the CMA decision that set a lower cost of capital in the Bristol Water appeal. As a result, the electricity distribution companies already face a lower cost of capital than transmission or gas distribution – a point that is often overlooked in discussions about energy networks returns.

However, aside from questions of timing (which might limit Ofgem's ability to take anything on board for transmission and gas distribution) it is important to remember that the appeals regime is different between the sectors.

While in ED1 it may have suited Ofgem to go for a lower cost of capital with the CMA decision providing back-up to its decision, it would remain open to Ofgem to stick with a lower number this time even if the CMA went for a higher figure in water. The test that the CMA have to apply on energy appeals is whether the decision is "wrong" (ie outside the bounds of what a reasonable regulator might decide). That is different to water where they have to come up with what they think the "best" answer is – and that does give Ofgem some leeway to stick with a different figure if it wanted to – provided it had good arguments for so doing.

More broadly, while the themes that are likely to be central to the water appeals will resonate strongly with the energy networks, they are very context and fact specific so it is not clear that there will be any read across - although all sides will be carefully reading between the lines of the final CMA decision for helpful quotes.

Of particular interest to me is what influence the consumer voice has in the process. Both Ofwat and Ofgem have talked about the importance of consumer engagement and have required companies to establish Customer Challenge Groups in water and Customer Engagement Groups in energy. In an appeal between the company and the regulator it ought to matter what customers themselves have to say on the matter in hand - and these groups were set up to ensure that voice was heard (and accurately reflected) in the business plan. One concern voiced by the water companies is that Ofwat were ignoring this critical input in the decisions they took. I don't know how far that is a fair criticism but I am well aware of the risk that regulators can get caught up in their own analysis and lose sight of the consumer as the price control process moves forward. I hope the CMA do give due weight to the CCG views in the water appeals or that tendency will be reinforced and we may as well say goodbye to what I believe is an important regulatory innovation.

Finally, the appeals do signal a shift in investor attitudes – wanting to see the companies stand up to the regulator. This machismo is likely to spill across into energy and increases the likelihood that RIIO2 will see a proliferation of appeals. This was already a risk given that in energy appeals the companies can "cherry pick" the individual issues where they have the strongest arguments and – unlike in water – can't end up with a worse outcome than they went in with. The only costs in appealing are the legal fees and management time and distraction – though these should not be ignored. Ofgem did try in their original RIIO2 framework consultation to find ways of creating some disincentives to appeal but I suspect found that this was legally too difficult to do.

So whichever way the water appeals go (and probably almost regardless of what Ofgem do) I think we can expect to see a similar flood of appeals in energy. And in the meantime, the sport of "CMA watching" will keep regulatory experts well occupied over the coming year.

PR19 - Reasons to be cheerful (if you are an energy network CEO)? (5/10/20)

Four water company CEOs will have been breaking open the champagne last week following the CMA Provisional Findings, while a few others will have been kicking themselves for not being on this particular bandwagon. But what does the CMA Decision mean for the energy networks who have put in their responses to RIIO2 Draft Determinations and are awaiting the Final Determinations in December?

As I argued in a previous article, there is not an automatic read across from water. The legal frameworks for appeals are different – in energy the bar is set high and the CMA have to conclude Ofgem is "wrong" on specific points – ie outside the bounds of what a reasonable regulator might decide - whereas in water the CMA are re-determining the whole price control and deciding what they would do in Ofwat's shoes. In addition, the panel structure at the CMA means that precedents aren't binding.

That said, regulators will normally pay a lot of attention to principles coming out of the CMA and the energy companies will be scouring the 800 pages for points that might help them in an appeal.

The most obvious area is on the cost of capital. The CMA has always been seen as the arbiter on this issue and for example during the RIIO ED1 process Ofgem shifted its proposed cost of capital sharply downwards following the then Competition Commission's provisional decision on NIE. Will Ofgem follow suit this time? At first blush, they don't necessarily have to – the CMA have come up with a range and Ofgem could simply say it has chosen a different point in that range. But it would still need a good reason for doing so. The CMA argue for "aiming up" on the cost of capital given the uncertainty around the right figure – that the "well established" long term detriment to consumers from too low a figure and the resultant underinvestment is greater than the detriment from customers potentially over-paying. The asymmetric nature of the incentives in water is another reason given for upping the equity return. In contrast Ofgem is still arguing for a reduction in the cost of equity through an "outperformance wedge" while also proposing a range of penalty-only incentives. While Ofgem doesn't have to simply take the cost of capital figure the CMA have come up with for water, they will need to be broadly aligned in terms of approach and that almost certainly means a higher figure than at Draft Determinations.

What else can energy companies pick up on? Efficiency is another obvious area. One bone of contention in GD2 has been the use of the 85th percentile as the benchmark for efficiency, setting a tougher standard than the usual upper quartile metric. The CMA have made clear that the decision on the appropriate threshold should essentially be tied to how confident one is in the underlying econometrics (so you can be sure that what the model finds as efficiency is not just modelling error). In water the CMA pulled Ofwat back to upper quartile. Given the major concerns being raised about the quality of Ofgem's modelling – and the fact that time pressure means they have this time only used one model not two – it feels like it would be hard for Ofgem to defend the use of anything more than upper quartile. And then on the annual efficiency gain ("frontier shift") the CMA have gone for 1.1% pa in contrast to Ofgem's proposed 1.2% pa for capex / repex and 1.4% pa for opex. Of course, there may be good arguments why energy is different – the level of innovation spend in past years being one – but Ofgem would need to make that case.

The other areas of big concern for the energy networks are the level of anticipatory investment allowed on transmission and repex on gas distribution – both areas that are important for de-carbonisation. Obviously there isn't the same read across here, but the CMA did allow several specific "enhancement" projects on water put forward to address resilience issues for example. In 6

out of 8 cases the CMA allowed some or all of the extra spend noting the clear link to Ofwat's duties on resilience and simply taking, say, 10% off the cost forecasts where the need was clear but the costs were uncertain. Energy will be different but companies could expect a receptive hearing if they can make a clear case linked to Ofgem's duty around reducing greenhouse gas emissions.

Of course, Ofgem's defence in this area will be that it has allowed funding through uncertainty mechanisms. The analogy there is with the costs that Anglian sought for tackling a pollutant (metaldehyde) where the environmental legislation was uncertain. Ofwat had proposed a re-opener that Anglian could trigger subject to materiality thresholds. The CMA are proposing a base allowance with a claw back. Obviously this is very case specific but will be worth the networks studying.

The big disappointment for me was the debate around how much weight should be given to customer evidence in setting the price controls. The companies had raised Ofwat's disregard for consumer views as a ground for appeal and the CCGs gave their support on a number of points. This seems to have had little impact on the CMA's own considerations. They make clear that they see consumer research and engagement as a valuable part of the process but then caution against an over reliance on willingness to pay in areas outside customers' direct experience, for example. While I can't disagree with their line on the specifics it didn't feel as if they were looking for ways to reinforce the importance of consumer engagement more broadly. But hopefully that won't deter Ofgem from doing the right thing in this space.

Finally, the PR19 appeals don't touch at all on process. That is a result of the different appeal regimes. But questions of process have been raised on the RIIO2 Determinations given the number of errors identified in the models and the lack of any opportunity to comment on corrected numbers. The lack of any procedural points in water does not mean that they won't be a feature of any energy appeals.

Looking across the piece then there are good reasons for energy networks to feel optimistic that if they appeal Ofgem's Final Decision they will get a fair hearing from the CMA. They might also reasonably hope that Ofgem will study the CMA decision closely and at least seek to avoid some of the obvious pitfalls. The challenge for Ofgem is that wanting to be tough isn't enough in the context of a CMA appeal – you have to have done your homework and have the detailed evidence to support your decisions. Ofgem have put some effort into trying to avoid the problems of a "cherry-picking" appeal by highlighting interlinkages and the need to look at the issues in-the-round. The water appeals are in-the-round but what they show is that that is not a panacea. The important thing is getting the individual elements of the decision right in the first place. Ofgem haven't got long to digest all the responses to Draft Determinations as well as the CMA decision. They have a real challenge on their hands.

What sort of animal is the CMA? (9/1/21)

Clearing out some papers over Christmas I came across a speech I gave at the Regulatory Policy Institute, just after the RIIO ED1 appeal, in which I tried to pull out some lessons around the appeals regime.

Given it was the first time the narrow-focussed energy licence appeals regime had been put to the test there had been some considerable uncertainty about how it would operate. I recounted the debates I had with legal colleagues at the time about the extent to which it was a legal process in which, for example, all representations would have to be made through QCs (as they are in code mod appeals). This did not apply and, as I expected, the CMA continued to want the more traditional "hear it from the decision makers directly" approach.

However, the nature of the test they were applying was essentially a legal one – had Ofgem made an error of fact or law or misapplied their duties – and there were a number of legalistic aspects to the arrangements. The CMA seemed to treat it as essentially a legal dispute between two parties not a question of public policy. For example, the provisional decision, which many of us have scrutinised in the water appeal and attracted 45 responses from a wide array of stakeholders, was not made public in the energy appeal. In the British Gas third party appeal even the networks whose revenues were directly affected struggled to get a full hearing.

In my speech I reflected on the different hybrid animals that exist and concluded that (for energy appeals) the CMA was a minotaur with a human face but four legal legs. I argued that Pan with a human face and only two legal legs would have offered a better model.

The main problem that I perceived at the time was to do with the cherry-picking nature of energy appeals in contrast to the "in the round" water appeals regime (more accurately described as a re-hearing). This was the problem that Professor George Yarrow had also identified with the single-issue Australian appeals regime where over successive price controls it was clear that the regime benefitted the better resourced companies over consumer bodies. Ofgem have taken this lesson to heart and made a strong play in the RIIO-2 documents about the linkages that exist and the potential for subsequent adjustment to the price control to redress any imbalances created to the "in the round" decision.

However, the idea that everything would be alright from a consumer / regulator perspective if only we had "in the round" appeals has been firmly squashed by the CMA decision on PR19 which has provoked strong reactions from Ofwat and others.

The CMA have recently (8 January) published a consultation on two working papers on cost of capital in which they move slightly towards the Ofwat position but are holding their line on some of the core elements and in particular the idea of "aiming up". The argument here is that regulators should pick a figure in the upper part of the range of figures identified because the risks of being wrong in terms of not allowing enough investment or risking the financial failure of a firm are a bigger concern than the risks of consumers slightly over-paying.

The working papers make very clear that this is a question of judgment, balancing the different regulatory duties around consumer protection, resilience and financeability.

Going back to my hybrid animals then the CMA in this instance is not a hybrid animal but pure man. This is not a legal argument about right and wrong. Of course they are bound by the same duties as Ofwat but as I have always argued – and as recent analysis by Slaughter and May for Sustainability First sets out – regulators have a lot of discretion in how they apply their duties.

We have seen the transformation in Ofgem's focus on de-carbonisation over the past year. That has nothing to do with any change of duties and an awful lot to do with the new CEO.

So back to the question at the start. What sort of animal is the CMA? How will it go about balancing the different duties and applying the discretion that it is afforded? I would make two observations.

First it is a body that is disconnected from the industries it regulates and from government. In days of old - when the independence of regulators was sacrosanct - this was a strength. But with the challenges of climate change and with utility bills (and the possibility of nationalisation) a manifesto level issue, regulators these days have to be more alive to the political agenda. In deciding how to balance their duties regulators have always had to take account of the wider social context and that is more important now than ever. The CMA's extreme independence now risks making them look distant and out of touch.

Second the CMA is not a single body but one whose face changes for each inquiry with a fresh panel appointed each time. It has been remarked on that the panel for the PR19 hearing, while very experienced, came predominantly from an industry background – no obvious consumer advocate or even academic. Another panel with a different set of individuals could reach a different conclusion - there is no "CMA view". Recall, if you will, that Professor Martin Cave was a member of the panel on the retail markets investigation and put out a minority report supporting a broader price cap. Different people will inevitably have different views and reach different judgments as they seek to balance the various duties, and in this case without a sectoral context and background to draw on.

These features may matter less when the question is whether the regulator's decision was "wrong" as it is in energy. But there may still a balancing of duties that needs to be done. Either way there would now seem to be a real question of whether this is the sort of animal that we want as the appeal body for our essential utilities or is it time for a rethink?

Full house! (4/3/21 – Linkedin)

Putting aside the ESO, all 8 of the networks subject to the RIIO 2 price control have appealed elements of Ofgem's Final Determinations to the CMA. Does that mean that Ofgem got it badly wrong? Not at all.

Following the RIIO ED1 appeal, when it became clear how the new focussed appeal arrangements worked, it always seemed likely that we would see a large number of appeals at RIIO2. The companies can pick the issues on which they appeal (ie the ones where they have the strongest case) and it's effectively a one way bet. Unlike on the water re-hearings you can't realistically end up worse than you went in - and who wants to be the only one not at the party if everyone else is getting a prize? The only downsides are some legal costs and – perhaps more importantly – the senior management time involved and the risk of tarnishing relationships with the regulator.

In addition to those inherent features of the focussed appeals regime, there are some particular circumstances this time round, with the CMA looking likely to settle on a more generous cost of capital in the ongoing water appeals. On that basis it does feel like a bit of a no-brainer. If the company keeps it tightly focussed on the cost of capital as National Grid have done, then they can probably avoid it being too much of a distraction and hopefully keep the heat out of the argument with Ofgem.

Others seem to have taken the view that if they are going to the effort of appealing to the CMA on cost of equity then they might as well throw in a few other points as well. SSEN Transmission have also challenged their inability to appeal against allowances for the major projects that are agreed in period (a process which Ofgem wants to make more use of as part of a shift to adaptive regulation). SGN are also challenging Ofgem's efficiency calculations. But both of them seem to be positioning these as technical issues and looking to maintain good relations with Ofgem. How easy that will be once they get into the heat of the debate remains to be seen but it is the right strategy.

All the rest have gone for slightly broader appeals and without the warm words. On gas distribution there is a common theme around the efficiency targets that Ofgem set but beyond that it is a pick and mix of issues.

So I've said it was a no-brainer to appeal but that doesn't mean it's a slam-dunk. The other lesson from the ED1 appeal was that it was a relatively high bar to prove that Ofgem was "wrong" which is the test for focussed appeals (and which is reflected in the fact that, leading for Ofgem on the appeal, I won on 8 out of 9 points). Even if the CMA do finally settle on a higher cost of capital for water that doesn't necessarily mean that they will over-turn Ofgem's decision if it falls within what they would consider a plausible range.

How successful the companies are will depend in the end on the detail of their arguments which will start to become clearer over the next few days. That will also make it clearer the size of the task facing Ofgem and the CMA. Managing 2 parallel appeals at ED1 was no small exercise. Managing 8 appeals – even with a bit of common ground – will be unimaginably stretching. Ofgem may have hoped they could avoid that fate by giving some ground at Final Determination but the cards were always stacked against them. They have a busy few months ahead.

A Headache for the CMA (11/3/21)

While the CMA is experienced in managing quick turnaround appeals and merger decisions the prospect of running 8 parallel appeals on the RIIO2 price controls (for transmission and gas distribution) must present them with a bit of a headache.

Formally the next step in the process is for Ofgem to make any comments on whether the appeals should be allowed and for the CMA then to grant permission (by the end of March). This is largely a formulaic process and there is no real prospect of the appeals not being allowed.

Aside from deciding on the panel members, the CMA's next task will be to think about the logistics, timelines and how far the appeals can be run in parallel.

How far is there common ground?

All the appeals cover the cost of equity and the "outperformance wedge" with all of the companies apart from National Grid then appealing on at least one other topic as well.

On cost of equity the companies all structure their appeals around the same three key areas – errors in the calculation including Ofgem's choice of evidence; errors around the cross-checks carried out and the failure to "aim up" (ie to use a number in the upper part of the range to avoid the risks of under investment). All companies argue that energy is higher risk than water and hence should have a higher cost of equity. The gas distribution companies also argue that gas is higher risk because of the potential for stranding. Interestingly NG Gas Transmission don't make this argument and have presented an identical case to NG Electricity Transmission (so at least these two appeals can be combined).

On the outperformance wedge (the adjustment Ofgem have made to the cost of equity to reflect the fact that historically companies have always out-performed their price controls), the companies are all running similar arguments that this is unjustified and undermines incentives.

On the basis of that high level summary, it might sound like the CMA could run the appeals together in this area. However, once you get below this initial level the specific evidence cited by each company is different and they are using different consultancies to help them. Given the nature of the focussed appeal in the energy sector the CMA have to decide each case on the evidence presented – which is different in each case.

This raises an interesting question (for regulatory geeks like me) as to whether you could have one network succeeding at appeal when others fail just because one has made better arguments? Or will the companies' arguments evolve through the process so that by the end any "winning" arguments will be woven into everyone's narrative? The CMA could try to get the companies to work together but the legal framework doesn't readily accommodate that. However, one has to hope that common sense will prevail and they will find a way to make this a manageable process and one that provides a coherent answer at the end of the day.

What else have companies appealed on?

Beyond the cost of equity there are a couple of other common themes and then some company-specific issues.

The first additional theme is around the ongoing annual efficiency target applied by Ofgem on gas distribution which all GDNs are challenging along with Scottish Power on the transmission side. Ofgem came up with an initial figure of 1% and then applied a 0.2% uplift for the impact of

innovation projects in GD1. All the GDNs are appealing against the innovation uplift (which is redolent of the so called "smart grids benefit" that Ofgem lost on at ED1) but in addition some are citing other errors in Ofgem's calculation.

At the end of the day SGN has made clear it would settle for the 1% it put in its business plan while WWU continues to argue for the 0.5% it included in its plan. The CMA could in theory come up with a different efficiency target for different companies if it accepted some of the arguments made by WWU that others have not made – but that would feel like a slightly odd result.

The second additional theme is the extent of change that Ofgem can make during the price control period in ways that leave the companies without their statutory right of appeal to the CMA. Ofgem has made "adaptive regulation" a cornerstone of its approach to RIIO2, to cope with the uncertainty around net zero and more broadly, but in doing so has arguably undermined the appeal rights of companies. SSEN and Scottish Power have highlighted in particular the LOTI funding for large investments (to be agreed in period), as well the large number of reopeners where Ofgem can simply direct changes. WWU has focussed on the proliferation of associated documents that they are required to comply with and which again Ofgem can change without going through the full licence change process.

I have some sympathy with these arguments. If government has decided there should be a right of appeal, then the regulator circumventing that by the way it does things doesn't feel right, especially where there could be significant financial impacts. However, SONI made a similar argument in 2017 but lost on the basis that it still had the option of judicial review. The question is whether what Ofgem has done is "wrong" or just poor regulatory practice. No doubt companies will be raising their concerns with policy makers as well as through the appeal route. But faced with the current deluge of appeals it's not clear that Ofgem (or government) will be very receptive to the idea of extending these rights.

Finally, there is a list of company specific gripes. For the most part these relate to claims that Ofgem has not allowed sufficient totex funding in particular areas, based on quite technical arguments about Ofgem's modelling.

SGN focus on the efficiency adjustment and the choice of the 85th percentile as the efficiency benchmark as well as details of how it is applied. Cadent focus on the inclusion of LTS diversions in the benchmarking model (which disadvantages them) and the lack of sufficient regional adjustment for the costs of their London network. NGN focus on the BPI mechanism and the failure to reward them as a frontier company (as well as the use of the 85th percentile). WWU, who have the longest list of complaints, pick up on the cost of debt (and the use of average rather than company specific rates), the repex allowance (compared to the initial tenders they have run) and a tax clawback mechanism (and how derivatives are treated within that). Finally, SHE Transmission pick up a specific point around the transfer of cashflow risk on TNUOS from the ESO to them.

All of these points will have to be considered on their individual merits. In some cases they are points of principal on Ofgem's side, in others one suspects that Ofgem simply ran out of time.

A mountain of evidence

The appeal documents from the companies vary in length with Scottish Power the shortest at 42 pages and WWU the longest at 186. A total of just over 1000 pages. And in each case the appeal documents are supported by half a dozen expert reports from the consultancies, witness statements and other evidence. The CMA are used to managing lorry loads of information but trying to digest it

enough to work out how to structure the appeals is a formidable task. Ofgem too will presumably be struggling with how to handle this volume in a world of home working.

Linked to the length of their documents, the companies also vary in how clearly they spell out the specific “errors” of fact or law that constitute the basis for their appeal. That is essential for the CMA to tease out what exactly they have to decide.

To address all of this the CMA may well request skeleton arguments from each of the parties where they have to boil down exactly what their argument is into a few pages. However, one feature of these focussed appeals is that such procedural steps are not visible to the outside world which sits oddly in the context of a RIIO process where stakeholder engagement was so central throughout.

In ED1 the appeals were clearly seen by the CMA as bilateral disputes between the company and Ofgem – not part of a wider policy landscape. On some aspects, of course, the CMA’s hands are tied by the legal framework. However, there are still things they could do to make the process more transparent, coherent and to avoid some of the potentially perverse outcomes identified above. Wider stakeholders need to be assured that the appeal regime strengthens rather than undermines the regulatory process. This is not simply a set of bilateral disputes (which might also involve a tightly defined set of interested parties) – we all have a stake in the outcome.

A busy month for CMA watchers (6/4/21)

The past month has seen announcements from the CMA on the three sets of appeals that should be on a CMA-watcher's radar – the granting of permission on the RIIO2 appeals, the final decision on PR19 in water and their decision on a rather obscure SSE code modification appeal.

RIIO2 Appeals Permission

Of surprising interest was the granting of permission for the eight RIIO2 appeals in which all the network companies have appealed against Ofgem's decision on the cost of equity with most then appealing on a number of other issues as well.

The fact that the CMA have granted permission is not of itself a surprise. However, their decision makes clear that Ofgem had argued against the companies being granted permission on all but the central grounds around cost of equity and ongoing efficiency savings. Ofgem had argued, for example, that the differences weren't material or that past CMA decisions (in particular the SONI case on appeal rights) meant there was no prospect of success. The CMA argued in all cases that they needed to hear the full case before they could decide. They also make the point (in relation to SONI) that the CMA is not bound by its past decisions. Decisions will always depend on the particular facts of the case but this is also an important reminder of the way that the CMA panels work – and of particular relevance as energy companies look across to the PR19 decision.

More importantly, the CMA have made their permission conditional on the appeals being joined across companies where they are appealing on cost of equity, the out-performance wedge, ongoing efficiency or the appeals rights for in period decisions. This really makes sense. As I flagged last month the alternative was both unmanageable but also risked perverse outcomes of some companies securing changes and others not, depending how well they argued their case. What is proposed is now much more manageable for Ofgem and the CMA but will create a real headache instead for the companies who will undoubtedly be required to agree a common set of arguments. The armies of lawyers and consultants that the companies have lined up will not be happy being shoe-horned into a common framework but it's hard to see how it could have worked otherwise.

The CMA have also announced the panel for the RIIO2 appeals – an ex-Treasury civil servant, a lawyer and an accountant with significant regulatory experience. That seems a reasonable balance given the nature of the appeals but notably there is no overlap with the panel for the water appeal (although at working level there presumably will be). The chair is the same as on the SSE code appeal which may not give the companies much comfort given where that landed (see below).

PR19 Water Decision

The Final Decision has moved slightly from the Provisional Decision that was published last year but is broadly in line with the working papers on cost on equity that the CMA published in February. As such the decision had been well trailed.

Putting aside the detail, the core message remains that this was very much a judgment call around the right balance between long term investment and short-term customer bill impact and where the CMA seemed to place more weight on the longer term. As I've flagged previously it is not clear what qualifies the CMA to be a better judge of where that balance should sit than a regulator that is closely plugged into the ongoing public debate in these areas. This is the argument in favour of the energy appeals regime where the CMA is not able to over-turn an exercise of regulatory discretion.

Of course it was not all about that balancing. The CMA's view that financeability should be addressed by increasing the cost of equity not by adjusting the "pay as you go rate" (in effect bringing forward cash flows from the future) is a more principled point and in line with how the rating agencies assess financial resilience. Interestingly this is not an issue raised in the RIIO2 appeals.

One final general observation is the number of times the CMA reached a different decision to Ofwat because it was able to draw on more up-to-date data – on operating costs and on cost of equity. The ability of the CMA to take account of data that was not available to the regulator is explicit in both the energy and water legislation but effectively gives companies two bites at the cherry. If the numbers are moving in a helpful direction then companies can effectively choose to have their settlement judged against a later set of metrics. If not they can "stick".

SSE code modification appeal

Ofgem's transmission charging review (TCR) was contentious, involving as it did a re-cutting of effectively a fixed "cake" of charges with, inevitably, winners and losers. There are also good reasons for thinking that the impacts on renewables might have been underplayed, given most of the work was done before Ofgem's Damascene conversion to net zero. However, it was always unclear whether SSE would get anywhere arguing that Ofgem's decision was "wrong".

SSE set out 6 grounds of appeal, one with 5 sub-grounds, based on detailed legal points. The CMA rejected all SSE's arguments. Even in the odd place where they said that it would have been better if Ofgem had taken a different approach they still concluded that Ofgem was not "wrong" to follow the course that it did. That is a strong reminder, if any is needed, that the bar is high for finding that Ofgem is "wrong". Ofgem were probably helped by having the ESO and Centrica as interveners on their side. However, as noted above, the RIIO2 appeals have the same chair (and largely the same legal framework) so the read across is very relevant.

Next steps

Following the RIIO2 set of administrative announcements, it remains unclear whether we will hear any more about the progress of the appeal until the decision in September. On the ED1 appeal there was radio silence and you had to qualify as an intervener if you wanted to know more. It is certainly a much more closed process than the water equivalent. I continue to reiterate that transparency is important and that given the wider public policy implications of these decisions they should not be seen as purely bilateral disputes.

Learning from all these appeals, which involve significant time and costs, there clearly is a need for a wider re-think on what the best approach is going forward. Neither model is perfect. Whether the answer is a hybrid or a more fundamental change is a difficult question. The RIIO2 appeals will be an important test.

It's all a matter of judg(e)ment (7/7/21)

We're roughly half way through the CMA appeals on Ofgem's RIIO2 price controls and at the minute it seems like the match could go in either direction.

In previous articles I've argued about the need for more transparency in the energy appeals process. In the electricity distribution (ED1) appeals nothing was published until the end. The good news is that this time the CMA have published all the submissions as they go along, so people like me can see what's going on. However the hearings which have been happening over the last few weeks remain behind closed doors – unlike Ofgem's own open hearings which, if nothing else, provided a window into the regulatory process.

The CMA process started with the companies setting out their grounds of appeal back in March. In April Ofgem submitted its response to those appeals and the companies had the chance to submit additional comments following the CMA decision on PR19 in water. In May Ofgem provided its response to the companies' responses. That's a lot of reading.

However, Ofgem's argument can be largely boiled down to the idea that their decisions are all a matter of judg(e)ment and on that basis the CMA cannot find that their decisions were "wrong" – the test that applies in energy appeals. Across Ofgem's two response documents (on cost of capital and other issues) the word "judgment" appears 71 times and "judgement" 76 times. The companies pick this up in their responses though none seem to have spotted the spelling inconsistency so they actually understate the word count. And "discretion" appears 84 times in case the point was in doubt.

Ofgem did admit to two errors in their calculations – on the business plan incentive for NPG (who have gained an addition £3 million) and in the exclusions they apply for atypical projects in assessing Cadent's efficiency (the impacts of which can't be quantified at this stage).

In their responses to Ofgem's response the companies inevitably push back, accusing Ofgem of hiding behind a veil of regulatory discretion and failing to engage with the substance of their arguments. I have argued previously that there is (rightly) a high bar in energy appeals – but it should not be an insurmountable bar or the appeals process is pointless. The energy appeals were intended to be appeals on the merits. The choice of the CMA as an appeal body reflects their specialist expertise – in contrast to a judicial review where the court will be reluctant to go against the judgment of a specialist regulator.

Which way the decisions go will depend crucially on how much discretion the CMA allows Ofgem. In my view, if the regulator has a range of options and the evidence in support of a particular option is much weaker then they should not be able to rely on their use of discretion to defend that choice. If however it is a genuine question of judgment where the regulator's ongoing role can help inform those judgments, then the CMA has no basis for intervening.

Of course, some of the detailed arguments made by the companies as to why Ofgem was wrong are stronger than others - but even where they might appear to have a strong case they still have to get over this first hurdle. Many pages have been written by both sides on the question of regulatory discretion and where the CMA lands will be a litmus test as to whether we have an appeals regime that provides the system of checks and balances that any regulatory system needs, or whether reform is required.

There are also some important legal arguments that come out in WWU's appeal on the cost of debt (but are of wider relevance) about the weight that Ofgem has to attach to its financing duty in balancing its overall set of duties. Again an important point to watch.

There is also a worry among the GDNs about whether Ofgem in correcting the errors it admits to on the Cadent benchmarking could end up reducing other companies' allowances. This debate about how you treat "linkages" is one that has been brewing throughout the policy phases on RIIO with Ofgem and the CMA not necessarily seeing eye to eye.

In terms of process there have also been a few interesting developments.

The energy appeals process is much more closed than the water one with third parties requiring the permission of the CMA to intervene. Both Citizens Advice and British Gas Trading were given permission to intervene on the question of the cost of equity and the outperformance wedge – Citizens Advice because it is the statutory consumer body and BGT because "its business is directly impacted" (a point I struggled with in the ED1 appeal knowing that they treat network charges as a pass-through cost that all suppliers face). Ofwat applied to intervene on the cost of equity but was turned down because it was not directly impacted and it might leave the CMA having to deal with a proliferation of evidence. Similarly, ENWL applied and were turned down on cost of debt and SP Transmission on TNUOS. While this might reflect a strict interpretation of the rules it confirms my sense that these are seen as bilateral disputes rather than matters of public interest. The CMA has said they can take evidence from Ofwat without them being formal interveners and it will be interesting to see whether they do.

The other procedural challenge that the CMA had was the sheer number of appeals on very similar but slightly different grounds. They granted permission to appeal on the condition that the relevant appeals were joined together. The companies were still able to submit individual responses but for the hearings that have been happening they have been required to nominate one of their number as the lead on each ground of the appeal. With every company having different advisers and slightly different positions this has inevitably prompted some tensions.

Aside from the question of consultants' egos there are real questions about how far the CMA will be able to explore the differences that may genuinely exist between the sectors. In transmission it is clear that there is a huge wall of investment needed over the T2 period to accommodate the growth in renewables required for net zero, which should be a consideration in the arguments around "aiming up" on the cost of equity. In contrast the GDNs face an existential threat from heat electrification and the risk inherent in that should surely impact in some way on the cost of equity. The CMA requirement for the appeals to be joined together was probably the only practical solution to the sheer number of appeals but one has to hope that there is still the flexibility for them to reach different conclusions on the different sectors if the evidence takes them there.

Looking ahead, the next step in the process is the CMA's provisional determination due in August. Again, in ED1 this was not made public and so there is another test for the CMA around the transparency of the process as to whether it will publish it this time. I for one will be watching out.

Victory for Ofgem - but some punches landed (12/8/21 – Linkedin)

Yesterday the CMA published a summary version of their provisional determination on the appeals against Ofgem's RIIO2 price control decisions for electricity transmission and gas distribution.

Ofgem won on six out of eleven of the broad grounds of appeal that the companies raised. Importantly Ofgem won on the centrepiece of the appeal, challenged by all companies, which was the cost of equity. While many people had assumed that the CMA approach on water would stand the energy companies in good stead, the test in energy is different and is about whether Ofgem were "wrong" to take the decision they did. The CMA unsurprisingly concluded that Ofgem's cost of equity was within the bounds of their regulatory discretion. They did however conclude that Ofgem was wrong on the associated point about the out-performance wedge (an adjustment to the cost of equity that Ofgem proposed introducing to reflect the fact that companies almost invariably outperform price controls, reflecting in part the information asymmetry that exists). The CMA have some sympathy with the problem Ofgem is trying to address but say they simply haven't made their case. To me, it was always clear that the mechanism was flawed and Ofgem's concession (not to apply it if there isn't outperformance) creates perverse incentives.

A similar story comes through on the assumptions around ongoing efficiency which had been appealed by all the gas distribution companies. The CMA supports Ofgem's basic headline rate of annual efficiency gains as being within the margin of appreciation but rejects the adjustment that Ofgem proposed to make for the benefits of innovation funding paid for by customers. This has echoes of the point that Ofgem lost on in the ED1 appeal around smart grid benefits - it is hard to prove the cost savings that will arise from innovation.

Then finally there were a string of other grounds that were typically unique to one or two companies. Ofgem lost on a procedural point around licence modification by the back door where their decision was deemed ultra vires. They had also conceded early in the process that they had made modelling errors in two specific areas (on NGN's business plan incentive and the benchmarking of Cadent's LTS costs). However, there were also a number of these more detailed points where the CMA concluded that companies had not demonstrated that Ofgem was wrong. An important reminder that to win on an energy appeal the companies need to have tight arguments as to what the errors are - the burden of proof sits with them.

From a customer perspective the end result will be an increase in bills. Given that energy appeals are a one way bet for the companies, that was inevitable. The CMA have estimated the impact as around £1 pa – not huge but not insignificant in the context of a network cost per customer of around £100. That's enough to justify the costs of the appeal for the companies - and there is a benefit for them as well in having put down a marker.

For Ofgem, even if they won on the central issue, it's not a great result. By contrast on the ED1 appeal, which I led on, we won on 8 out of 9 grounds. The Ofgem senior team on RIIO2, who were all new to price controls at the start, will have learned the hard way that in

regulation it isn't enough to simply be on the side of the consumer you have to have the evidence and robust arguments (and processes to double check your sums).

For the appeals process itself it looks a positive result. I had a worry that Ofgem's defence on all issues was that they were a matter of judg(e)ment. That word (counting both spellings) appeared 147 times in their response. If that position had been upheld it would have made a mockery of the appeals process. It wasn't. But equally the CMA have clearly allowed Ofgem a reasonable margin of discretion which feels right. Many points are genuinely matters of judgement where being familiar with the industry and plugged into the wider public and political debate is essential as a basis for making the difficult trade-offs.

The CMA have also managed an amazing feat in terms of running 8 parallel appeals on a diverse set of topics against a tight timetable. It will be interesting to hear from the companies whether they felt they got a fair hearing as they were forced to pick lead spokesmen and agree on positions. However, it's hard to see how else it could have worked. Of course, this is only the provisional determination and Ofgem and the companies get a chance to respond. But it would be surprising if anything changed materially at this stage. All sides will no doubt continue to make their case but will probably be at least as focussed on the detail of the full document that the rest of us have not yet seen. Ofgem in particular will want to ensure that on the points on which it lost the tone is not too critical.

For the DNOs watching this play out, this should provide some helpful clarity as they finalise their business plans. While in principle Ofgem could try again with new arguments it should be a safe bet that the outperformance wedge will be off the table for ED2 but the companies will have to face up to an underlying efficiency target of around 1% pa.
As always, appeals place a heavy resource demand on the companies and on Ofgem. This may make Ofgem keener to avoid a further round of appeals on ED2 but equally the DNOs will have been reminded of the high bar involved in proving Ofgem wrong.

It's not great for a regulator to be found "wrong" on so many counts but Ofgem have welcomed the decision, noting in particular the affirmation on the cost of equity. All sides seem to have been trying to maintain good relations while the appeal is ongoing which is a credit to everyone given it is an inherently adversarial process. It's also crucial given how much we have to do as an industry to deliver on the challenge of net zero. The hope has to be that – barring a final round of petitioning – the arguments are over and all concerned can give their full attention to this vital task.

What's the point of appeals? (26/11/21)

There was an initial flurry of interest at the start of the year when all transmission and gas distribution networks appealed their RIIO2 price control determinations. However the CMA's final determination published at the end of last month has prompted relatively little comment. In large part that reflects the fact that there were minimal changes from the provisional decision published in August. But the publication of the full text of the final decision amounting to 5 volumes and over 1200 pages does give regulatory enthusiasts plenty to chew on.

At the time of the provisional decision, I described the result as a victory for Ofgem but with companies having landed some punches. Ofgem won on the central issue of the cost of equity but lost on their attempt to apply a reduction to the cost of equity through the novel device of an "outperformance wedge". They also lost on the innovation uplift they had applied to the ongoing efficiency rate and on the process around some of the key uncertainty mechanisms where Ofgem's approach would have left companies without a right of appeal against significant decisions. While not huge in financial terms these wins will have covered the companies' costs in lodging an appeal and have set down a marker for Ofgem about the level of evidence it needs if it wants to push out the regulatory envelope.

However, at this stage, what is interesting is not so much the final score but what all this says about the appeals regime overall, in particular when viewed alongside the earlier PR19 appeal in water.

As a reminder, the appeals regime in energy requires appellants to demonstrate that Ofgem was "wrong" on a point of fact or law or on the weighting of its duties. In contrast in water the CMA is carrying out a full re-determination - deciding what they would do if they were in Ofwat's shoes. Throughout the RIIO2 decision the CMA reiterates that this is not what they are doing here.

What this means in particular is that they allow Ofgem a margin of discretion on issues which are a matter of judgement. Unsurprisingly, Ofgem argued that almost everything was a matter of judg(e)ment. If the CMA had accepted that, it would have made a mockery of the appeals process - but they didn't. However there was lengthy legal debate on exactly how much discretion should be allowed to the regulator with the companies noting that the CMA itself is an expert regulator with experience across sectors. In terms of overall approach the CMA made clear that while Ofgem should be afforded a margin of appreciation as an expert regulator, that margin of appreciation is not unbounded.

Expanding on this the CMA set out a principle that the fact there were alternative approaches the regulator could have taken is only relevant if they were "clearly superior".

This then takes us into some interesting territory in terms of the interplay with the CMA's decision on the cost of equity in PR19. Unsurprisingly one of the arguments mounted by the companies was that Ofgem's approach was wrong where it took a different approach to the CMA in the way that it built up the cost of equity. For example, in PR19 the CMA had used AAA corporate bonds as a benchmark for the risk-free rate. However, in the RIIO appeal the CMA says that its own approach was not clearly superior and also describes its own decision as "novel in a regulatory context" and needing scrutiny. Ofgem was therefore not wrong to depart from the approach taken by the CMA. This line that the CMA's PR19 approach was not clearly superior appears several times in the decision. After a year of submissions and hearings on PR19 Ofwat must be wondering what the point of it all was.

More generally there is no recognition of the value in consistency across regulatory regimes. The CMA play down the relevance of the PR19 case arguing that this was a different decision, in a different sector under a different regulatory framework. Never mind that they have some of the same investors and that one strength of the CMA is that it does look across sectors and should therefore be able to help drive greater consistency. Indeed it explicitly rejected the companies' argument that Ofgem was wrong not to pay more regard to the CMA's PR19 decision in the round, dismissing the idea that this created regulatory uncertainty for investors. It did acknowledge the work of the cross-regulator group (the UKRN) but only to show that Ofgem's views were informed by wider practice (and hence not wrong).

It does feel as if out of all this must come calls for a review of the appeals mechanism. It is not clear why the CMA "judgment" on subjective issues should be superior to Ofwat's and an approach, as on energy, that allows the regulator a margin of discretion (but not too much) feels more appropriate.

However, on cost of equity, where the UKRN work was done in order precisely to try to provide consistency, there are good grounds for questioning whether either appeals model has really worked. A fresh approach is needed to the cost of capital, to make the process less confrontational and to drive consistency. The UKRN process is not a transparent one but could perhaps be built on. Scottish Power have called for some sort of Commission on the cost of capital. What is clear is that an appeals regime that can come up with two quite different answers really doesn't help.

In contrast, the CMA's reflections on the outperformance wedge make for interesting reading as a guide to good regulatory practice. The CMA make clear that some outperformance by companies can be justified if it is a reward for delivering improved outcomes for customers that they value. They acknowledge the problem of information asymmetry but see it as a core part of the regulator's job to try to find ways to address that, pointing to the various steps that Ofgem had taken in RIIO2. In essence what they conclude is that to justify an outperformance wedge Ofgem would have to show that there is still an expectation of outperformance after all these steps have been taken (ie not just that there was outperformance historically). They are also clear that an adjustment to the cost of equity is not the best way of dealing with the problem – the aim should be to get the incentives and allowances correct - and that the proposed form of the wedge would dampen incentives on companies to perform.

Throughout the decision the formulation the CMA use is that the appellants did not demonstrate that Ofgem was wrong or (where it was wrong) that Ofgem did not provide the evidence to support its approach. That essentially reflects the legal framework in which energy appeals are considered but does create the sense that if you tried again with better arguments you might win.

As such there is no sign yet in ED2 that Ofgem are rowing back on the outperformance wedge or that companies have now accepted Ofgem's cost of equity and ongoing efficiency level (although we wait on the final Business Plans to see how far they have moved). That may simply be a part of the regulatory "dance" at this stage but in the past a CMA decision would have been seen as setting down a definitive marker. The different outcomes between water and energy in large part reflects the different regimes but may also simply reflect a different panel composition. The CMA repeat regularly that their past decisions are not binding. The appeals regime is not providing the certainty it should if parties think they can roll the dice again and hope for a different result.

One final reflection is that huge credit has to be given to the CMA for managing the process of 8 concurrent appeals and delivering a verdict in 7 months (as against the 12 taken for water). They achieved this by joining appeals where they covered common issues. This will have created problems

for the companies who all had their own legal advisers and economic consultants. It is clear from the CMA decision that on technical points around cost of equity for example the companies all had their own views on the right approach. Although not articulated in the decision one cannot help but feel that this range of views will have only reinforced the sense that there is no “right answer” and hence that it is hard to argue that Ofgem was “wrong”.

No doubt the process was frustrating at times with companies limited to a single spokesman on particular issues at the oral hearing. But it is hard to see how it would have worked otherwise. There is nothing in the CMA’s decision to suggest that the companies raised major procedural concerns which is a credit to all concerned (although the companies formally have 3 months to lodge a judicial review if they feel the process was unfair).

The end result would seem to be in broadly a sensible place viewed as a decision in its own right. But it raises serious questions about how the appeals processes across energy and water (and more widely) needs to evolve to facilitate a consistent approach across regulators which commentators have long been calling for. That needs Treasury and BEIS to make clear that this is a policy outcome they would like to see, but without a bit more noise being made about the CMA’s decision it’s unlikely to happen any time soon.

Back to the CMA (23/3/23)

Northern Powergrid (NPg) is alone among the DNOs in appealing against Ofgem's latest RIIO ED2 decision.

When all the transmission and gas distribution companies appealed against their RIIO settlements two years ago I noted that the design of energy appeals did mean there was no downside risk in appeals with companies able to cherry pick the issues on which they felt they had a good case. However, there are costs – as well as the hefty adviser fees it's a management distraction and risks damaging the regulatory relationship. What the last round of RIIO appeals also showed is that the bar for the CMA to decide that a decision is "wrong" is a high one.

It had seemed as if the changes that Ofgem made between Draft and Final Determinations (plus a few further corrections made after Final Determinations) would be enough to deter companies from appealing. On the big issues such as cost of capital and the efficiency challenge Ofgem used the same figures in ED2 that had been supported by the CMA previously, further reducing the prospects for an appeal.

However, NPg who had been alone among the DNOs in appealing against ED1, clearly felt driven to try its hand again.

The appeal is on a relatively technical question around cost allocation. One of the features of ED2 was the huge uncertainty that exists around the level of take-up of electric vehicles, heat pumps, batteries etc – and hence the level of investment that will be needed in the local networks over the next 5 years. Ofgem left it to the companies to decide what assumptions to make and then at the eleventh hour realised that they couldn't actually benchmark the companies without picking a central scenario to do their analysis around. At Draft Determinations they therefore based their analysis on the lowest cost scenario consistent with net zero (which was the ESO's System Transformation scenario that has more reliance on hydrogen and less on electrification). As the companies had all put in their plans based around different scenarios Ofgem then had to adjust the costs in the companies' plans to align with that chosen scenario.

NPg's appeal isn't about this process per se – it's a long way from ideal but could easily be defended by Ofgem as regulatory discretion. NPg's issue is with how Ofgem did that cost adjustment and in particular how it then allocated the reduced total costs between different cost categories. This is important because the other feature of ED2 is the heavy reliance being placed on uncertainty mechanisms / volume drivers to adjust the cost allowances through the course of the price control depending on, for example, the levels of demand growth that actually materialises. In doing this allocation Ofgem used a 50-50 mix of the original cost breakdown from the company plans and the cost breakdown from Ofgem's own modelling.

The problem for NPg is that their plan which was based on a high level of electrification included a high level of load related expenditure. If that same proportion of load related expenditure is assumed in the scaled back total costs and is then stripped out into an uncertainty mechanism NPg get left with a lower baseline allowance than they should.

Ofgem accepted this point to some degree and moved from using 100% company cost allocations at Draft Determination to the 50-50 approach at Final Determination. NPg argue that this is a question of principle not degree. Ofgem will no doubt argue, as they did at Final Determination, that the alternative of their own model is not perfect either, that the 50-50 approach is therefore a reasonable compromise and that this a point of regulatory discretion.

In my view NPg have a point but Ofgem will probably win. But let's see.

For NPg the motivation seems to be in part about money – the cost allocation is worth £157m – but also pride. The second strand of their appeal is that as a result of the approach Ofgem has taken they were not awarded a Business Plan Incentive. On other metrics of efficiency which Ofgem uses NPg (Yorkshire) were judged second most efficient with two of UKPN's licence areas coming first and third. The two UKPN areas then secured a BPI reward and NPg didn't. This feels like it's a matter of pride for Phil Jones rather than a real concern about the £15m reward.

The next step is for Ofgem to make a submission as to whether the appeal should be allowed (and they will no doubt say it shouldn't be). The CMA will then have to decide whether to allow the appeal (and will almost certainly say they do). There's then a 6-month process of submissions and hearings.

One other question is what interest the other DNOs take in the appeal. At ED1 all the DNOs ended up heavily involved in part because there was a parallel appeal by Centrica that would have directly impacted their allowed revenues. However, in this case the outcome has no direct bearing on the other DNOs so I would expect them to watch quietly from the sidelines (unless UKPN pride leads them to want to defend their BPI reward!).

Given concerns about the costs of these appeals – including the impact on an already stretched Ofgem team – minimising the number of interveners and keeping the process as streamlined as possible would be a good thing.

The subject matter of this appeal is very much a technical question down in the detail of the price control cost models. However, how it is approached remains of interest given that the appeals regime itself is one of the topics that government has said it will be looking at as part of its Review of Economic Regulation. In its original paper government said it was looking at moving water (where there is a full re-hearing) onto the energy appeals model. However, the energy model is not without its faults. In my view what is required is a hybrid. Or does that sound too much like the 50-50 approach that Ofgem proposed for its cost models?