Neutral Citation Number: [2026] EWHC 99 (Admin)

Case No: AC-2022-LON-001117

IN THE HIGH COURT OF JUSTICE
KING'S BENCH DIVISION
ADMINISTRATIVE COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 22/01/2026

Before :

MR JUSTICE SHELDON

- -

Between :

THE KING (on the application of WALES & WEST UTILITIES LIMITED)	**Claimant**
- and -	
COMPETITION AND MARKETS AUTHORITY	**Defendant**
-and-	

1. **GAS AND ELECTRICITY MARKETS AUTHORITY**

2. **SCOTTISH HYDRO ELECTRIC TRANSMISSION PLC**

3. **NATIONAL GRID ELECTRICITY TRANSMISSION PLC**

4. **NATIONAL GRID GAS PLC**

5. **NORTHERN GAS NETWORKS LIMITED**

6. **SCOTTISH HYDRO ELECTRIC TRANSMISSION PLC**

7. **SOUTHERN GAS NETWORKS PLC**

8. **SCOTLAND GAS NETWORKS PLC**

9. **SP TRANSMISSION PLC**

10. **BRITISH GAS TRADING LIMITED**

11. **CITIZENS ADVICE**

12. **WATER SERVICES REGULATION AUTHORITY**

13. **ELECTRICITY NORTH WEST LIMITED**

Interested Parties

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Rhodri Thompson KC, Zoë Leventhal KC and Florence Iveson (instructed by **Gowling WLG (UK) LLP**) for the **Claimant**
Ben Lask KC, Christopher Brown and Arnold Ayoo (instructed by **CMA Legal Service**) for the **Defendant**
Daniel Cashman and Natasha Simonsen (instructed by GEMA Legal) for 1st Interested Party
Monica Carss-Frisk KC and Sean Butler (instructed by Freshfields LLP) for the 6th Interested Party

Hearing dates: 8th-10th October 2025

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Approved Judgment

This judgment was handed down remotely at 10.30am on 22nd January 2026 by circulation to the parties or their representatives by e-mail and by release to the National Archives.

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MR JUSTICE SHELDON

Mr Justice Sheldon:

1. The Wales &West Utilities Limited ("WWU"), which owns and operates the regional gas distribution network in Wales and the South West of England, appealed to the Competition and Markets Authority ("the CMA") against a price control decision covering the period from 1 April 2021 to 31 March 2026 made by the Gas and Electricity Markets Authority ("GEMA"). GEMA is the statutory regulator for the gas and electricity markets in the United Kingdom. By way of judicial review, WWU challenges the determination of its appeal by the CMA.

2. The issues raised in this case include the correct legal approach to appeals against a price control decision made by GEMA. The regulatory framework for GEMA's approach to price control is known as "RIIO". There are also specific questions as to the lawfulness of a number of decisions made by the CMA when considering WWU's appeal from the decision made by GEMA.

3. The CMA's decision was made on 28 October 2021. Permission to proceed by way of judicial review was initially refused on the papers by Henshaw J on 30 June 2022, and at an oral renewal hearing by Mostyn J on 21 November 2022. In a decision on the papers dated 22 March 2023, Green LJ granted permission to proceed with WWU's application for judicial review on the basis that the application raised issues of general importance and there were issues of public interest to be explored.

I. Factual Background

4. As the statutory regulator for the gas and electricity markets in Great Britain, GEMA issues licences to companies engaged in conveying gas through pipes, such as WWU. GEMA sets price controls periodically by modifying their licence conditions. A price control is generally set for a five year period.

(a) The proceedings before the CMA

5. On 3 March 2021, WWU and the other gas distribution network operators sought permission to appeal the price control decision pursuant to section 23B of the Gas Act 1986, as amended ("the 1986 Act"). On the same date three electricity transmission companies and the national gas transmission company also sought permission to appeal the decision. The only company which did not appeal was the Electricity System Operator.

6. Four grounds of appeal were common to more than one appellant:

(1) The "*cost of equity*" ground, namely that the cost of equity chosen by GEMA was too low and therefore wrong (all appellants, including WWU);
(2) The "*outperformance wedge*" ground, namely that it was wrong for GEMA to apply a reduction to the allowed cost of equity, reflecting its view that companies would be expected to achieve operational outperformance during the price control period (all appellants, including WWU);
(3) The "*ongoing efficiency*" ground, namely that GEMA had erred in its approach to setting ongoing efficiency (i.e. the cost reduction applied by GEMA to account for expected productivity improvements in the energy sector) (five appellants, including WWU); and
(4) The "*licence modification*" process ground (three appellants, including WWU).

7. WWU appealed in respect of other specific aspects of the price control decision on the basis of a further series of alleged errors by GEMA. WWU alleged, among other things, that GEMA had erred in its approach to WWU's cost of debt and in its approach to tax clawback. WWU contended that GEMA had erred and had acted inconsistently in its treatment of derivative debt instruments when measuring the cost of debt and tax clawback, refusing to take account of the use of such instruments by WWU in respect of the cost of debt while taking them into account in respect of tax clawback, in each case to the disadvantage of WWU.

8. On 31 March 2021, the CMA granted permission to appeal to all appellants on all grounds. Oral hearings were held with the parties in May, June and July 2021, and written closing submissions were provided by 23 July 2021. On 11 August 2021, the CMA issued its provisional determination. The parties and the interveners made submissions in response by 3 September 2021. On 28 October 2021, the CMA issued their final decision.

(b) The final determination of the CMA

9. The members of the CMA panel who made this determination were Kirstin Baker, Susan Hankey and David Thomas. In a written determination, the CMA:

(i) found in favour of all appellants (including WWU) that GEMA was wrong to impose the outperformance wedge (Order at §§3-5);

(ii) partially found in favour of WWU (and other appellants) that GEMA was wrong to impose the innovation uplift (Order at §§6-13);

(iii) partially found in favour of Scottish Hydro Electric Transmission Plc ("SSEN-T") and one other appellant that GEMA acted *ultra vires* in the manner in which it sought to use a directions process to modify certain licence conditions (Order at §§14-18), but dismissed WWU's appeal under joined Ground D (Licence modification process) (Order at §19); and

(iv) in all other respects, dismissed WWU's appeal, including on the cost of debt and tax clawback (Order at §29).

10. WWU initially contended that a number of passages within the CMA's determination contained confidential material and it was requested that this material not be included in a judgment that would be open to the public. I raised some of the passages with WWU during the course of the hearing. After the hearing, WWU has written to say that it no longer requests that some of those passages be treated as confidential, although it does not mean that they are accepted as accurate. There is one particular passage, however, where confidentiality is maintained by WWU, but a gist has been proposed: this relates to paragraph 14.212 of the CMA's determination. I accept that the material contained in paragraph 14.212 is confidential to WWU as it refers specifically to financial information and payments made to shareholders. In my judgment, the fundamental objective of open justice is served by using this gist, rather than redacting the entire passage in an open judgment and including the full passage in a closed judgment.

II. Statutory Framework

11. Before setting out in detail the relevant parts of the CMA's determination, it is useful to outline the relevant statutory framework.

12. The key statutory provision that is applicable to this case is the 1986 Act. Section 7 of the 1986 Act empowers GEMA to issue licences to companies engaged in conveying gas through pipes. GEMA sets price controls periodically by modifying licence conditions (under section 23 of the 1986 Act).

13. Section 4AA of the 1986 Act sets out the principal objective and general duties of the Secretary of State and GEMA (referred to in the text as "the Authority") as follows:

> (1) The principal objective of the Secretary of State and the Gas and Electricity Markets Authority (in this Act referred to as "the Authority") in carrying out their respective functions under this Part is to protect the interests of existing and future consumers in relation to gas conveyed through pipes.
>
> (1A) Those interests of existing and future consumers are their interests taken as a whole, including - . . .
>
> (b) their interests in the security of the supply of gas to them
>
> . . .
>
> (1B) The Secretary of State and the Authority shall carry out their respective functions under this Part in the manner which the Secretary of State or the Authority (as the case may be) 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 shipping, transportation or supply of gas conveyed through pipes.
>
> . . .
>
> (2) In performing the duties under subsections (1B) . . . the Secretary of State or the Authority shall have regard to -
>
> (a) the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
>
> (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part [and various other statutory provisions]; and
>
> (c) the need to contribute to the achievement of sustainable development.
>
> . . .
>
> (5) Subject to [*not material*] the Secretary of State and the Authority shall carry out their respective functions under this Part in the manner which he or it considers is best calculated -

> (a) to promote efficiency and economy on the part of persons authorised by licences or exemptions to carry on any activity, and the efficient use of gas conveyed through pipes;
>
> (b) to protect the public from dangers arising from the conveyance of gas through pipes or from the use of gas conveyed through pipes . . . ; and
>
> (c) to secure a diverse and viable long-term energy supply,
>
> and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the conveyance of gas through pipes . . .

14. Section 4AB of the 1986 Act requires the Secretary of State to issue guidance on social and environmental matters, and obliges GEMA to have regard to any such guidance. Section 4A is concerned with health and safety matters, and obliges the Secretary of State and GEMA to take into account advice given by the Health and Safety Executive with respect to any gas safety issue.

15. Section 23B of the 1986 Act contains provisions relating to appeals to the CMA. This was inserted by the Electricity and Gas (Internal Markets) Regulations 2011/2704 ("the 2011 Regulations"), and amended by Schedule 6 to the Enterprise and Regulatory Reform Act 2013. It provides as follows:

> (1) An appeal lies to the CMA against a decision by the Authority to proceed with the modification of a condition of a licence under section 23.
>
> (2) An appeal may be brought under this section only by –
>
> (a) a relevant licence holder (within the meaning of section 23); . . .
>
> (3) The permission of the CMA is required for the bringing of an appeal under this section.

16. The procedures relating to appeals to the CMA are set out in Schedule 4A: see section 23C of the 1986 Act. Relevant features include that:

    (1) The appeal is heard by three members of the "CMA panel" (paragraph 4(2)) which is comprised of individuals appointed for their expertise in (broadly) competition economics, law, finance, and business (see paragraph 35 of Schedule 4 to the Enterprise and Regulatory Reform Act 2013).

    (2) The CMA may require the production of documents and information (paragraph 6), and may also require oral evidence and cross-examination (paragraphs 7(2) and (4)).

(3) The CMA may commission expert advice on any matter a party raises (paragraph 9).

17. Section 23D of the 1986 Act provides for the determination by the CMA of an appeal:

(1) This section applies to every appeal brought under section 23B.

(2) In determining an appeal the CMA must have regard, to the same extent as is required of the Authority, to the matters to which the Authority must have regard—

(a) in the carrying out of its principal objective under section 4AA;

(b) in the performance of its duties under that section; and

(c) in the performance of its duties under sections 4AB and 4A.

(3) In determining the appeal the CMA -

(a) may have regard to any matter to which the Authority was not able to have regard in relation to the decision which is the subject of the appeal; but

(b) must not, in the exercise of that power, have regard to any matter to which the Authority would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so.

(4) The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—

(a) that the Authority failed properly to have regard to any matter mentioned in subsection (2);

(b) that the Authority failed to give the appropriate weight to any matter mentioned in subsection (2);

(c) that the decision was based, wholly or partly, on an error of fact;

(d) that the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 23(7)(b);

(e) that the decision was wrong in law.

(5) To the extent that the CMA does not allow the appeal, it must confirm the decision appealed against.

18. Where an appeal is allowed, the CMA's powers are set out at section 23E of the 1986 Act. With respect to a "price control decision", defined (at subsection (7)) as "a 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", section 23E(2) provides that the CMA 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 the Authority for reconsideration and determination in accordance with any directions given by the CMA;
>
> (c) substitute the CMA's decision for that of the Authority (to the extent that the appeal is allowed) and give any directions to the Authority or any other party to the appeal.

For other appeals, the CMA has the powers under subsections 23E(2)(a) and (b), but not (c).

19. Section 23F of the 1986 Act provides for time limits for the CMA to determine an appeal. For a price control decision, the appeal must be determined within a "period of 6 months beginning with the permission date" (subsection (1)(a)), and within 4 months for any other decision (subsection (1)(b)). These time limits can be extended to 7 months and 5 months respectively, where the parties make representations to that end.

III. The CMA Decision

20. The CMA's decision was lengthy. To understand the various grounds of challenge, it is necessary to set out substantial extracts from that decision.

21. As part of the decision, the CMA gave a description of the energy sector, setting out recent developments and upcoming challenges, some details about the parties to the appeal, as well as some background on relevant regulatory issues.

> 2.58 At the point of privatisation, a new form of price control regulation was developed and implemented in the UK. This was known as RPI-X and was designed to incentivise improvements in efficiency, particularly as the networks were seen as being inefficient with high operating costs and spare capacity.
>
> 2.59 Under RPI-X the regulator limits average network charges from rising at the rate of inflation (measured by the retail price index, or **RPI**) less an efficiency factor (called 'X'). Since price limits are set before expenditure has been incurred by companies, RPI-X is a form of ex-ante regulation. Once price caps are set, companies face incentives to reduce expenditure as much as possible to maximise their profits. In doing so, they reveal the potential for efficiency gains to the regulator. The regulator periodically resets the caps, and 'squeezes out the remaining efficiency potential' by increasing the X factor and reducing prices.
>
> 2.60 While RPI-X was generally considered to have worked well initially, some potential issues arose, particularly around the incentives

to reduce customer service (in order to reduce costs), limited levels of innovation, and a bias towards capital expenditure in order for companies to expand their asset bases.

2.61 In 2008, GEMA decided to review its approach to setting price controls, in particular to try and address some of the issues it saw arising from RPI-X. This resulted in the creation of the 'RIIO' framework (where RIIO stands for: Revenues = Incentives + Innovation + Outputs). This aims to build on the previous RPI-X regime, but places more emphasis on incentives to drive the outputs and innovation needed to deliver a sustainable energy system in a way that provides value for money to existing and future consumers. GEMA's first RIIO price control (**RIIO-1**) ran from 1 April 2013 to 31 March 2021 for the gas transmission and distribution networks as well as the electricity transmission networks.

2.62 The latest iteration of GEMA's updated regulatory framework (RIIO-2) is the price control that is subject to this appeal. When needing to differentiate between the controls for different sectors these are often referred to as RIIO-GT2 (for the gas transmission network), RIIO-GD2 (for the gas distribution networks), and RIIO-ET2 (for the electricity transmission networks).

Structure of RIIO and components of allowed revenue

2.63 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. GEMA explained the total allowed revenue as comprising:

(a) the baseline revenue;

(b) mechanisms that adjust this revenue during the price control period relative to company performance, eg rewards and penalties to specific incentives; and

(c) other adjustments to baseline revenue, eg due to uncertainty mechanisms that increase or reduce allowances within the price control period.

2.64 Baseline revenue is the revenue that a 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.

2.65 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**), an element 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 the company.

(d) Tax.

2.66 RIIO adopts a totex approach to ensure companies make balanced decisions between different types of solution. Totex includes capital expenditure (**capex**), operating expenditure (**opex**), and replacement expenditure (**repex**). 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, which is subsequently depreciated. The expenditure funded by slow money may be thought of as akin to capital expenditure.

…

2.72 In order to better balance these requirements, GEMA made a number of changes from RIIO-1, in particular:

(a) **Length of the price control:** Reduced from 8 years in RIIO-1 to 5 years for RIIO-2;

(b) **Price control deliverables (PCDs):** Baseline funding linked to delivery of outputs, so consumers are refunded if the work is not needed or not carried out;

(c) **Output delivery incentives (ODIs):** Calibrated to reward companies for going beyond business as usual (**BAU**), and focused on areas which are under the company's control;

(d) **Baseline funding vs uncertainty mechanisms:** Increased proportion of costs expected to be funded through uncertainty mechanisms to allow for more flexibility as both needs and costs become clearer over time;

> (e) **Increased efficiency challenge:** Ongoing efficiency challenge set at 1.2% pa (vs 0.8% pa in RIIO-1), and catch-up efficiency set to rise to 85th percentile in later years of the price control (vs 75th percentile throughout RIIO-1);
>
> (f) **Confidence-dependent totex cost sharing factors:** Lower totex cost sharing factors (incentive rates) compared to RIIO-1 to more closely align with GEMA's level of confidence in its cost benchmarks;
>
> (g) **Indexation:** Use of indexation for elements of input prices and financial metrics;
>
> (h) **Cost of equity and allowed returns:** Reduced cost of equity allowance vs RIIO-1 (from around 7.8% to 4.55%), and introduction of an 'outperformance wedge' of 25 Basis Points (**bps**);104 and
>
> (i) **Return adjustment mechanisms:** Implementation of a symmetrical return adjustment mechanism if return on equity is significantly above or below the expected value.

22. At paragraph 2.73, the CMA set out the key financial information for the gas transmission network, gas distribution networks and the electricity transmission operators in RIIO-2.

23. At paragraphs 2.79-2.84, reference was made to the CMA's re-determination of the PR19 price controls applying to water and wastewater suppliers in England and Wales for the period 2020 to 2025. It was explained that the parties were able to make submissions with respect to that re-determination for the purposes of the CMA's consideration of the appeals from GEMA's decision.

24. The CMA described the "Test on appeal" in paragraphs 3.20 to 3.54. Under the heading "Standard of review", the CMA set out the key parts of the statutory scheme. The CMA went on to explain:

> 3.23 This is the second time that an appeal has been brought under section 11C of EA89. In the appeals of the RIIO-1 price control decision (ED1 Determinations) the CMA published its conclusions on the standard of review in its two decisions of 29 September 2015. Neither decision was challenged by any party in the **ED1 Determinations**, and the applicable legislation remains unchanged. We have therefore applied the standard of review employed in the ED1 Determinations in the current appeals.
>
> 3.24 Furthermore, in considering the submissions we have received on the statutory framework in the course of these appeals, we have also drawn on the approach taken in other regulatory appeals involving substantially the same statutory framework, where relevant. Notably, as

in the ED1 Determinations, we have had regard to cases under the Energy Act 2004 (**EA04**) on the basis that the grounds for allowing an appeal under EA04 are very similar to the grounds for allowing an appeal under EA89 and GA86. 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. We have also taken guidance from the approaches taken in more recent appeals brought under the Gas (Northern Ireland) Order 1996 and the Electricity (Northern Ireland) Order 1992, given that the statutory grounds for allowing an appeal are essentially the same as the grounds for allowing an appeal under EA89 and GA86. Although we are not bound by these decisions, which concern a different statutory appeal mechanism under a different legislative scheme, we consider that they are instructive for the approach which the CMA should take in the present appeals.

3.25 Similarly, we have also drawn 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.

3.26 Both ED1 Determinations concluded that the CMA's role was not limited to reviewing the decision on traditional judicial review grounds and that the CMA is not only able, but required by EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute. In this context, the appeals took note of the fact 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 approach in relation to code modifications to be helpful in this regard.

3.27 In the ED1 Determinations, the CMA found that a useful analogy could be drawn between the appeal on the basis of EA89 and the approach taken by the CAT in the context of appeals against Ofcom price controls in the telecommunications sector. In *BT v Ofcom*, the CAT stated that:

> [b]y section 192(6) of the 2003 Act and rule 8(4)(b) of the 2003 Tribunal Rules, the notice of appeal must set out specifically where it is contended OFCOM went wrong, identifying errors of fact, errors of law and/or the wrong exercise of discretion. The evidence adduced will, obviously, go to support these contentions. What 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. Where no errors are pleaded, the decision to that extent will not be the subject of specific review. What is intended is an appeal on specific points.

3.28 We agree with and adopt the CMA's position outlined in the ED1 Determinations, where the CMA decided that an appeal under EA89 does not involve a rehearing where it is open to it to decide matters afresh untrammelled by GEMA's decision. Furthermore, we also agree with the ED1 Determinations that consideration of the merits of the decision under appeal must be within the confines of the specific grounds of appeal laid down in the statute.

3.29 We note that the CAT confirmed this approach in two recent cases brought under CA03:

(a) In *Virgin Media Limited v Ofcom (Virgin Media)*, the CAT stated that

> … the focus is Ofcom's decision and whether Ofcom got their decision materially wrong. It is that decision that is being challenged. The question is not what decision the appellate body might itself have reached if it had started afresh.

(b) In *TalkTalk Telecom and Vodafone Limited v Ofcom*, the CAT cited *Hutchison 3G UK* and *BT v. Ofcom* when discussing the new standard of review for cases brought under CA03:

> [Ofcom's] Decision is the centre point of the challenge and must be the target of any challenge; there is no blank canvas upon which the parties can paint a new picture which fails to heed the reasoning in the decision under challenge.

3.30 In the present case, whilst there was common ground between the appellants and GEMA as to the fact that the CMA's role is not limited to reviewing the Decision on traditional judicial review grounds, there was some disagreement on the extent of the merits review:

> (a) WWU argued that 'the CMA … is to assume Ofgem's role, re-consider the case as if it were the primary decision-maker, and reach its own expert judgment as to what constitutes "proper" regard or "appropriate weight" in respect of any matter'.

> (b) GEMA took issue with this position, describing the standard of review as being 'more intense than the approach taken by the courts in an application for judicial review, but fall[ing] short of a full rehearing or appeal on the merits. The CMA will take into account the merits of GEMA's decision, but the question for the CMA will be whether GEMA's decision was wrong on one of the statutory grounds and not whether the CMA would have made the same decision as GEMA, had it been in the regulator's position'.

3.31 In line with the CMA's position outlined in the ED1 Determinations, we reject WWU's submission that we should 're-consider the case as if [we] were the primary decision-maker' and agree with GEMA's submission that the standard of review falls short of a full rehearing. We are required to consider the merits of the Decision but only through the prism of the specific errors alleged by the appellants. The appeals do not entitle the CMA to proceed with a re-run of the original investigation or have a de novo re-hearing of all the evidence. The key question is whether GEMA made a decision that was wrong (on one of the prescribed statutory grounds). Only to that extent must the merits of the Decision be taken into account and we have done so in the present appeals.

3.32 Our final determination in this appeal reflects the application of a standard of review that is in line with the approach set out above. We consider that this approach is consistent with the approach taken by the CMA in the ED1 Determinations and the more recent decisions in appeals against decisions by the Northern Ireland Authority for Utility Regulation, as well as the CC in Energy Code appeals, and by the courts in relation to appeals under CA03. It also reflects the government's intention in implementing the relevant appeal provisions.

25. The CMA explained "The meaning of 'wrong'" as set out in the statutory scheme.:

3.34 On the point of deciding errors of fact, 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. Once the appellant has shown a real prospect (justifying permission to appeal) that a finding or inference is wrong, the role of an appellate court is to determine whether or not this is so, giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the claimantschallenge, while (b) reminding ourselves that, so far as the appeal raises issues of judgment on

> unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge's conclusion lay outside the bounds within which reasonable disagreement is possible. In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence.

3.35 Both ED1 Determinations were based on the reasoning in *Assicurazioni* and also referred to the CC's approach in the energy code modification appeal of *E.ON UK plc v GEMA* ***(E.ON)*****,** which we discuss below. While the CMA recognised that it was not bound by the decision in *E.ON* (which concerned a different statutory appeal mechanism under a different legislative scheme), it considered that the *E.ON* decision accurately characterised the approach which the CMA should take in the RIIO-1 appeals.

3.36 In the decision of *SONI Limited v Northern Ireland Authority for Utility Regulation* (***SONI***), having referred to *Assicurazioni*, the CMA concluded that:

> when applying the five statutory tests… 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.

3.37 In the present appeals, the parties made submissions on what 'wrong' means, variously arguing that the Decision may be wrong if:

> (a) there are better alternatives;
>
> (b) there are flaws in GEMA's assessment of the evidence;
>
> (c) there are flaws in GEMA's reasoning; and/or (d) there were procedural deficiencies in the process that led to the adoption of the Decision.

3.38 We consider each of these issues below.

Alternative approaches

3.39 In the present appeals, GEMA submitted 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 it should have started from a different place…

3.40 Consistent with the ED1 Determinations, we note and adopt the finding made in *E.ON* and various other more recent cases that our starting point should not be to determine whether there is an alternative approach and then decide whether it is better. We should only determine whether there is an error in the approach chosen by GEMA, as alleged by the appellants.

3.41 In *SONI* (an appeal under The Electricity (Northern Ireland) Order 1992) the CMA also adopted this position, stating that:

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

3.42 In their response to the provisional determination, NGET/NGG submitted that the CMA should have considered the appellants' alternative approaches **alongside** the GEMA's approach and evaluated the relative merit of the different approaches to determine whether GEMA's approach was wrong. Similarly, Cadent submitted in its reply to GEMA's Response that: '[w]here an alternative approach would have been clearly better, GEMA's decision is wrong.'

3.43 As noted at paragraph 3.40 above, our starting point will be to consider the adequacy of GEMA's chosen approach rather than considering which approach we ourselves might have chosen had we been in GEMA's position. However, we agree that, 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 appellants. If, out of the alternatives available, we conclude that some alternatives clearly had greater merit than the solution chosen by GEMA, then we are more likely to be persuaded that GEMA has erred. On the other hand, where the alternative options each have competing pros and cons, and none is clearly superior, it will be more difficult to persuade us that GEMA has erred.

GEMA's assessment of the evidence

3.44 In the present appeals, NGN submitted 'that a number of GEMA's decisions are extreme and not supported by a reasonable consideration of the evidence' and that GEMA is required to '[take] into account all relevant evidence, [give] it appropriate weight and [adopt] a decision which is consistent with such weighing of evidence.'

3.45 SSEN-T submitted that the CMA should find an error if 'GEMA has not taken account of relevant evidence or data, and placed weight on unreliable data'.

3.46 In *Northern Powergrid*, the CMA overturned GEMA's decision to impose a cost adjustment relating to Smart Grid Benefits (**SGB**) on the basis that:

> [N]either the evidence nor the reasons put forward by GEMA … support GEMA's decision to make a specific … adjustment. In the absence of evidential support for the judgement, GEMA's discretion cannot … be treated as sufficient to justify the adjustment … that it made.

3.47 We thus agree with the appellants that we may find an error if the Decision is based on unreliable data or fails to take account of the relevant evidence.

GEMA's reasoning

3.48 In the present appeals, SGN argued that 'GEMA acts unlawfully where its decision is unreasonable…' and that 'A decision can be unreasonable … where there is a demonstrable flaw in the reasoning'.

3.49 GEMA argued in relation to cost of equity, aiming up and sufficiency of return that 'it is not enough for an appellant to identify some error or absence of reasoning, since an appeal can only succeed if the decision itself cannot stand.'

3.50 In *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation (**Firmus**)*, the CMA found that:

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

3.51 In line with *Firmus*, we agree with GEMA that the fact that its reasoning underpinning its Decision is wrong does not mean that the Decision itself will necessarily be wrong if it can be supported on a basis other than that on which GEMA relied.

Procedural deficiencies

3.52 In the present appeals, several appellants invited us to take into account procedural deficiencies in GEMA's decision-making process when determining whether its Decision was wrong. In particular:

> (a) NGET and NGG submitted that 'in assessing errors of law, the CMA will consider whether GEMA has made any procedural errors ... For example, whether GEMA has conducted the consultation prior to the decision with an open mind and taken account of representations by interested parties.'
>
> (b) NGN argued that 'the well-established error of law based on procedural unfairness will arise if: the decision-maker has not properly observed the relevant statutory procedures, such as a failure to consult or to give reasons…'
>
> (c) SGN contended that 'the phrase 'wrong in law' includes the public law concept of procedural unfairness/breach of natural justice … [and] that this requires GEMA, when making price control decisions, to conduct consultations prior to such decisions with an open mind, allow interested parties to make representations, and to provide clear reasons for its decision.'
>
> (d) SSEN-T argued that '…a failure of process that is sufficient to undermine the substance of GEMA's decision … will render that decision wrong in law.'

3.53 In *Firmus*, the CMA found that:

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

3.54 Consistent with *Firmus*, our analysis should only take into account procedural deficiencies (including a flawed consultation process) if they are so serious that we cannot be assured that the Decision was not wrong.

26. The CMA discussed "GEMA's margin of appreciation" in paragraphs 3.55 to 3.79.

3.55 The margin of appreciation afforded to GEMA in matters of regulatory judgement is important to bear in mind in reaching a finding as to whether a decision is 'wrong', as recognised by the CMA and courts in previous regulatory appeals.3.56 In the present appeals, we were invited by GEMA to find that:

> (a) 'where the alleged error lies in the judgement GEMA has made about an unchallenged primary fact or inference, provided GEMA has not made an error of law, the CMA should not substitute its own judgement simply because it would have taken a different view had it been in the position of the regulator. In other words, there is a field of possible judgements in which GEMA may exercise its regulatory discretion lawfully, and

> reasonable people may disagree about the judgement which is ultimately made.'
>
> (b) 'As to uncertainty, where a regulator is making decisions that address present and future uncertainties, the regulator enjoys a greater margin of appreciation.'
>
> (c) 'Many decisions taken by regulators involve judgement and an estimation of what might happen in an uncertain context, and the CMA is not expected to impose its own judgement in place of that of the sector regulator provided that the regulator's response is reasonable.'

3.57 Most of the appellants took issue with the way GEMA described its regulatory discretion in its submission. They submitted that GEMA had overstated the extent of its margin of appreciation.

3.58 Cadent argued that:

> GEMA repeatedly falls into the error of overstating the limits of its discretion by asserting that its approach meets the baseline standard of rationality … This is not the standard of review applicable in the present case, which goes further and is concerned directly with the merits of GEMA's decision. Where an alternative approach would have been clearly better, GEMA's decision is wrong. It is not necessary for Cadent to show that GEMA acted outside the bounds of reasonableness; that is the test for judicial review (Wednesbury unreasonableness). A merits review will quite rightly hold GEMA's decisions to a higher standard.

3.59 Further, Cadent contended that it was not correct for GEMA to say that '[T]he question before the CMA … is whether GEMA's decision "lay outside the bounds within which reasonable disagreement is possible"' and that '… the standard of review in relation to matters of judgement is not limited to Wednesbury unreasonableness'.

3.60 NGET/NGG said that GEMA had 'taken the point on regulatory discretion and judgement too far' and that 'there is no principle that an appeal must fail if it relates to a judgement on which "reasonable people may disagree".'

3.61 Similarly, SGN maintained that 'GEMA seeks to distort and subvert the relevant legal framework by replacing the applicable statutory test, which entails considering whether GEMA's decision is wrong on one of the grounds set out in section 23D(4) GA86, with an alternative test, which entails considering whether the Decision fell outside reasonable bounds…a decision may be "wrong" even if it is not "unreasonable".'

3.62 Quoting the CMA's decision in *Northern Powergrid*, NGN submitted that 'there has to be … a limit to the discretion of regulators to make adjustments' and ultimately '[t]he exercise of regulatory discretion remains bounded and subject to legal principles.' NGN also argued that 'GEMA's margin of discretion does not allow GEMA to take decisions based on extremely selective, inconsistent and/or inadequate evidence and assumptions.'

3.63 SSEN-T argued that 'GEMA's attempt to hide behind discretion betrays a lack of confidence in the substance of its decisions and must be rejected.'

3.64 SPT submitted that 'Whilst of course it is true that GEMA is to be allowed some margin of appreciation as an "expert regulator", this does not give GEMA carte blanche. It must not be allowed to denude the CMA of its own expert regulatory function.'

General principles

3.65 The CMA's starting point when considering an appeal is as set out in *SONI*, where the CMA considered that:

> … the test is not whether the decision under appeal was 'unreasonable'. 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.

3.66 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.'

3.67 We consider that these dicta in *SONI* and *Virgin Media* are equally apposite for the margin of appreciation afforded to GEMA in the present context.

3.68 In essence, while we agree that GEMA should be afforded a margin of appreciation as an expert regulator, we also agree with the appellants that its margin of appreciation is not unbounded. As explained below, we consider that the approach we should take is different depending on whether the appellants are alleging an error of primary fact (or inferences from such primary facts) or an error of law, or whether they are alleging that GEMA's weighting of factors or other exercise of judgement is wrong.

Errors of primary fact and errors of law

3.69 In *E.ON*, in relation to an appeal under EA04, the CC found in relation to errors of fact that:

> 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.

3.70 As regards errors of law, 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.'

3.71 In the present appeals, GEMA itself recognised 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.'

3.72 Thus, if we find that the Decision is based on a plain error of fact or is wrong in law, there is no room for a margin of appreciation.

Regulatory judgement

3.73 In *E.ON*, the CC considered the appellate body's function. The CC noted that the appellate body will exercise a degree of restraint when considering matters of regulatory judgement:

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

3.74 The CC further took the view that the statutory test under section 175 of EA04:

> …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.

3.75 In *BT v Ofcom* the Court of Appeal considered the CAT's approach to its jurisdiction to review Ofcom's exercise of judgement. While that appeal concerned a different statutory scheme, the court confirmed the general principle underlying the approach, saying:

> Whether or not it is helpful to encapsulate the appropriate approach in the proposition that Ofcom enjoys a margin of appreciation on issues which entail the exercise of its judgment, the fact is that the Tribunal should apply appropriate restraint and should not interfere with Ofcom's exercise of a judgment unless satisfied that it was wrong.

3.76 In line with *E.ON* and *BT v Ofcom*, we find that where the exercise of regulatory judgement is involved, GEMA will have a margin of appreciation. 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. We will apply appropriate restraint and, in principle, not question issues of judgement on unchallenged primary findings and inferences determined by GEMA unless we are satisfied that GEMA's decision is wrong.

3.77 Similarly, where GEMA has exercised regulatory judgement in selecting amongst various alternative solutions to a regulatory problem, we will not substitute GEMA's assessment or weighting of the evidence or reasoning with our own unless we are satisfied that GEMA's approach was wrong – for example, because there was a clearly superior alternative approach (see discussion at paragraph 3.42 above). In their responses to the CMA's provisional determination, a number of the appellants argued that the CMA had shown undue deference to GEMA's expertise in economic matters, which they contended was unwarranted. SSEN-T noted that the CMA considered issues relevant to the Capital Asset Pricing Model (**CAPM**) and cost of equity across a range of regulated sectors and that, by contrast, GEMA's experience was confined to the energy sector. It went on to contend that we should therefore show no deference to GEMA's decision-making on these points.

3.78 We accept that the CMA is itself an expert body, in particular in relation to CAPM and cost of equity, and that it benefits from cross-sector experience. We also agree that we must not uncritically accept GEMA's assessment and weighting of the considerations before it simply because GEMA is an expert body. However, we do not accept that these points mean GEMA has no margin of appreciation when these matters are appealed to us. Nor do we accept that allowing GEMA a margin of appreciation equates to the adoption of a judicial review standard. We note that even in a full merits appeal of an infringement decision imposing quasi-criminal penalties under the Competition Act 1998, it can be consistent with such an appeal to allow the decision-maker a margin of appreciation. 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 GEMA has erred.

3.79 We note that in their replies WWU, NGET/NGG, and Cadent all objected to GEMA including the following quote from the *Cellcom* case: 'the court should be very slow to impugn decisions of fact made by an expert and experienced decision-maker, it must surely be even slower to impugn his educated prophesies and predictions for the future.' The appellants noted that these observations were made in the context of judicial review proceedings and so are not applicable in the present appeals. While we agree with the appellants that *Cellcom* is a judicial review case, as explained above, we will apply appropriate restraint when reviewing issues which entail the exercise of GEMA's judgement, which may include GEMA's predictions for the future.

27. The CMA discussed precedents in a couple of paragraphs:

> 3.87 Past decisions taken by the CMA in other regulatory appeals are not binding. This means that we are not required to adopt an identical approach to determining the issues, nor to ensure that our decision in the present appeals mirrors assessments made and conclusions reached by the CMA in other regulatory appeals. While the CMA may have regard to such past decisions in considering the present appeals, it will also take into account the fact that other regulatory appeals may be subject to different statutory regimes and relate to different sectors.
>
> 3.88 For example, the CMA may decline to adopt an approach taken in the recent CMA PR19 Redetermination which was a full redetermination of the PR19 price control by the CMA. By contrast, our role in these appeals is limited to finding whether GEMA was wrong on any of the specific grounds raised by the appellants. As indicated above (see paragraph 3.22), the appeals do not entitle the CMA to proceed with a re-run of the original investigation or have a de novo re-hearing of all the evidence.

28. At paragraphs 3.89-3.96, the CMA discussed the issue of "Materiality". It concluded at paragraph 3.97 that in the present appeals it had considered whether "the cumulative effect of immaterial errors could have a highly significant impact on the price control".
29. At paragraph 3.98-3.99, the CMA identified its powers on determination of the appeals.

30. With respect to the individual grounds of appeal brought by WWU, these are contained in Volume 3 of the CMA's determination. The Cost of Debt consideration runs to more than seventy pages. The Tax Clawback consideration runs to more than thirty pages.

31. With respect to the Cost of Debt appeal, the CMA said as follows:

> 14.1 This ground covers errors alleged by WWU relating to GEMA's cost of debt allowance within the RIIO-2 price control.
>
> **Background**
>
> 14.2 The cost of debt component of the WACC estimate reflects the return required to compensate debt investors for lending to a business. Unlike the forward-looking cost of equity, the majority of debt costs are accounted for by interest costs on historic (embedded) debt already held by businesses.
>
> 14.3 Elements of WWU's appeal involve GEMA's treatment of derivative debt instruments when measuring the cost of debt. For further background on such instruments, please see paragraphs 16.6 to 16.8 below.
>
> **The RIIO-2 Decision**
>
> 14.4 GEMA based its cost of debt allowance on an average of the yield on the iBoxx GBP 10yr+ Utilities index. Under this approach,

> companies receive an allowance based on the 10-year average of this index at the start of the control, with the average used increasing by a year throughout each year of the control, so that in the final year companies receive a 14-year average of the index.
>
> 14.5 In changing from the mix of A and BBB indices used in previous controls, GEMA stated that it considered that broadly matching the average borrowing costs of networks, by using an investment grade index that was expected to be more representative of network borrowing costs, was more important than precisely matching a theoretical notional company rating.
>
> 14.6 GEMA noted evidence that indicated that the average rating of the constituents of the Utilities index had fallen over time and suggested that would be prudent to monitor the average rating over time before reassessing the approach for RIIO-3.
>
> 14.7 GEMA tested its chosen approach against a range of rate and inflation scenarios and was comfortable that its 10 to 14 year trailing average approach was an appropriate calibration.
>
> 14.8 GEMA allowed 0.25% for additional costs of borrowing (outside of explicit interest costs). This allowance comprised:
>
> (a) Transaction costs of 6 Basis Points (**bps**);
>
> (b) Liquidity/Revolving Credit Facility costs of 4 bps;
>
> (c) Cost of carry of 10 bps; and
>
> (d) Additional CPIH-linked debt costs of 5 bps.
>
> 14.9 GEMA noted that it remained of the view that it was appropriate to exclude intercompany loans and derivatives from its calibration exercises. However, it also noted that its modelling suggested that if both these products were included in modelled expected costs for the Gas Distribution and Transmission (**GD&T)** companies, the 10 to 14-year trailing average plus 25 bps of additional allowance (GEMA's RIIO-2 cost of debt approach) would be expected to be sufficient to cover the combined expected GD&T company debt and derivative costs.

32. Under the heading "Additional allowance for exceptional company circumstances", the CMA said that:

> 14.11 GEMA assessed SSEN-T's Regulatory Asset value (**RAV**) growth profile over the RIIO-1 and RIIO-2 period as materially different from other networks, justifying a RAV-weighted approach to its debt allowance.
>
> 14.12 GEMA noted that SGN Scotland and NGN had provided estimates of the additional costs faced by smaller networks as being 6 bps. GEMA considered this estimate to be reasonable and decided to 'err on the conservative side' in allowing this additional provision for notional licensees expected to issue debt at smaller size or less frequently than

other networks due to their lower RAV size and RAV growth for RIIO-2. GEMA defined less frequently issuing notional networks as those that are expected to issue less than £150 million per annum on average, namely SGN Scotland, NGN and WWU.

14.13 GEMA considered these adjustments for RAV profile differences to be appropriate for notional company allowances because RAV was not solely determined by management decisions and was heavily influenced by regulatory decisions and regulatory requirements for investment. GEMA distinguished these notional company adjustments from other requests for actual company-specific adjustments (for example, from WWU for actual company debt costs), which were to a much greater extent driven by management or shareholder decisions on capital structure, M&A activity, dividend policies, and type and timing of debt.

33. The CMA described the ground of appeal at paragraphs 14.14-14.15.

14.14 WWU submitted that GEMA had erred in both law and policy in that it had failed to provide an adequate cost of debt allowance for WWU. WWU submitted that GEMA had misdirected itself in law and failed to give effect to its financing duty, and, as a result, had determined an allowance for all GDNs [*ie. Gas distribution networks*] based on an average of the actual cost of debt of a group of companies in circumstances where the effect of that approach was to over-remunerate some companies while penalising others. WWU submitted that GEMA's approach discriminated against WWU. WWU submitted that, in addition, GEMA had adopted an irrational and inconsistent policy of not taking account of derivatives in assessing the cost of debt.

14.15 WWU divided its appeal on this ground into three main sections, relating to alleged errors stemming from:

(a) GEMA's misinterpretation of its statutory duties;

(b) GEMA's irrational design of a cost of debt index; and

(c) GEMA's irrational failure to take account of derivatives.

14.16 In the paragraphs below we briefly describe GEMA's approach in RIIO-2, summarise the evidence that has been presented to us and present our assessment of whether GEMA's cost of debt allowance for WWU was wrong.

34. Having set out the submissions from the parties, the interveners, and third parties who had been invited by the CMA to make representations to assist them, on GEMA's misinterpretation of statutory duties, the CMA set out its assessment and conclusions as follows:

14.73 WWU's case is that GEMA has a statutory duty to secure the actual financeability of any particular licence-holder. It contends that this duty is embedded in GEMA's principal objective.

14.74 For the reasons given below, we do not accept WWU's submission that the duty to have regard to financeability requires GEMA to secure the actual financeability of particular licence-holders.

14.75 In our assessment, we consider first the structure of section 4AA GA86 before analysing the nature of the financeability duty itself.

14.76 When looking at the wording of section 4AA:

(a) The Principal Objective is clearly set out in subsection (1) as being '… to protect the interests of existing and future consumers in relation to gas conveyed through pipes'.

(b) Subsection (1A) sets out certain specific interests to be included in the definition of 'interests of existing and future consumers'.

(c) Subsection (1B) introduces an element of discretion on GEMA's part in exercising its functions, in that it shall do so '… in the manner which the Secretary of State or the Authority (as the case may be) considers is best calculated to further the principal objective …', factoring in the need to promote effective competition 'wherever appropriate'.

(d) Subsection (1C) directs GEMA to consider certain factors when deciding how to carry out its functions under Part 1 GA86 (also with a view to promoting competition).

(e) Subsection (2) refers to the duties under (1B) and (1C) and directs GEMA, in performing those duties, to have regard to the need to secure that reasonable demands for gas are met and the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under (inter alia) the GA86 itself.

(f) Subsection (3) refers to the duties under subsections (1B), (1C) and (2), and directs GEMA, in performing those duties, to have regard to the interests of a range of consumers.

(g) Subsection (4) confers on GEMA the discretion, in carrying out its functions, to have regard to the interests of other utility consumers.

(h) Subsection (5), which is explicitly subject to subsections (1B) and (2), directs GEMA to perform its functions in the manner best calculated to promote efficiency on the part of (inter alia) licence-holders and protect the public from danger.

14.77 It seems clear that the financeability duty does not have the same status as the Principal Objective in subsection (1). In our view, this is not so much because of the positioning of subsection (2) following the amendments made to the GA86 by the Utilities Act 2000, but rather because of its wording.

14.78 Subsection (2) contains matters to which GEMA must have regard in carrying out its functions in furtherance of the Principal Objective. Unlike the Principal Objective, however, the duty is to ‘have regard’.

14.79 We note that WWU focused on the words ‘need to secure’ in subsection (2)(b) and sought to minimise the effect of the words ‘have regard to’. We do not agree that that is the correct focus. The words ‘have regard to’ are contained in the main body of subsection (2) and describe the nature of the obligation on GEMA to consider the needs described in (2)(a) and (2)(b). Subsection (2)(b) does not say, either expressly or by necessary implication, that GEMA has a duty to secure the actual financeability of any particular licence-holder.

14.80 We therefore accept GEMA’s submission (see paragraph 14.44(a) above) that a duty to ‘have regard’ is not a duty slavishly to follow and that the statutory wording does not impose an obligation of result. We do not accept WWU’s argument that the words ‘need to secure’ in section 4AA(2)(b) lead to a different conclusion.

14.81 Contrary to WWU’s submissions, we consider that the use of a notional company approach does properly have regard to the need to secure that licensees are able to finance their activities, bearing always in mind GEMA’s principal objective of protecting the consumer interest. In short, we agree with GEMA that it creates strong incentives on the part of licensees to manage company debt prudently and efficiently. GEMA explained its thinking on the placement of risk as being:

> ‘…allowing for a pass through for each individual network’s debt costs subject to an efficiency check would expose each network’s customers to that network’s decisions on debt type, tenor, timing and risk management. We consider it more appropriate that a network company’s shareholders are instead exposed to these risks, in common with corporates in the broader market.’

14.82 As Ofwat explained (see 14.72 above), a notional company approach incentivises companies to secure efficient costs of finance and protects customers from the risks of companies’ financing decisions; the notional approach reflects the principle that companies and their investors are best placed to bear the risks associated with their borrowing choices. It is therefore unsurprising that the notional company approach has been used in a variety of regulatory contexts.

14.83 We asked WWU in its hearing to reconcile the elements of its case set out at paragraphs 14.20(a) and 14.24(a) above (that GEMA is not required to indemnify licence holders but that its financeability obligations are mandatory). WWU initially said that GEMA had enforcement sanctions available to it and would be expected to take action under the relevant condition. We did not find that a convincing explanation because adopting WWU's proposed interpretation of the financing requirement would mean that GEMA would in fact be in breach of its duty if a situation were to arise in which enforcement sanctions became necessary.

14.84 WWU later appeared to accept that GEMA could be said to have discharged its financeability duty even in a situation where a licence holder ultimately could not finance its activities:

> It may be that there are circumstances in which Ofgem has fulfilled that duty by putting a company in [a] position in which it is able to finance its activities, but nonetheless through some default – corporate fraud, for instance, or some other serious failing – the company does not finance its activities. Not because of an Ofgem failure of duty but because of the company's failure itself.

14.85 In its response to the provisional determination, WWU said that the two positions could be reconciled on the basis that GEMA was only required to put licence holders in a position whereby they were able to finance their activities. WWU then described the position of 'being able' as meaning '… by allowing them to recover all reasonable costs'. In paragraphs 14.182 to 14.183 we assess WWU's notion of reasonably incurred costs and do not repeat that here.

14.86 We do not agree that the financeability duty requires GEMA to ensure that each licensee can recover all of the costs which it has reasonably incurred. Furthermore, as we have explained, there is in our view a sound reason for avoiding an approach which focuses on market rates, in that such an approach would not provide sufficient incentives to licensees to manage their debt costs efficiently (see 14.81 above).

14.87 We are not persuaded by WWU's argument that GEMA must have regard to the individual circumstances of each company regulated by the RIIO regime. WWU contended that the reference to 'licence holders' in section 4AA of GA86 must be read to mean individual companies when setting the parameters of the price controls. Section 4AA sets GEMA's Principal Objective and duties '…in carrying out [its] respective functions under this Part…', and Part 1 of GA86 covers many aspects of GEMA's functions in regulating the entire gas transmission and distribution system across England, Scotland and Wales. When section 4AA is read in the wider context of Part 1, it does not lend itself to the interpretation that section 4AA focuses on individual companies. On the contrary, we consider section 4AA to be a provision that sets the priorities and considerations for GEMA when governing the whole regulatory system.

14.88 WWU contended that if GEMA did not investigate licence holders' individual circumstances it must be in breach of its public law duty. We do not agree with that characterisation. WWU's argument is premised on its anterior argument that GEMA is required to have regard to the individual circumstances of each licence holder; but we have rejected that argument immediately above.

14.89 WWU pointed to the fact that GEMA used the actual circumstances of a company in setting the cost of debt when dealing with OFTOs. When asked about that point in GEMA's hearing, GEMA described OFTOs as being '…single asset, fixed term contracts that are subject to competition'. GEMA had previously described OFTOs as being for a fixed period of 20 or 25 years. We agree with GEMA that the competitive nature of the OFTO auction process means that bids based on inefficient debt costs would be likely to be uncompetitive and so would likely fail. As a result, the efficiency of debt costs within the OFTO sector is ensured by a market process, and so does not require regulatory judgement from GEMA in order to protect consumer interests and ensure efficiency. That is very different to the regulation of monopoly energy networks with an ongoing licence to operate.

14.90 It is therefore clear that OFTOs are in a different position, where because of the competitive nature of the tender process, GEMA can legitimately take the view that the tendering companies' costs of debt are set at efficient levels. That same logic does not apply in the case of the licensees subject to RIIO-2.

. . .

14.93 We note that section 4AA(1B) confers on GEMA a wide scope in decision making, '…the Authority shall carry out their respective functions under this Part in the manner which the Secretary of State or the Authority (as the case may be) considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition…'.

14.94 In our view, to displace that scope and impose specific and mandatory outcomes in terms of licensees' financeability would require clear and unambiguous wording. We do not think subsection (2) is worded in such a fashion as either to restrict GEMA's decision making scope by compelling it to assess the individual circumstances of companies or, specifically, to compel GEMA to design a system that automatically passes through licence holders' debt costs to customers and consumers.

14.95 Finally, we agree with WWU's general point (paragraph 14.32 above) that, when interpreting any given statute, material relating to other statutes governing other sectors is not binding. In any event, we do not consider the references to other statutes are necessary for reaching a conclusion on this point.

> 14.96 For the reasons set out above, we conclude that WWU has not demonstrated that GEMA's interpretation of its statutory duties was wrong.

35. The CMA then addressed the argument that GEMA had acted irrationally in relying on a cost of debt index. The submissions of the parties to the appeal, and third parties, were set out. The CMA then set out itsprovisional assessment:

> 14.141 In assessing WWU's claims, we considered the impact of GEMA's use of an index as well as the underlying analysis of actual costs that underpin GEMA's choice of index used. We presented our analysis of this error with reference to the issues raised by WWU in its NoA, namely:
>
> (a) inherent irrationality;
>
> (b) no basis in economic theory;
>
> (c) skewed results;
>
> (d) unlawful discrimination; and
>
> (e) retrospective imposition of an interest rate policy.
>
> *Inherent irrationality and basis in economic theory*
>
> 14.142 With regard to inherent irrationality, and the associated issue of basis in economic theory, we disagreed with WWU's assessment. It appeared clear to us that GEMA had taken a rational and economically sound approach when considering how to construct its cost of debt allowance. GEMA had presented evidence that it has followed an approach that allowed it to meet its sometimes competing duties to consumers, financeability and efficiency.
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> 14.143 WWU has claimed that there is no reason why an average of industry actual costs (or an index average that corresponds to this figure) should correspond to a position of efficiency and that such an approach is not underpinned by sound economic principles or reasoning. Conversely, GEMA has stated that the assessment of whether a corporate financing strategy is efficient, appropriate and prudent is based on an assessment of the risks the strategy exposes the company to as well as the rates at which the funding is contracted. In addition, GEMA has noted that it looked at evidence from across the sectors and more broadly to consider whether, on balance, the strategies that network companies had employed, in aggregate, represented a reasonable balance of risk and return for businesses that have long life assets but revenues that periodically reset.

14.144 Absent a definition of efficiency within the statute, we took the view both that GEMA is able to define efficiency in this context, and that the approach to assessing the efficient and appropriate cost of debt allowance adopted by GEMA was not wrong. We considered it inherently rational for the regulator to consider a number of factors when deciding an efficient and appropriate cost of debt allowance, and that average cost faced by companies within a sector was an acceptable way of achieving this.

14.145 WWU's definition of efficiency amounts to 'at or below market price at issue'. In the context of debt efficiency, almost all market participants are price takers with no direct efficiencies possible as a result of greater effort. This is inherently different to opportunities for efficiency evident in operational elements of business plans and the price control, where the application of best practice can lead to greater efficiency (lower costs) over time. Under WWU's proposal, almost all financing approaches, however esoteric, would be very likely to be allowed and thus funded by customers. This transfer of risk to customers would seem to be a direct threat to GEMA's duty to consumers if it came without commensurate control on the financing strategies that companies are permitted to follow. We agreed with GEMA that financing choices, and the risk and rewards that come from those choices, sit most appropriately with companies and their owners.

14.146 It is worth noting that GEMA's approach broadly matches the approaches taken by other multi-company sector regulators, and the CMA has previously found its basic tenets to be not wrong. The CMA specifically turned down a similar request for company specific allowances from Yorkshire Water in the CMA PR19 Redetermination – noting that the water sector was broad enough to ensure that aggregate industry debt costs provided a good indication of the efficient costs associated with securing that water companies can finance the proper carrying out of their statutory functions. We considered that such a rationale also applies to the calculation of the cost of debt for the energy networks, despite a somewhat higher level of company concentration in the energy networks sector relative to the water sector.

14.147 GEMA highlighted that there could be a tension between its duty to have regard to financeability and its duty to promote efficiency and economy on the part of licensees – and that this tension would be apparent if GEMA adopted an approach to the allowed return on debt which offered no or minimal incentive to licensees to manage their debt portfolios efficiently. We agreed with this assessment. In the CMA PR19 Redetermination, the

CMA noted that a cost pass-through approach would reduce incentives to ensure that companies drive best practice, ensure efficiency and do not take inappropriate risks in their treasury management practices.

14.148 As discussed further in relation to 'skewed results' below, we would have been more concerned about inherent rationality if GEMA had disregarded all individual circumstances and relied solely on the size weighted average actual cost. However, GEMA provided sufficient evidence that this has not been the case. In addition, GEMA's approach has been sufficiently consistent that all companies in the sector, including WWU, should have been able to 'know the rules' under which the cost of debt allowance would be set.

14.149 With regard to the potential irrationality of customers paying an average sector cost rather than a company-specific cost, in our view we have been provided with no evidence from WWU that GEMA's approach is wrong. Other types of cost, such as totex, are allowed on an individual company basis as they are likely to relate to company-specific and unavoidable factors. The appropriate costs of equity and debt are easier to define at a sector or market level, and thus we found no evidence that GEMA's approach was wrong. An average approach does mean that in each price control there could be 'winner' and 'loser' consumers relative to the actual costs at their specific energy network. However, WWU's alternative approach, where company-specific debt costs were paid by the region's consumers, would leave consumers directly exposed to the financing decisions of each company without material protection from the regulator. On balance, we concluded that the 'average' approach is consistent with GEMA's duties.

Skewed results and unlawful discrimination

14.150 With regard to the potential for skewed results, and the associated issue of unlawful discrimination, we disagreed with WWU's assessment. It appeared clear to us that GEMA's allowance has been suitably calibrated and considered to allow it to be applied in accordance with GEMA's duty to have regard to ensuring that energy companies are able to finance their obligations. We did not find evidence of skewed results or unlawful discrimination.

14.151 WWU submitted that the companies whose costs of debt are included in the index have varying characteristics which make them unsuitable for direct comparison with each other and that, as a result, GEMA's approach to indexation rewards some companies and penalises others without justification. WWU also argued that GEMA 'nodded in the direction' of the need to recognise differences in circumstances between companies when it allowed a 6 bps uplift in the cost of debt for those companies likely to engage in infrequent issuance.

14.152 Conversely, GEMA submitted that skewed results because of the different characteristics of the companies was inevitable in any sector, but that the important point is not that companies within the sector should be identical in every respect, but rather that GEMA should control for differences between the companies which are outside their control. GEMA submitted that the timing of WWU's debt issuance is not the reason it faces higher costs in respect of its debt and derivative portfolio, and that decisions taken by WWU's management and shareholders as to its capital structure and risk management are not an appropriate ground on which to base differential treatment.

14.153 It was our view that suitably similar companies can be used in aggregate to make an 'actual' cost of debt assessment, and the companies within the same regulated sector are likely to be suitably similar in terms of their potential (rather than actual) costs of debt. While this may lead to companies sitting above or below the average during any one price control, this is only a concern if companies are subject to structurally higher or lower costs.

14.154 We agreed with GEMA that to avoid unfair skew in the data and/or the potential for unlawful discrimination, it is important to consider factors that are outside of the management's control and adjust allowances accordingly. We considered that GEMA has provided sufficient evidence that it considered and made adjustments for structural factors outside of the control of management, such as RAV profile in the case of SSEN-T and size in the case of WWU, SGN Scotland and NGN. Rather than WWU's assessment that suggests this approach shows that the average is not appropriate, we viewed adopting an 'average with suitable adjustments' to be clearly within GEMA's discretion as regulator.

14.155 We specifically questioned whether WWU's higher costs were the result of structural or unavoidable factors. WWU confirmed that its treasury approach was the choice of WWU's management and owners and was not subject to factors outside of the company's control. As a result, we agreed with GEMA's assessment that WWU's higher costs are the result of its decisions and not the result of skew in GEMA's analysis or unlawful discrimination. We agreed with GEMA that financing strategy, and the associated risks and rewards, should continue to sit with companies and not be transferred to regulators and consumers.

14.156 We also considered whether GEMA's actual cost calculation methodologies (which underpin the index-based allowance), specifically decisions to size-weight its analysis and exclude most derivatives, could lead to skewed results. GEMA provided evidence which we provisionally concluded demonstrates that it sufficiently cross-checked its actual cost of debt estimate against methodologies with and without the use of derivatives and using unweighted rather than weighted averages - and that the results were similar to, or lower than, their original estimate. This evidence supports the assessment that regardless of the merits of the approach taken, the value chosen in this price control was not subject to unfair skew or unlawful discrimination.

Retrospective imposition of an interest rate policy

14.157 With regard to the potential for the retrospective imposition of an interest rate policy, on balance we disagreed with WWU's assessment.

14.158 WWU has argued that each GDN took a different approach to its issuance profile and the way in which it managed its interest rate and inflation risk. WWU submitted that each of the strategies was appropriate in principle at the time it was adopted, and that there was no regulatory policy in relation to the notional interest rate risk profile against which the licensees could benchmark themselves. In addition, WWU submitted that its specific financing strategy involved a decision to fix the long-term interest rate with effect from 2007 - an 'entirely reasonable' approach in line both with the legitimate expectations of investors and current regulatory practice.

14.159 GEMA has argued, as noted above, that whether a transaction was done at market rates was merely one factor which is relevant to an assessment of a corporate entity's financing efficiency; others include timing, type, tenor, profile, and spread. GEMA submitted that it has never given WWU to understand that its actual debt costs would be met, and that it has been clear to licensees since privatisation that an allowed return on debt would be set by reference to medium-term market trends, and that the allowance would be sector-wide rather than specific to actual company costs.

14.160 In our view, there is no single way to set the cost of debt allowance. The broadly 'average actual' at the notional structure approach that has underpinned recent decisions by GEMA, Ofwat and the CMA has the benefit of ensuring that customers do not pay more than is strictly necessary to fund the debt costs of the sector. However, it is reasonable to conclude that under this approach companies do not have an explicit ex-ante benchmark to frame their decisions or accurately define the risks that they are taking. While this poses some difficulties for companies, a prudent treasury approach that issues debt incrementally and at appropriate tenors offers significant mitigation against these difficulties. In addition, such difficult policy trade-offs exist throughout regulatory price controls, and regulators often have to take the approach that they consider best matches the requirements of their statutory duties.

14.161 In this specific case, WWU could not have predicted the path of future interest rates or the exact future cost of debt allowance that would be presented by GEMA. However, given the evidence presented by GEMA of a broad consistency of approach going back to 1999, well before the hive-down of WWU from National Grid, we saw no evidence that WWU could have rationally expected a multi-decade fixing of interest costs to be specifically remunerated by GEMA through a cost of debt allowance.

14.162 It was our view that we did not have to decide whether WWU's financing decisions were efficient (as measured versus contemporary benchmark rates) or even whether they were appropriate or reasonable. Rather, we view such decisions for WWU alone to take, and that the risks and rewards of those decisions should also sit with WWU alone. WWU was, or should have been, sufficiently aware of GEMA's historical approach to the cost of debt allowance and there was no indication that this was likely to change in the future. In deciding to lock-in costs for multiple decades, despite operating in a regulatory regime that updates the revenue allowances designed to cover those costs at regular intervals, WWU was taking a clear and obvious risk. WWU could have, and could still, benefit in aggregate from taking this risk.

14.163 Although it would be an option for GEMA to follow an approach which shares costs between customers and companies, this would be a different approach which would represent a divergence from a precedent which, in our assessment, is consistent with GEMA's duties and the interests of customers. We therefore considered that WWU has failed to demonstrate that GEMA was wrong not to implement such an option.

Our provisional conclusion

14.164 For the reasons set out above, in our provisional determination we provisionally concluded that WWU had not demonstrated that GEMA placed irrational reliance on a cost of debt index.

36. The CMA then set out responses to the provisional determination from the parties to the appeal, and then explained its final assessment:

> 14.175 WWU provided an extensive response to the provisional determination, noting that WWU strongly disagreed with both the assessment and the conclusions of the provisional determination on this matter. We note that WWU's disagreement, in the main, focused on our interpretation and our weighing up of the evidence, as well as our interpretation of GEMA's duties, rather than a failure to take material evidence into account.
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> 14.176 As at the provisional determination stage of assessment, we have collated our assessment of the alleged irrational reliance on a cost of debt index into three main sub-categories:
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> (a) Inherent irrationality and basis in economic theory;
>
> (b) Skewed results and unlawful discrimination; and
>
> (c) Retrospective imposition of an interest rate policy.
>
> *Inherent irrationality and basis in economic theory*
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> 14.177 WWU raised a series of complaints in relation to the provisional determination assessment of this sub-section, which we address in the paragraphs below.
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> 14.178 On the issue of the finance duty and the potential for competition with other duties, our assessment of the statutory duties under GA86/EA89 is set out above (see paragraphs 14.76 to 14.80).
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> 14.179 On the issue of conflating efficiency and prudence, we continue to agree with GEMA that, in the absence of a statutory definition of efficiency, regulators can use their judgement to take a broader assessment of efficiency than simply 'cost versus benchmark at the time of issue'. We maintain the view expressed in the provisional determination (see paragraph 14.144) that an average cost of debt within the sector (including when matched to an equivalent external benchmark) is an acceptable way to consider a number of factors when deciding an efficient and appropriate cost of debt allowance.
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> 14.180 We disagree with WWU's assessment that there is more scope for efficiency than acknowledged in the provisional determination. WWU highlights factors such as credit rating, capital structure and effort as ways to create debt efficiencies. It is our view that efficiency must be measured on a like-for-like basis. To claim that companies can achieve lower costs by, for example, having a higher credit rating, would seem to be 'comparing apples and oranges'. If this was evidence of like-for-like efficiency, we would expect all energy network companies to have extremely high credit ratings to capture such efficiency benefits – this is clearly not the case. It appears evident that such decisions involve trade-offs rather than obvious net efficiencies.
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> 14.181 Similarly, capital structures approaches, such as WBS schemes, may increase the level of debt burden that is sustainable at a given credit

rating, but this appears to trade-off equity holders' control of cashflows for higher financial returns – rather than increase the 'efficiency' of debt. In the case of WWU, the use of a WBS scheme does not appear to have led to more 'efficient' or lower debt costs . . .

14.182 We continue to view WWU's interpretation of the 'correct' approach to setting debt allowances as being one where almost all financing approaches, however esoteric, would very likely be allowed and required to be funded by customers.

14.183 In its response to the provisional determination, WWU countered this view by stating that the requirement for companies to maintain a strong investment grade rating negates this risk. It is our view that WWU's argument inappropriately conflates two issues – costs and financial resilience. Under WWU's preferred approach, the investment grade requirement would largely constrain excess leverage rather than esoteric (or high cost) treasury approaches. It is a circular argument to suggest that all company debt approaches must be funded (at the notional level of gearing) as long as they are executed at or below a benchmark price, and then claim that credit ratings will constrain choice. In a scenario where (effectively) all approaches must be funded by customers, there is likely to be little or no impact from treasury strategy on a company's credit rating. The more likely impact on credit ratios would be if debt costs were funded at the notional level, but total debt costs were significantly higher due to much higher levels of gearing.

14.184 Looked at a different way, a regulated company taking out 100-year fixed rate debt denominated in Yen (at or below benchmark prices) may not cause an immediate credit rating issue, especially if a regulator is required to allow the recovery of these costs. However, funding such an approach for 100 years, regardless of prevailing costs of debt over that period, may still be far from in the best interest of customers. This range of arguments is similar to WWU's statements refuting the CMA's view that an (effectively) cost pass through approach would reduce incentives to appropriately manage debt costs. It is precisely in taking a broader assessment of efficiency and prudence (relative to the average cost) where such incentives are likely to feature.

14.185 WWU has also disputed our comparison to the approach taken in the water sector, primarily on the basis of a higher level of company and ownership concentration in the energy network sector. While we agree with WWU that company and ownership concentration is higher in the energy network sector, this higher concentration does not appear to be a contributing factor to WWU's higher than average costs. As WWU acknowledges, its costs are exclusively a feature of its choices in relation to debt issuance strategy. WWU's size (either in absolute terms or relative to other companies in the sector) is not a material factor in WWU's actual costs of debt being higher than GEMA's allowance. GEMA told us that size and other non-controllable factors did not skew its actual cost calculation or cost of debt allowance. As a higher level of concentration versus another sector does not appear to cause material issues in GEMA's assessment, or be the cause of WWU's actual cost differences, we do not find it to be an error in GEMA's approach.

14.186 WWU has questioned the consistency of GEMA's historical approach, and what we meant by companies being in a position to 'know the rules'. Our view is that, on the basis of the evidence submitted, GEMA's historical approach is sufficiently stable for companies to have an appropriate and broad sense of future debt cost remuneration approaches without GEMA constraining future decisions. Perhaps more importantly, WWU has failed to persuade us that GEMA's pre-2007 approaches to calculating its cost of debt allowance would have given any reasonable expectation that future licence modification exercises would result in company-specific cost recovery.

14.187 WWU disagreed with our assessment that, in a system where customers can 'win' or 'lose' due to non-identical debt costs at different companies, the fairest system is for everyone to be exposed to the same cost of debt allowance (as they are with the cost of equity allowance). At provisional determination, we noted that there are pros and cons to different approaches in this area, but on balance we considered that the 'average' approach is consistent with GEMA's duties (see paragraph 14.149). It remains our view that this approach has the benefit of ensuring no customer is faced with extreme outcomes resulting from decisions taken by a single local monopoly that they cannot substitute away from.

14.188 In its response to the provisional determination, WWU has made several mentions of the fact that Cadent enjoys lower costs of debt which WWU argues is the result of more recent funding, and WWU specifically focuses on the fact that this means that Cadent's customers are currently paying 'much more than they need [to]'. WWU has noted that the total cost is the same in both the 'aggregate cost' and 'company-specific' approaches, and has argued that it would be more rational for Cadent's customers to pay less in RIIO-2. The logical implication of WWU's argument is that customers in other regions should pay less, funded by WWU's customers paying more. While this is a plausible approach, on balance we continue to view it as fairer to all customers that they are not generally exposed to the specific financing choices of their regional monopoly energy network.

14.189 We take this view on the basis of financing approaches being fully in the control of management and owners of the networks. This is not the same as regulators making adjustments for facts that were largely outside of the control of management, for example due to the relative size of the company. We note that in RIIO-2 there are already differences in the allowance that companies receive, such as the lower allowance for SSEN-T and the 6 bps higher allowance received by WWU (see paragraphs 14.11 and 14.12), based on circumstances outside of the control of management.

14.190 Our conclusion here is based on a general principle and does not preclude a regulator matching allowances to specific circumstances such as these. Customers may also face different bills as the result of localised operating costs, as these again are most often the result of structural differences between regions that are outwith the control of management teams.

14.191 In practical terms, if GEMA were to follow WWU's request for (efficiency tested ex-ante) actual costs at the notional structure, then WWU's customers would be faced with higher bills for no other reason than their energy network company historically took a differentiated debt issuance approach that has subsequently become unprofitable. We consider that the outcome that WWU appears to be promoting would result in the imposition of higher costs for its own customers to fund lower costs for customers elsewhere in the UK, and we do not view this approach as superior to the approach taken by GEMA in RIIO-2.

Skewed results and unlawful discrimination

14.192 WWU raised a series of complaints in relation to the provisional determination assessment of this sub-section, which we address in the paragraphs below.

14.193 WWU has complained that it does not understand what the CMA meant by 'suitably similar companies' within our provisional determination assessment. At paragraph 14.153 above, we state that:

> It was our view that suitably similar companies can be used in aggregate to make an 'actual' cost of debt assessment, and the companies within the same regulated sector are likely to be suitably similar in terms of their potential (rather than actual) costs of debt.'

We are unclear as to WWU's confusion with regard to this point. For clarity, it remains our view that regulated monopolies in the same sector and subject to the same price control regime are suitably similar for the purposes of assessing appropriate costs of debt within that sector. For the purpose of this exercise, we disagree with WWU that a regulator must consider GD, GT and ET companies separately.

14.194 WWU has also argued that all costs of debt approaches involve management decisions and should only be assessed on an ex-ante basis. WWU noted that the CMA should not judge WWU's approach with the benefit of hindsight. As discussed extensively above, it is our view that the regulator can take a number of factors into account when assessing debt, and it is far from clear that sole reliance an ex-ante assessment of price is sufficient. In addition, the CMA is not judging WWU's decision with hindsight – that is not the function of this appeal process. WWU has appealed against a licence modification and, having considered the evidence and arguments, we are of the view that in introducing that modification GEMA was not in error.

14.195 WWU has reiterated its argument that GEMA's acceptance of a single debt allowance and the failure to treat WWU differently amounts to unlawful discrimination. As described above, we disagree with this assessment. GEMA has taken steps to address what might otherwise have been potentially discriminatory factors when calibrating its cost of debt allowance, as evidenced by the exclusion of SSEN-T's lower costs as a result of its recent growth and the additional allowance awarded to WWU, SGN Scotland and NGN as a function of size. As WWU has clearly stated, its debt approach and subsequent costs are exclusively the result of its own decisions, not structural factors. As a result, we find no reason why WWU should require further company-specific adjustments to its cost of debt allowance, and conclude that GEMA has committed no error in this regard.

14.196 WWU has also stated that it is impossible for any company to issue debt in line with the GEMA allowance or the 'prudent treasury approach that issues debt incrementally and at appropriate tenors' as described in the provisional determination. We disagree with WWU's assessment on three grounds.

(a) First, GEMA's use of an index is calibrated to more than cover the average actual cost of debts in the industry. It is then, by definition, completely illogical to state that companies cannot meet such a cost.

(b) Second, while we do not dispute WWU's proposition that no one company is likely to issue perfectly equal amounts of debt in each year and that there are several factors a company must take into consideration, we think it is more realistic that aggregate debt issuance for the sector will follow a smoother pattern over time as a number of companies invest and refinance. This is a benefit of taking an aggregated approach. The fact that companies may temporarily be in a better or worse position than the average is an acceptable feature of such an approach, as long as those relative positions are not permanent and due to factors outside of management control.

(c) Third, it is clear that it would have been possible for WWU to match the average of their peers more closely if it had taken a different strategy. WWU chose to, effectively, fix the interest costs on the vast majority of its debt at a single point in time, and to apply this fix over several decades and multiple price controls (see paragraph 14.128). Again, we offer no judgement on this – we merely agree with GEMA that the risk and the reward of WWU's decisions must remain with WWU and should not be passed to its customers.

Retrospective imposition of an interest rate policy.

14.197 Many of WWU's points on retrospective imposition of an interest rate policy are adequately covered by the assessments above. Here, we specifically note that WWU reiterated that GEMA's approach to the cost of debt allowance had not been as consistent as suggested and that neither the approach to the cost of debt nor the future path of interest rates could have been predicted ex-ante. We disagree, and consider that the evidence presented by GEMA showed sufficient consistency around debt allowance calculation. It may not be in customers' best interests to have one fixed cost of debt calculation policy, as market conditions may change over time. Conversely, and as discussed above, there has been no evidence presented that would suggest that WWU could have reasonably expected the outcome of RIIO-2 to be their actually incurred and company specific costs being covered in full (at the notional level of gearing or otherwise).

14.198 We agree with WWU that the future path of interest rates was unknowable at the time. Despite this truism, WWU chose to, effectively, lock in its costs for several decades despite it being highly likely that the absolute level of debt allowances would change in each price control. Once again, we pass no judgement on this decision – it is inescapable however that WWU must take responsibility for it, as we expect that it would have if such a decision had proven to be financially advantageous.

14.199 WWU flagged that the CMA had noted that, due to the long nature of the interest rate 'fix' within WWU's debt strategy, WWU may still benefit relative to future allowances. WWU has argued that the CMA has failed to acknowledge that the opposite scenario is also possible, and that WWU's position could continue to deteriorate versus the average of the sector and/or future allowances. We acknowledge this, but would point out that if this is a genuine concern for WWU, then it is within WWU's power to unwind the current treasury strategy and/or corporate structure. WWU has told us that it has already prepaid debt that was not yet due in order to improve financeability, but also that further restructuring of the derivative portfolio would not be viable as issuing new debt would 'absorb leverage headroom' while issuing equity 'is not justifiable due to the low returns that such action would achieve'. As a result, we consider WWU's decisions in this area to be influenced by the potential costs and benefits of restructuring, rather than the technical viability of such actions. We are very clear in our view that these issues and decisions sit entirely with WWU, and that individual company financing decisions are not the concern of GEMA when calculating the RIIO-2 price controls.

GEMA's alleged irrational reliance on a cost of debt index - Overall conclusion

14.200 In the paragraphs above we have again considered WWU's arguments and evidence relating to GEMA's alleged irrational reliance on a cost of debt index. As at the provisional determination stage of this appeal, we do not consider that WWU has provided sufficient evidence that GEMA's use of average actual costs or an equivalent debt index was wrong in theory or in practice. As a result, we conclude that GEMA's reliance on a cost of debt index was not irrational and did not lead to GEMA's cost of debt allowance being wrong.

37. The CMA then addressed the submissions on GEMA's alleged irrational failure to take account of derivatives. It summarised the evidence from the parties, stated its

provisional determination, summarised the responses to the provisional determination, and then stated its final determination of the appeal.

38. The submissions were set out as follows:

WWU submissions on GEMA's alleged irrational failure to take account of derivatives

WWU NoA

14.202 WWU submitted that GEMA's approach to derivatives was essentially to treat them as company-specific management decisions which were entirely at the risk of equity investors and so could safely be disregarded by regulators. WWU submitted that derivatives should not be regarded separately from the underlying debt to which they relate, but must be viewed as intrinsic to a company's debt financing. WWU submitted that GEMA had disregarded derivatives when they were a relevant factor which it was required in law to take into account when determining the cost of debt.

14.203 WWU's submission on the reasons for this error are summarised as:

a) Derivatives are commonly used and well understood financial instruments which form a normal, appropriate and desirable part of operational financing for network companies. Accordingly, all the main credit rating agencies take into account derivatives when considering companies' debt portfolios. Derivatives are therefore a relevant consideration that should have been taken into account by GEMA for the purposes of its price control determination, in accordance with its legal duty to have due regard to all relevant circumstances of the companies that it regulates.

(b) All companies have to address the issue of interest rate risk when they raise debt. One way of doing so is by means of index-linked debt, another is through the issue of nominal-rated debt coupled with derivatives, to create synthetic forms of index-linked debt. Synthetic index-linked debt may, in certain market conditions, be either more readily available or more economically advantageous than index-linked bonds. The CMA has recognised in a recent working paper that index-linked debt and synthetic index-linked debt are able to be treated as equivalent options while GEMA erroneously distinguishes functionally equivalent approaches.

(c) GEMA engages in internal inconsistencies of reasoning - for example. while it generally excludes derivatives, it does make allowance for cross currency swaps which are relatively complex financial instruments and not used by all companies (including WWU). GEMA has also indicated that it will take into account derivatives for the purpose of calculating tax clawback, which is entirety inconsistent with its disregard for them when considering the cost of debt.

14.204 WWU also submitted arguments and evidence that GEMA's objections to including derivatives were invalid. These are summarised as:

(a) A precedent of not including derivatives is not sufficient to justify its continuance - there is no 'precedent' effect of past practice in any legal or other meaningful sense. GEMA's prior policies can be changed, frequently are changed, and indeed must be changed if they are irrational and therefore wrong.

(b) With regard to the ability to carry out an efficiency assessment against benchmark data, it is an error of fact to treat this as if it posed undue difficulties. GEMA has collected significant detail on companies' derivative positions through annual reporting with effect from the 2018/19 regulatory year. It has therefore been able to assess, and has assessed, those positions against market benchmark data. WWU submitted that Oxera was able to assess the efficiency of WWU's debt and derivatives positions against well-established benchmarks for the purpose of conducting their assessment, and there is nothing inherently difficult about this task when compared to other analyses that GEMA has carried out for the purposes of its GD2 FD.

(c) With regard to future derivative use, and the question of long-term costs or benefits, these are quite capable of being re-assessed in each five-yearly price control. Moreover, GEMA did not rule out cross-currency swaps on this basis, which are relatively complex derivatives – if cross currency swaps can quite properly be taken into account in GD2, there is no reason of principle why other derivatives cannot.

(d) The existence of company-specific positions in relation to derivatives does not provide any basis for excluding them. There is no single optimal position in relation to the management of inflation or interest rate risk, just as there is no single ex-ante valid strategy for debt financing in general.

WWU's Reply to GEMA's Response

14.205 WWU submitted that it rejected GEMA's implication that derivatives were too difficult or complex or variable to be subject to appropriate regulatory assessment, or that differences in the way they are used across different companies makes them unsuitable for regulatory consideration. WWU submitted that the first point was a simple error of fact, and that the second point was impossible to understand in a context in which networks adopted widely different approaches to financing strategies as a whole and that GEMA has said that these were matters it was best placed to manage.

WWU's RFI Response

14.206 In response to questions from the CMA regarding the impact of WWU's decision to use derivatives instead of index-linked bonds in 2007, WWU noted that one of the factors affecting WWU's cost of debt was the 2007 decision to fix a base rate in RPI-real terms with RPI swaps with maturity dates in 2023 and 2035-39.

14.207 WWU submitted that it had estimated the (CPIH-real) cost for the RIIO-GD2 cost of debt that WWU might have been able to achieve if it had issued an index-linked bond instead of entering swaps contracts in 2007 to be 2.5% to 3.4%. WWU submitted that its expected RIIO-GD2 cost of debt and derivatives (including transaction costs) of 3.2% fell within the range, highlighting that the decision to use derivatives with nominal debt instead of natural index-linked debt was not a key driver of WWU's GD2 efficient cost of debt at notional leverage.

GEMA submissions on its alleged irrational failure to take into account derivatives

14.208 GEMA's response to WWU's appeal against the irrational failure to take account of derivatives is summarised as:

(a) WWU's debt costs (absent derivatives) are well within GEMA's allowed return on debt for RIIO-2. It is only once the long-dated inflation swaps from 2007 are factored in that WWU is likely to exceed the allowance.

(b) The frequency of derivative use is 'no answer' to the fact that derivatives can be manipulated so as to shift financing costs from one period to another, and their future use is difficult to predict, making their costs and benefits difficult for the regulator to assess. For example, GEMA's cross checks identified 190 derivative pay or receive legs as being more than 25 bps from market benchmarks, demonstrating to GEMA that it is difficult to draw comparisons across derivatives given the bespoke nature of these instruments.

(c) The features of derivatives mean that a snapshot of their use by a company at one point in time cannot necessarily give an accurate picture of their costs and benefits in the medium and longer term. It is not the case that derivatives are simply another means of securing a functional equivalent to index-linked bonds.

(d) GEMA does not accept that Oxera's work is a rigorous assessment of the efficiency of WWU's derivative portfolio.

(e) The different approaches which different network companies take to derivatives indicates that their use reflects company-specific management decisions, the costs and benefits of which it is appropriate for equity investors to hold. WWU's decision to use these instruments to fix real interest rates at a single point in time for a very long period was a strategy decision by its management and reflected company choices as to the balance of risk and reward. In addition, the decision as to which measures to take to remediate those risks, once they had materialised, were matters for WWU's management and shareholders, not for GEMA. It is not appropriate in these circumstances for consumers to meet these costs.

(f) Ratings agencies do tend to take derivatives into account. However, they only consider the current cost of derivatives and their impact on particular credit ratios, they do not assess whether derivatives were undertaken 'efficiently' many years ago (which would be the task facing GEMA in the event that derivatives were included in the analysis).

14.209 GEMA submitted that although approaches to derivative use vary across licensees, the use of cross currency swaps to return foreign currency liabilities to GBP is the one area of commonality. It is for this reason that GEMA had taken into account the post-swap GBP equivalent costs of foreign currency issuance in its calibration. GEMA stated that the derivatives that have caused WWU's costs to deviate most substantially from allowances are largely bespoke 'bond style' inflation derivatives, which are the least common and least well understood. GEMA submitted that they are also typically the most credit intensive for the bank counterparty because they involve an expectation of the bank being a net payer in the swap in the early years and a net receiver in the latter years. This can be viewed as 'lending through the swap' and is the reason these swaps typically attract much higher credit charges from banks than the other forms of swaps.

14.210 GEMA submitted that it disagreed with the efficiency assessment of WWU's debt and derivatives conducted by Oxera. GEMA submitted that, contrary to the simplified approach taken by Oxera to assessing whether WWU's derivatives were undertaken at market rates, it was GEMA's view that valuing derivatives properly would require the entire trade history and all related flows (including all historical cash movements on both pay and receive legs) to be discounted at the rate indicated by the appropriate yield curve at the precise time of the derivative trade. GEMA also stated that such an exercise would also require an assessment of any subsequent restructurings, and that it was not simply a case of looking at the rate on the derivative at each five-yearly interval as suggested by WWU. In GEMA's view, such an exercise should not be necessary if it is accepted that a trailing average of an external benchmark calibrated to average actual debt costs provides a reasonable allowance. GEMA further stated that even taking a simplified approach, its checks had highlighted that, given the bespoke nature of derivatives, it was difficult to make comparisons and assess if they had been incurred at market rates. GEMA stated that it does not consider its decision not to include most derivatives in its calculations to have removed the ability of companies to make choices. Rather, GEMA is of the view that derivatives are not intrinsic to the need to finance a company's activities, they represent choices, the consequences of which should be borne by shareholders. In addition, GEMA stated that WWU's argument that GEMA was informed in 2005 of its plan to use derivates is 'not relevant'. GEMA submitted that network companies do sometimes update GEMA about financing or structural decisions they are taking but that it is not GEMA's role to advise companies on their treasury strategies, pass judgement or approve or reject financing plans. GEMA stated that financing decisions are for companies and their boards and GEMA awareness does not convey implicit approval or otherwise.

14.211 GEMA submitted that although it stands by its position that derivatives should not be included in the calibration, it did collect detailed data on these instruments, and presented the results of the calibration testing both including and excluding derivatives (and intercompany loans). According to GEMA's modelling, on an aggregate basis across GD&T, these costs are expected to be covered by the allowed return on debt.

14.212 [*this is the gist of what was set out*]

In its submissions to the CMA, GEMA relied on payments made by WWU to its shareholders and asserted that WWU had chosen to make these rather than address what GEMA considered to be WWU's relatively high costs of debt. GEMA put forward figures regarding payments to shareholders and submitted that these payments were higher than assumed by the notional company in RIIO-1.

14.213 GEMA stated that these payments to shareholders had been made despite the company facing increasing pressure from a derivative position that was building in terms of negative mark to market (and principal accretion payments) as real rates continued to fall. GEMA submitted that breaking derivatives over time would have involved a cost (as they had a negative mark to market given rate movements since fixing date) and may have meant less would have been available to distribute to shareholders to date. In GEMA's view, these choices had been made by WWU and had contributed to the current situation which was that the cost of these derivatives was having a negative impact on their credit quality, financial resilience and potential to distribute to shareholders in future years. GEMA stated that not providing WWU with a specific allowance to cover these costs was not only in line with its duties, but was a fair and reasonable decision of a stable and predictable regulator.

39. The provisional determination of the CMA was set out as follows:

> 14.218 We conducted our provisional assessment of this issue in relation to two main sub-arguments – the first an assessment in principle, the second an assessment in practice. We considered the following questions:
>
> (a) Is it irrational to exclude derivatives in principle?
>
> (b) Does the exclusion of derivatives lead to GEMA's cost of debt allowance being too low?
>
> *Is it irrational to exclude derivatives in principle?*
>
> 14.219 We agreed with the view expressed by WWU that derivatives are a generally accepted and widely used tool within corporate treasury departments. This is especially true if derivatives are used to replicate instruments such as index-linked debt, which are useful debt instruments in a regulatory framework. Such debt may not always be available from the markets in the quantities or calibrations required – leading companies to synthetically create them using derivatives. We also noted WWU's evidence that GEMA does count some derivatives in its assessment of actual costs, such as those relating to currency swaps and in the pricing of OFTO cost of debt allowances. As a result, we would agree that in order to achieve the most comprehensive view of the actual cost of debt incurred in the energy sector, it would be beneficial to also count incurred derivative costs.
>
> 14.220 Conversely, GEMA contends that it has set (both in RIIO-2 and previously) an appropriate debt allowance that can reasonably be achieved using standard debt instruments. As such, if companies choose to use derivatives it must be to their advantage and should not require additional compensation. This stance is rational and defensible. WWU has not provided any evidence that this is not the case, and as discussed above, WWU's debt (excluding derivatives) has a cost which is below GEMA's allowance.
>
> 14.221 GEMA has also noted that companies, including WWU, have used derivatives that are specifically designed to move cashflows between periods rather than to be economically equivalent to standard debt (in terms of interest rate profile). We agreed with GEMA that the use of such instruments would potentially increase the obligation on a regulator to assess the merits and appropriateness of a large number of derivative contracts in order to count only the appropriate derivatives in the context of calculating the cost of debt. In particular, we noted that this raises legitimate concerns that companies might be in a position to report derivative costs which differ from the true underlying financing costs.

14.222 GEMA indicated that it counted derivatives related to currency swaps as these were commonly used by companies, and did not have some of the esoteric or high-cost characteristics of other types of derivatives. GEMA also argued that derivatives that fixed interest costs were acceptable in OFTO auctions as these were priced on a competitive basis (helping to ensure the 'efficiency' of the instruments used) and fixing costs via derivatives was appropriate in relation to contracted levels of revenues. We agreed with GEMA that there is sufficient difference between the specific scenarios highlighted by GEMA and the general assessment of the cost of debt, and that it is open to GEMA to include these derivatives in the relevant areas of its analysis, whilst focusing on the cost of bond debt when designing an index for the cost of debt.

14.223 We consider whether GEMA was wrong to include derivatives within the measure of interest for tax clawback purposes at paragraph 16.97 to paragraph 16.106

14.224 In making our assessment, we noted that all 'standard' derivatives should have an NPV zero at the point of deployment (ie are deployed as a 'fair bet') and that GEMA has provided evidence that companies could, at least on average, work within its cost allowances or capital structure without derivatives. As a result, we provisionally concluded that GEMA was not wrong to apply an approach to indexation that excludes derivatives.

Does the exclusion of derivatives lead to GEMA's cost of debt allowance being too low?

14.225 Turning to the question of whether the exclusion of derivatives leads to GEMA's cost of debt allowance being too low, we considered the evidence provided as to what the impact of this decision has been.

14.226 As noted in paragraph 14.207, WWU has presented evidence that its actual costs of debt in this price control (3.2%) is broadly similar to the cost that would have been the case if it had instead taken out long-term index-linked debt in 2007 (an estimated range from 2.5% to 3.4%).

14.227 GEMA has presented evidence that suggests that the type of derivatives used by WWU are expensive relative to the derivatives used elsewhere in the sector, but also that WWU's costs are higher as the result of WWU's 2007 decision to lock-in long-term interest rates (and view that matches WWU's evidence at paragraph 14.206). In addition, GEMA has provided evidence which demonstrates that, when measured at an aggregate level, the sector's actual cost of debt including derivatives is not significantly different to the measure excluding derivatives – and that both 'actual' measures sit below the index-based allowance used by GEMA.

> 14.228 As a result, we provisionally concluded that the practical impact of GEMA's decision to exclude derivatives from its calculation is immaterial. It is clear that WWU's costs are the result of the type and intended consequences of the derivatives used by WWU (specially to fix real interest rates for a multi-decade period), not the use of derivatives in principle. As above, we concluded that WWU is not being discriminated against through GEMA's decision not to include derivatives when setting the cost of debt in this price control. Rather, WWU's higher costs are the result of risk explicitly taken as part of its financing strategy. As in relation to the use of an index, there is no evidence that GEMA was historically willing to count derivatives in its assessment of actual costs, and thus WWU was aware of GEMA's approach when it decided to follow its strategy.
>
> 14.229 We provisionally concluded that WWU should not be entitled to relief on appeal simply because its chosen strategy has not proven to be profitable. GEMA has presented evidence that the inclusion of all derivative costs would not have had a material impact on its estimate of the sectors actual debt costs, and both approaches (including and excluding derivatives) give a result that is lower than the cost of debt allowed by GEMA. As a result, we disagree with WWU's assessment that GEMA's decision not to include derivatives led to a cost of debt allowance that was too low.
>
> *GEMA's alleged irrational failure to take into account derivatives – Our provisional conclusion*
>
> 14.230 In our provisional determination we provisionally concluded, for the reasons set out above, that WWU had not demonstrated that GEMA had irrationally failed to take account of derivatives.

40. The CMA then set out the responses to the provisional determination. The final assessment was as follows:

> 14.246 In making our final assessment of this cost of debt sub-issue, we note that GEMA has broadly agreed with the assessment conducted for the provisional determination and supported its conclusions, other than the recommendation that it may be useful to count derivative costs in the future. WWU provided an extensive response to the provisional determination, noting that WWU strongly disagreed with both the assessment and the conclusions of the provisional determination on this matter. We note that WWU's disagreement, in the main, focused on our interpretation and balance of the evidence, in particular the CMA's view of WWU's derivative portfolio, rather than a failure to take material evidence into account.
>
> 14.247 As at the provisional determination stage of assessment, we have collated our assessment of the alleged irrational reliance on a cost of debt index into two main sub-categories:
>
> (a) Is it irrational to exclude derivatives in principle?

(b) Does the exclusion of derivatives lead to GEMA's cost of debt allowance being too low?

Is it irrational to exclude derivatives in principle?

14.248 WWU has disagreed with the assessment of its derivative portfolios implied in the provisional determination, and has variously asked the CMA to clarify what it means by 'standard' swaps, 'esoteric' instruments and 'underlying financial costs'. We view much of this semantic debate as irrelevant to the basis of WWU's appeal. As in the previous sub-section, our role in this appeal is not to judge or opine on the nature of WWU's particular financing strategy. Rather, it is to assess whether GEMA's cost of debt allowance was wrong when considering the issues raised in WWU's appeal.

14.249 Conversely, GEMA has reiterated its view that it should not be required to include derivative costs in any future assessment, as it believes that a 'snapshot' of derivative costs does not provide the same clarity on overall funding costs as would be expected from debt instruments held on balance sheets.

14.250 It remains our view that, in theory, it may be useful to count some derivative instruments when calculating an average actual cost of debt for a regulated sector. The most useful derivative instruments to count would seem to be those that are used to synthetically replicate debt instruments, such as index-linked debt – particularly when such approaches are used when useful debt instruments such as index-linked debt are not readily available in the size or tenor required. However, this approach may not be practical or desirable if companies use either more complex derivatives or use derivatives for other purposes – and assessment of each derivative may place an inappropriate burden on regulators.

14.251 WWU's own description of using derivatives to 'defer income from GD1 to GD2 and accelerate costs from GD2 to GD1 by altering certain payment and receipt legs on a relatively small number of RPI swaps' is clearly not an example of synthetically replicating a debt instrument that was not otherwise available. As WWU stated, these actions were 'taken to improve financeability for GD2', and as a result the cost of these instruments cannot readily be seen as a proxy for debt costs. We disagree with WWU's view that such actions are equivalent to WWU deciding to 'buy back bond debt before its due date' as both 'had the effect of accelerating interest costs'.

14.252 In our view, buying back debt uses shareholder funds to reduce the future cost of debt, while WWU's description of 'altering certain payment and receipt legs' is more likely to result in the movement elements of the debt costs between periods for the benefit of cashflow management, with no overall reduction in debt burden and no reduction in leverage.

14.253 WWU also argued that GEMA's exclusion of derivatives in general leads to one uniform interest rate and inflation profile of the notional efficient operator which is not followed in practice by any network. We disagree with WWU that this is either strictly the case or, looked at more broadly, is an irrational approach.

> (a) Firstly, an index calibrated to cover the average actual cost in the sector does not reflect 'one uniform interest rate and inflation profile', rather it reflects the average of all the debt strategies used by the companies in the sector;
>
> (b) Secondly, we note that WWU singles out this issue in the cost of debt but ignores the application of this principle elsewhere in the control. There are many areas across the price control where it is efficient and effective for a regulator to allow broadly appropriate rather than specifically tailored allowances. Even within the cost of capital, the regulator estimates what it considers to be an appropriate single notional level of gearing and single cost of equity allowance, neither of which perfectly represents the actual metrics or costs of any one company in the sector.

14.254 On the basis of this assessment, we agree with GEMA that there are complications to consider when choosing whether and how to count derivatives within an actual cost of debt calculation – particularly if such instruments are used for reasons other than to synthetically replicate standard debt instruments such as index-linked debt. The challenges in interpreting this data mean that regulators must use judgement when choosing whether and how to apply this information within the estimation of an appropriate cost of debt allowance. In this case, there is evidence that derivative costs within the energy network sector may not be representative of the costs of debt we are looking to assess (as opposed to other costs, such as risk management) and so we do not consider their exclusion from GEMA's calculations to be irrational. In the paragraphs below we consider whether their exclusion led to a cost of debt that was too low in practice.

Does the exclusion of derivatives lead to GEMA's cost of debt allowance being too low?

14.255 While in the section immediately above we conclude that exclusion of derivatives is not wrong in principle, we must also make a final assessment of the more practical question of whether such exclusion led to GEMA's cost of debt allowance being too low in this price control.

14.256 In response to the provisional determination, WWU have argued that derivatives are vital risk management tools and that GEMA's allowance cannot be achieved (in terms of following the financing strategy implied by the index) without derivatives. This argument appears flawed.

(a) Firstly, GEMA's cost of debt allowance is fundamentally based on the actual costs incurred by the sector, excluding derivatives. It appears fundamentally illogical for WWU to claim that such a cost cannot be met without the use of derivatives.
(b) Secondly, WWU suggested that all companies need derivatives in order to meet GEMA's cost of debt allowance, and referenced the approach taken by NGN as evidence. While NGN may have chosen to follow this strategy, it is not clear that this is sufficient evidence that all companies are compelled to use derivatives in this way. As clearly established during this appeal, needing to meet the current cost of debt allowance was not the driver of WWU's decision to use derivatives within its treasury strategy.

14.257 WWU has also stated that the CMA has mischaracterised the nature of its appeal in this area by assessing that 'WWU is not being discriminated against through GEMA's decision not to include derivatives'. While we consider our provisional determination assessment of whether excluding derivatives was discriminatory to be a valid consideration in determining whether GEMA's decision was wrong, we concur with WWU that 'it is not WWU's case that Ofgem's [GEMA] decision not to include derivatives led to a cost of debt allowance that was too low'.

14.258 As noted in the provisional determination assessment, GEMA has provided evidence which demonstrates that, when measured at an aggregate level, the sector's actual cost of debt including derivatives is not significantly different to the measure excluding derivatives – and that both 'actual' measures sit below the index-based allowance used by GEMA. WWU has not disputed this fact with new evidence (subject to the procedural comments below). As a result, we continue to conclude that the exclusion of derivatives did not lead to GEMA's cost of debt allowance being too low.

The alleged irrational failure to take into account derivatives – Overall conclusion

14.259 In the paragraphs above we have again considered WWU's arguments and evidence relating to GEMA's alleged irrational failure to take into account derivatives. As at the provisional determination stage of this appeal, we do not consider that WWU has demonstrated that GEMA's exclusion of derivatives was wrong in theory or in practice. As a result, GEMA's exclusion of derivative costs was not irrational and did not lead to GEMA's cost of debt allowance being wrong.

41. The CMA's final determination on the Cost of Debt ground of appeal was as follows:

> 14.260 As a result of the assessments described in the paragraphs above, we determine that GEMA was not wrong in its approach to, or estimate of, its cost of debt allowance. We have received insufficient evidence to demonstrate, and are not persuaded, that GEMA has failed correctly to interpret or to give effect to its financing duty, that GEMA was irrationally reliant on a cost of debt index nor that GEMA irrationally failed to take account of derivatives in its cost of debt allowance.

42. With respect to the ground of appeal relating to the "Tax Clawback", the CMA explained at paragraph 16.1 that the ground of appeal related "to the way in which GEMA applies a policy described as 'tax clawback'. The tax clawback policy is designed to pass through to customers any tax benefits from higher gearing. WWU disagreed with GEMA about whether, and to what extent, reported movements on WWU's derivatives should be included within the measure of interest used to calculate the level of tax clawback". At paragraph 16.2, the CMA stated that "As interest on debt is tax deductible, highly geared networks pay less tax than they otherwise would. Were there to be no tax clawback policy, these networks would, as part of their price control settlement, receive allowances for tax they do not in fact pay."

43. The CMA described the derivatives that WWU had taken out at paragraph 16.9-16.15:

> 16.9 WWU has taken out two sorts of derivatives, namely:
>
> (a) Interest rate swaps
>
> (b) Inflation swaps
>
> *Interest rate swaps*
>
> 16.10 We understand WWU has entered into interest rate swaps where it exchanges one series of interest payments on a defined principal amount with another series of interest payments. The most common type of such swaps is to exchange fixed interest for floating interest. These swaps will be specified as per paragraph 16.6.
>
> *Inflation swaps*
>
> 16.11 WWU has entered into a number of swaps which, when combined with its bond debt, have the effect of creating an obligation to pay interest on an index-linked basis, ie interest that increases and decreases with the level of underlying inflation. This form of inflation-linked financing is commonly used by network companies, as price-controlled revenues also increase and decrease in line with inflation.

> 16.12 This form of derivative is comprised of three elements of 'interest' on the notional principal sum:
>
> > (a) a fixed rate of interest payable (designed to reflect an expected real level of interest)
> >
> > (b) a specified measure of inflation payable (which in combination with the above, to form an index-linked rate of interest payable)
> >
> > (c) a fixed rate of interest receivable (normally designed to reflect an expected nominal level of interest)
>
> 16.13 One of the characteristics of index-linked bond debt is that the inflation-linked part of interest payable is added to the principal during the life of the bond, and therefore is only paid out to holders of that debt when the principal is repaid at the end of the debt term. We understand that the kind of inflation swaps used by WWU to a certain extent replicate this feature. The element of interest payable related to inflation, as per 16.12(b) above, is only settled every few years, typically every three or five years. Although the inflation-linked element of interest on these bonds and derivatives is not necessarily paid (ie settled) each year, they still represent a cost in those years. As a result, normal reporting conventions apply as set out in paragraph 16.16 below with this interest being reported as a finance charge within the relevant periods and the sum owed shown as an accrual in the balance sheet. This process of rolling up interest is called interest accretion.
>
> 16.14 In summary, firms can use inflation swaps, in conjunction with debt they have issued with a nominal coupon rate, to synthetically create index-linked debt. Network operators can use this index-linked debt to match the nature of the revenue stream they are awarded under their price control, which is also linked to inflation, and therefore better match revenues received under the price control with payments out to holders of debt.

44. At paragraph 16.16-16.17, the CMA discussed the accounting treatment of derivatives:

> 16.16 Up until relatively recently most firms only reported interest relating to the current period on the derivatives they held within their accounts. Both interest payable and receivable, including any elements linked to an inflation index, that was incurred or earned in respect of the period would be reported as a financing charge within the profit and loss account. Likewise any amounts due or payable in respect of interest charges at the balance sheet date would be reported as a debtor (accrued income) or accruals (an accrued expense).
>
> 16.17 For firms that report under International Financial Reporting Standards derivatives came on balance sheet in 2005. For other UK

firms that requirement came in with the introduction of Financial Reporting Standard 102 (**FRS102**) in 2016. Bringing derivatives on balance sheet has implications for reporting of the finance charge within the profit and loss account. As a result, the finance charge may need to include an adjustment, so that changes in market value of the derivatives from one balance date to the next are appropriately reflected. This adjustment is called the fair value adjustment and relates to interest payable / receivable in relation to future periods (ie beyond the balance sheet date) in respect of derivatives held by the firm.

45. The development of GEMA's policy with respect to tax clawback was set out at paragraph 16.18-16.39:

> 16.18 In the price control period before RIIO-1, GEMA identified the need to put in place a tax clawback policy. The concept of a tax clawback policy has also been applied by other regulators. This section sets out the process by which and the legal instruments through which GEMA designed and implemented its tax clawback policy pre RIIO-1 and throughout RIIO-1 and RIIO-2.
>
> 16.19 The process by which GEMA re-calculates annually each licensee's allowed revenue by updating the forecast values set at FD for actual outturn data is called the Annual Iteration Process (**AIP**). This process is not specific to tax clawback.
>
> 16.20 GEMA implements its tax clawback policy via two documents which are incorporated in the licence by reference, and which it collectively terms 'Price Control Financial Instruments':
>
> > (a) The Price Control Financial Model (**PCFM**): The PCFM is the financial model that derives the incremental changes to base revenue during the price control period.
> >
> > (b) the Price Control Financial Handbook (**Handbook**): This document gives a description of PCFM, and the AIP for it, that is used to calculate licensees' allowed revenue during the course of the price control period.
>
> *Pre RIIO-1 (GDPCR1)*
>
> 16.21 Following a consultation process, GEMA set out its policy on tax clawback by way of an Open Letter in 2009 (**2009 Open Letter**).
>
> 16.22 According to the 2009 Open Letter, the intention was to claw back from licensees the revenue benefit they obtained from lower tax costs as a result of high gearing. The clawback would be triggered when in any year:
>
> > (a) actual gearing exceeded notional gearing; and
> >
> > (b) interest costs exceeded those modelled at the relevant price control.

16.23 The 2009 Open Letter explained that, when both of these conditions were satisfied, GEMA would clawback the tax benefit which resulted from the difference between actual and modelled interest costs in that year.

16.24 The 2009 Open Letter noted that the clawback adjustments for the then current price control period would be made at the next Price Review, ie RIIO-1.

RIIO-1 price control

16.25 GEMA enacted its tax clawback policy within price control licence conditions for RIIO-1, which ran from 2013 to 2021. GEMA referred to the 2009 Open Letter in the Handbook for GD1, one of the Price Control Financial Instruments that has the same status as a licence condition. It did so by the following means:

> (a) a legacy adjustment in relation to the previous price control was detailed in part 2 of Chapter 10 (Legacy price control adjustments) of the Handbook for GD1; and
>
> (b) an in-period tax clawback mechanism was incorporated in Part B of Special Licence Condition 3C (Specified Financial Adjustments) with effect from 1 April 2013. Part B provided for the determination and direction by GEMA of revised PCFM variable values for the relevant network operator for tax liability revenue allowance adjustments in respect of the network operator's gearing levels and corporate debt interest costs. The implementation of the mechanism was further detailed in part 3 of Chapter 4 (Tax liability allowances) of the Handbook for GD1.

2015 correspondence

16.26 WWU wrote to GEMA in June 2015 seeking guidance, amongst other things, as to the correct treatment of the inflation expense on RPI derivatives for the determination of actual interest for the purposes of tax clawback.

16.27 GEMA replied in July 2015 (**2015 Letter**) advising that:

> Although interest on indexed linked debt is included in tax deductible net interest paid values for tax clawback calculations, expenses (or income) associated with derivatives are not.
>
> ….
>
> Inflation related expenses and income both accrued and actual should be excluded from the value for adjusted tax deductible net interest paid for the purposes of RIIO GD1 tax clawback adjustment calculations.

Developments in reporting of financial performance under RIIO price control

16.28 GEMA has a long-established regulatory reporting mechanism for network operators which are referred to as the Regulatory Instructions and Guidance (**RIGs**).

16.29 On 2 August 2018, GEMA announced by way of an open letter that, following a review, it wanted to see a step change in how financial performance under RIIO price controls was reported by network operators. A key proposal was to require additional reporting to provide insight into the impacts of each network operator's level of gearing, cost of debt, and actual tax payments on its returns under the price controls which, GEMA explained, current reporting did not easily allow. GEMA labelled this reporting initiative Regulatory Financial Performance Reporting (**RFPR**). Guidance and templates it was currently developing, GEMA explained, would include the accounting standards that it expected companies to adhere to, and establish common and consistent methodologies in how key financial data (such as the actual cost of debt, gearing and tax liabilities) was reported.

16.30 GEMA set out that it considered a key reporting requirement for each network operator was its Return on Regulatory Equity (**RoRE**)– including and excluding finance and tax; and based on actual as well as notional gearing. Network operators would also be required to reconcile their RFPR reports to their own:

(a) Statutory Accounts;

(b) HMRC corporation tax returns – CT600; and

(c) PCFM.

16.31 On 13 March 2019 GEMA sent an open letter to gas distribution network operators stating that it was now proposing for comment modifications to the existing reporting regime (the RIGs) for gas network operators to include the RFPR requirement. GEMA explained that if it implemented the changes, they would take effect in April 2019, meaning that data submitted in July 2019 (in respect of the 2018/19 reporting year) would use the RIGs as modified.

16.32 On 30 April 2019 GEMA issued a direction to licensees, including WWU, which provided a link to the following documents:

(a) RIIO Regulatory Financial Performance Reporting – Regulatory Instructions and Guidance; and

(b) RIIO Regulatory Financial Performance Reporting – Template.

16.33 We refer to the first of these documents as the **RFPR Decision**.

16.34 One instruction for completion within the RFPR Decision was, in respect of Tab R7 Financing of the accompanying template, the following:

> Row 28 - Net Interest Per Regulatory (RIIO-1) Definition actuals should reconcile to previous RIGs reported Net Debt & Tax Clawback Inputs to previous Tax Clawback Calculations.

RIIO-2 price control

16.35 GEMA re-enacted its tax clawback policy within price control licence conditions for RIIO-2. GEMA referred to the 2009 Open Letter in the Handbook for GD2, one of the price control financial instruments.

PCFM Guidance

16.36 On 12 April 2021 GEMA consulted on the introduction of a new Associated Document, namely the RIIO-2 PCFM Guidance.

16.37 The purpose of that guidance was as follows:

> The proposed drafts set out guidance and instructions to help licensees update the variable values in the Price Control Financial Model (PCFM) for the first Annual Iteration Process submission as well as the reporting templates, which licensees need to fill out to calculate some of these variable values.

16.38 This PCFM Guidance was intended, amongst other things, to cover the annual adjustment to allowances for tax clawback.

The RIIO-2 Decision

16.39 As part of the decision to implement price control licence conditions for RIIO-2, GEMA imposed the PCFM and the Handbook for GD2 (which are an integral part of Special Condition 8.1 of WWU's licence). Taken together, these two documents, along with the PCFM Guidance, aim to set out both GEMA's tax clawback policy and the mechanism through which tax allowances are clawed back.

46. At paragraph 16.73, the CMA described WWU's appeal against "the policy of including the interest associated with derivatives within the assessment of tax clawback, both going forwards into RIIO-2 as well as historically". It was explained that WWU's submissions were that this policy was "inconsistent and irrational, in breach of legitimate expectation, in breach of requirements to consult, and lacking in policy justification of any kind. It was consequently wrong in law (section 23D(4)(e) of [the 1986 Act])": see paragraph 16.74. At paragraph 16.75, it was stated that WWU had submitted that the policy "would also have a material adverse effect on its revenues, and accordingly had failed to have proper regard (section 23D(4)(a) of [the 1986 Act]) or give appropriate weight (section 23D(4)(b) of [the 1986 Act]) to its financing duty".

47. The CMA characterised the errors as follows:

16.77 We find it helpful to articulate the errors alleged by WWU for the purposes of our assessment as follows:

> (a) Was the tax clawback policy wrong because it included derivatives within the measure of interest for tax clawback purposes (alleged lack of logical coherence)?
>
> (b) Was the tax clawback policy wrong because it set a policy for RIIO-2 which breached an alleged legitimate expectation set out in the 2015 Letter (alleged breach of legitimate expectations, looking forwards)?
>
> (c) Was the tax clawback policy wrong in seeking to recover tax clawback from before RIIO-2 (alleged breach of legitimate expectations, looking backwards)?
>
> (d) Did the various alleged procedural deficiencies, not least the alleged lack of consultation on the alleged change in policy, make the tax clawback policy wrong (alleged procedural deficiencies)?

48. The CMA's analysis with respect to the argument based on "alleged lack of logical coherence" was as follows:

> 16.89 The principal argument of WWU's appeal, as set out at paragraph 16.79, is that it is logically incoherent for GEMA to adopt one position regarding derivatives for the purposes of setting cost of debt allowances and another position for the purpose of tax clawback. These are, however, two distinct purposes. The appropriate treatment of derivatives in each case are separate questions where different objectives come into play; it follows that it may be justified for GEMA to adopt differing positions in relation to these separate questions. We set out our assessment for the purpose of setting WWU's cost of debt allowance in WWW Head A: Cost of Debt (see Chapter 14). We set out our assessment for the purpose of tax clawback below. We refer to the different objectives of the cost of debt calculation and tax clawback calculation at paragraph 16.98 below.
>
> 16.90 As set out in paragraph 16.77, we frame our assessment of this alleged error under the question 'Was the tax clawback policy wrong because it included derivatives within the measure of interest for tax clawback purposes?'.
>
> 16.91 In considering whether GEMA's policy to include derivatives within the measure of interest for tax clawback purposes was wrong, we consider the following three questions, which, in our view, are relevant steps in the logic as to why GEMA included derivatives in tax clawback:
>
> > (a) Whether it is normal business practice to include derivatives within financing/financing costs;
> >
> > (b) Whether it is wrong to seek to assess the position of the individual firm rather than a notional firm; and

> (c) Whether it is wrong to seek to measure interest based on the firm's actual financing strategy rather than on an alternative notional financing strategy.

Whether it is normal business practice to include derivatives within financing/ financing costs

16.92 Tax clawback calculations rely on a measure of the financing costs of debt ie interest. In our view, interest on debt derivatives are as much a part of the measure of interest as the interest on primary debt instruments for the following reasons:

> (a) firms, including network operators, finance their businesses and determine their interest rate profile using a combination of both primary financial instruments and derivatives and, in principle, so could a notionally efficient network operator;
>
> (b) both measures are treated as interest within accounts that firms prepare. Whilst recent accounting practice separates out interest on primary debt instruments from interest on derivatives, both items appear under the same umbrella heading of 'interest'; and
>
> (c) for tax purposes, interest on derivatives is included within the measure of total interest used when assessing an individual firm's tax liability.

16.93 As a starting point when considering what comprises interest of a regulated firm such as WWU, there is therefore a solid foundation for including interest related to both debt and any associated derivatives. This is in practice also WWU's position: it accepts that derivatives could be included but says that GEMA is wrong to do so while excluding the same derivatives when setting the cost of debt allowance. We therefore consider it is normal business practice to use derivatives to alter the expected interest rate profile on debt taken out, and for the resulting amounts owed (or owing) at period ends to be reflected within the balance sheet and the resulting interest payable in financing costs within the profit and loss account.

Whether it is wrong to seek to assess the position of the individual firm rather than a notional firm

16.94 We consider that, for the purposes of a calculation to adjust the tax allowances of an individual firm to reflect the actions of that firm, it is appropriate to seek to assess the position of that individual firm. That is the whole point of the tax clawback policy.

16.95 We recognise that there may be questions on how 'actual' firm and 'notional' firm are defined, particularly for firms with complex financing structures. However, in our view it is clear and not in dispute that the tax clawback mechanism is based on assessing the financing costs of an ‘actual’ firm.

16.96 We therefore consider it not wrong for GEMA to seek to assess the actual financial position of the individual firm rather than the costs of a ‘notional’ firm.

Whether it is wrong to seek to measure interest based on the firm’s actual financing strategy rather than on an alternative notional financing strategy

16.97 If the above two points are accepted, and given that we do not consider that WWU is seeking to dispute those points, then the alleged error is whether GEMA was wrong in how it calculated the interest incurred by the ‘actual’ firm for tax clawback purposes. In particular, GEMA calculated interest based on the ‘actual’ financing strategy, including derivatives, whereas WWU said GEMA should calculate interest on a basis which excluded derivatives, which we consider could be described as a ‘notional’ financing strategy. WWU’s position is that GEMA’s approach is wrong, as it is inconsistent with the position on the cost of debt.

16.98 For the purposes of measuring interest payable by the actual firm for the purposes of tax clawback policy, it is not necessary to consider some of the broader questions around the definition of interest, such as whether it was efficiently incurred. This contrasts with the position for measuring interest for the purposes of preparing the evidence base used to set cost of debt allowances, which is intended to provide an allowance for a notional company. The objective of the calculation of tax clawback is to calculate and claw back for consumers the tax benefits that the actual firm has gained from the financing actions it has taken to the extent that they differ from the notional company, whether taken efficiently or inefficiently.

16.99 As described above, it is therefore evident that the calculation of tax clawback needs to be based on actual financing, in that it is based on the consequences for tax payable of the differences between actual and notional financing decisions. Given that we also consider that derivatives are a normal part of financing strategy, and indeed that WWU has not disputed this, this would imply that the tax clawback policy would also include derivatives.

16.100 The tax benefit to a firm from deducting interest is a function of its actual interest charge, which will reflect actual financing, including derivatives, rather than the notional financing used in setting the cost of debt. As a result, the tax benefit will also be affected by the firm’s choice of actual debt instruments, including the mix of floating and fixed rate debt and the use of bank and bond debt, as well as any related derivative instruments. There are therefore a number of differences between the financing assumptions used in measuring the ‘actual’ interest deductible for tax purposes and the measure of interest used to set the cost of debt allowances. Other than derivatives, WWU has not indicated that the other differences in financing policy between the actual and notional firm should be excluded when calculating interest for the purposes of tax clawback.

16.101 We recognise that there was evidence received during this appeal that the ‘actual’ interest under GEMA’s definition for tax clawback may still differ from the ‘actual’ interest applied for tax purposes, in particular for WWU’s derivatives. However, this does not change the question of whether it is right as a general principle to include or exclude derivatives in calculating the interest used for tax clawback, which was WWU’s ground of appeal.

WWU’s arguments in response to our provisional determination

16.102 In its response to our provisional determination, WWU pointed out that, whilst obligations arising from interest rate (real or nominal) derivative contracts might be presented as a financial liability within financial statements under FRS102, that did not mean that such derivatives provided debt finance. Rather such derivatives were used by WWU to achieve a target interest rate profile. WWU went on to note that GEMA agreed that interest rate derivatives were neither intrinsic to debt financing nor required for capital raising purposes.

16.103 WWU further submitted that the sole purpose of the tax clawback policy was to deter excess leverage. As its derivatives were not debt instruments, derivatives were, WWU argued, not relevant to assessing the extent of a firm’s leverage. It was therefore wrong for us to state in our provisional determination that, because derivatives were part of normal financing strategies, derivatives must be included in clawback. The fact that, WWU contended, derivatives were Net Present Value (NPV) zero contracts ab initio fundamentally distinguished them from debt. That, WWU argued, necessarily meant that the tax clawback policy could not apply any incentive power (whether negative or positive) to derivative actions ab initio.

16.104 We agree with WWU that derivatives are generally not a means by which external investors provide finance to businesses. Derivatives such as those held by WWU are instead used to alter the interest rate profile of the primary financial instruments (ie debt) that WWU holds. As such they are part of the financial toolkit with which network firms are able to service their debt obligations.

16.105 However, the evidence does not support WWU’s contention that the **sole** purpose of the tax clawback policy was to deter excess leverage. As stated in the 2009 Open Letter the tax clawback policy ‘claws back from licensees the revenue benefits they obtain from lower costs as a result of higher gearing.’ We note that including interest relating to

> derivatives would, all other things being the same, result in a calculation for the tax liability that more closely reflects what the individual firm would be required to pay. Therefore the treatment actually adopted by GEMA more closely reflects the implementation approach set out in the 2009 Open Letter than that proposed by WWU. We therefore do not consider that GEMA erred in adopting this approach.
>
> 16.106 In summary, we conclude that GEMA was seeking, in applying tax clawback, to identify a measure of interest for an actual financing structure. We consider that, for companies that choose to enter derivative contracts, the ‘actual’ financing structure would normally include derivatives as well as primary debt instruments. On that basis, we conclude that, rather than being incoherent by including derivatives, GEMA was in practice taking into account the different objectives it faced when defining a measure of interest for the purpose of, on the one hand, the cost of debt and, on the other, tax clawback. We therefore conclude that GEMA was not wrong to take a measure of actual interest which includes derivatives for tax clawback purposes.

49. The CMA’s analysis with respect to the argument based on breach of legitimate expectation was divided into “looking forwards” and “looking backwards”. With respect to the former, this was set out as follows:

> 16.123 A legitimate expectation may arise in circumstances where a public decision-maker changes, or proposes to change, an existing policy or practice. A legitimate expectation will only be created if a public authority has given a promise or adopted a practice which represents how it is going to act in a given matter or area. The promise or practice relied upon must give rise to a representation which is clear, unambiguous and devoid of any relevant qualification.
>
> 16.124 In the seminal case *Ex p Coughlan*, the Court of Appeal held that:
>
> > Where the court considers that a lawful promise or practice has induced a legitimate expectation of a benefit which is substantive…, the court will in a proper case decide whether to frustrate the expectation is so unfair that to take a new and different course will amount to an abuse of power. Here, once the legitimacy of the expectation is established, the court will have the task of weighing the requirements of fairness against any overriding interest relied upon for the change of policy.
>
> 16.125 We agree with GEMA that any expectation that would have arisen as a result of the 2015 Letter would have been defeated by the RFPR Decision. On 13 March 2019, GEMA notified its intention to consult on certain proposed changes to the RIGs, including within the consultation document the note ‘We would expect Net Interest Per Regulatory (RIIO-1) definition to include all inflation derivative payments that attract tax relief (because that is the definition used for tax clawback)…’. WWU responded to the consultation on 11 April 2019. Its response noted that the draft RIGs ‘appears to conflict with

what we have previously been advised by Ofgem', which shows it was aware of the clarification GEMA was intending to make to its approach regarding tax clawback. On 30 April 2019, GEMA published the RFPR Decision updating the RIGs, which included the language cited above. The notification of GEMA's intention to consult on certain proposed changes to the RIGs, followed by the consultation, in which WWU participated, and the publication of the resulting Direction was sufficient to remove any legitimate expectation that would have been created by the 2015 Letter (to the extent such a legitimate expectation actually arose).

16.126 In response to our provisional determination, WWU argued that a legitimate expectation created by means of a clear and unequivocal promise given by a regulator to a licence holder could not be 'defeated' merely by making a public statement that was at odds with the promise. We disagree with WWU's characterisation of the RFPR Decision (and its prior consultation process) as being merely 'a public statement … at odds with the promise.' Whilst GEMA might have handled the matter better than it did, we conclude that the circumstances described in paragraph 16.125 above are such that WWU ought reasonably to have understood that no reliance should be placed on the 2015 Letter following the RFPR Decision (to the extent that such a legitimate expectation actually arose).

16.127 WWU also disagreed with the way we had characterised its legitimate expectation claim in the provisional determination. WWU submitted that it had not relied on a claim of legitimate expectation with regard to the forward-looking GD2 period. WWU therefore contended that our provisional conclusions concerning its legitimate expectations 'looking forwards' were academic and unnecessary. We note that WWU submitted to us in its NoA that the 2015 Letter established a legitimate expectation in law as to the continuation of the policy set out in it as part of the price control arrangements. Thus, WWU clearly contended that its legitimate expectations extended into GD2. In the absence of a request by WWU to withdraw that part of its appeal, it is appropriate for us to rule upon it.

16.128 In any case, to the extent that any legitimate expectation was created by the 2015 Letter, we also agree with GEMA that it would not be unfair for it to depart from the position described in such letter. We consider that GEMA's decision to depart from such position for RIIO-2 did not meet the threshold of being so unfair that it amounted to an abuse of power. Indeed, GEMA's statutory duties required it to apply the approach to tax clawback which it considered best met those duties and its objectives.

16.129 For the above reasons we therefore do not find that GEMA breached any legitimate expectation on the part of WWU by including interest on derivatives within the measure of interest for tax clawback purposes in its RIIO-GD2 decision.

50. With respect to "looking backwards", the analysis was as follows:

> 16.134 We agree with GEMA that the issue of recovering tax clawback from before RIIO-2 is a matter for the RIIO-1 close out process as it relates to the consequences of transactions and events occurring before the outset of RIIO-2. Therefore, the decision on this close out process, which has not yet been concluded in practice, is outside of the scope of the RIIO-2 appeal process.
>
> 16.135 We have therefore not reached a view as to whether there has been any breach of legitimate expectation in relation to the recovery of tax clawback from before RIIO-2.

51. The CMA did not reach a conclusion on the alleged procedural deficiencies, for the reasons explained in paragraph 16.141. The CMA's determination of this ground of appeal was as follows:

> 16.143 We therefore determine that GEMA was, for the purposes of the RIIO-2 price control, not wrong to set the policy it did in respect of the measure of interest for tax clawback purposes. We also do not find that GEMA breached any legitimate expectation on the part of WWU by including interest on derivatives within the measure of interest for tax clawback purposes. Any breach of legitimate expectation on the part of GEMA in respect of periods prior to RIIO-2 is outside the scope of the appeal. Accordingly, we dismiss this ground of appeal.

IV. Grounds of Challenge

52. WWU seeks to challenge the CMA's decision on four grounds:

    (i) The CMA erred as to the appropriate standard of review: the CMA misconstrued its appellate function, failing to apply the requisite scrutiny under section 23D(4) of the 1986 Act. The CMA wrongly took a supervisory approach to the appeal, akin to judicial review, and incorrectly applied an enhanced margin of appreciation to GEMA's discretionary decision-making;

    (ii) The CMA misconstrued the financing duty in section 4AA(2)(b) of the1986 Act by failing to consider the financial circumstances of individual licence holders;

    (iii) The CMA erred in law in upholding GEMA's cost of debt approach: (a) in using a "notional company" averaging approach, GEMA discriminated against WWU; and (b) GEMA unlawfully excluded derivatives (with one exception) from the cost of debt allowance;

    (iv) The CMA erred in its approach to WWU's tax clawback appeal: if (contrary to ground (iii)), GEMA was entitled to exclude derivatives in its cost of debt policy, it was irrational and inconsistent for the CMA to uphold GEMA's inclusion of derivatives in its tax clawback policy.

V. Submissions

53. WWU was represented before me by Rhodri Thompson KC, Zoe Leventhal KC and Florence Iveson. SSEN-T (an Interested Party to this judicial review) was represented by Monica Carss-Frisk KC and Sean Butler. The CMA were represented by Ben Lask KC, Christopher Brown and Arnold Ayoo. GEMA (another Interested Party to this judicial review) was represented by Daniel Cashman and Natasha Simonsen.

54. The parties made detailed arguments with respect to the grounds of appeal. I will summarise them in the following paragraphs.

Ground 1: The CMA erred as to the appropriate standard of review

55. Mr Thompson KC submitted, on behalf of WWU, that an appeal under section 23B of the 1986 Act is an appeal on the merits and must go beyond supervisory review. What is required of the CMA is an in-depth consideration of price control decisions reflected by the statutory context and also (i) the specific wording of section 23D of the 1986 Act; (ii) the expert composition of the CMA panel; (iii) the CMA's power to compel oral and documentary evidence; (iv) the CMA's power to commission expert advice; (v) the CMA's power to hear fresh evidence; and (vi) the CMA's power to substitute its own decision for that of GEMA.

56. When deciding an appeal under section 23B, the CMA "must have regard" to the same matters as GEMA when setting price controls, including the Financing Duty (arising under section 4AA(2)(b) of the 1986 Act) and the Best Practice Duty (arising under section 4AA(5A) of the 1986 Act), and must do so "to the same extent as is required of" GEMA. The effect of these obligations is that the CMA is required, when considering a particular ground of appeal, to form its own independent view of how those matters should influence a price control decision. To that extent, the CMA must step into GEMA's shoes.

57. When the CMA was required to consider whether GEMA "failed properly to have regard to", or "failed to give the appropriate weight to" the Financing Duty and the Best Practice Duty, the CMA was required to consider the issues raised on the appeal in detail on the evidence, having regard to those matters, which could include seeking expert evidence and/or oral evidence and cross-examination. The CMA must consider what degree of regard or weight it considers to be appropriate or proper for each relevant matter.

58. This approach does not necessarily involve the CMA substituting its own view for that of GEMA. Where the CMA finds there was more than one approach which demonstrated that proper regard and appropriate weight was given, and GEMA took one such approach, the CMA can decide that was not "wrong", even if the CMA would have taken a different approach. To reach that view, however, required the CMA to make its own independent determination of the correct application of the section 23D(2) factors.

59. Mr Thompson KC contended that this approach is a more intensive form of review than that of traditional judicial review – which is reflected in section 23D(4)(e) ("wrong in law").

60. In the instant case, the CMA erred by applying a different approach, drawn from different statutory regimes. The CMA specifically rejected the contention made by WWU that it was were required to reach its own judgment as to what constitutes "proper" regard or "appropriate" weight, saying merely that "[w]e are required to

consider the merits of the Decision but only through the prism of the specific errors alleged by the appellants".

61. Mr Thompson KC contended that it was not WWU's case that section 23D of the 1986 Act required there to be a *de novo* appeal or re-hearing. However, the role of the CMA involves the exercise of exceptional powers and duties; the CMA can investigate issues that it has identified, and can make decisions based on evidence that it has called for as well as evidence provided by interveners. The CMA's remedies include substituting its own views for that of GEMA. These are unusual powers and impact on the approach that the CMA should take.

62. Mr Thompson KC highlighted the wording of section 23D(2), which refers to the CMA having regard "to the same extent as is required by" GEMA to the matters to which GEMA must have regard "(a) in the carrying out of its principal objective under section 4AA; (b) in the performance of its duties under that section". The effect of the words "to the same extent" means nothing more, and nothing less; the CMA has to step into the shoes of GEMA.

63. With respect to specific errors alleged to be made by the CMA, Mr Thompson KC contended that the CMA erroneously applied a "rationality" review to the cost of debt appeal, referring specifically to paragraphs 14.142, 14.144 and 14.179 of the final determination; and with respect to the treatment of derivatives, referring specifically to paragraphs 14.219-14.220 and 14.254.

64. Mr Thompson KC also submitted that the CMA erred in their approach to the margin of appreciation to be applied to GEMA's decision-making when exercising a regulatory judgment.

65. Mr Thompson KC argued further that the CMA misdirected itself by stating at paragraph 3.79 that "we will apply appropriate restraint when reviewing issues which entail the exercise of GEMA's judgment, which may include GEMA's predictions for the future". That degree of deference was in error because the CMA is a body which is (i) expert and experienced in its own right; (ii) expressly bound by statute to have regard to the same factors to the same extent as GEMA, and to apply an objective standard; (iii) able to take account of evidence that was not available to GEMA, including new evidence and interventions from third parties; and (iv) empowered to substitute its own views for those of the original decision-maker.

66. Reference was also made by Mr Thompson KC to the distinction between price control and other appeals to the CMA. The time limits for the former appeals were longer and he indicated that they would be subject to more in-depth investigations. This was reflected in the Department of Energy and Climate Change's consultation materials for the new appeals. In the Department's Proposals for implementation of licence modification appeals under the EU Third Package – Final Impact Assessment, June 2011, it was stated at pp.20-1 that:

> "We consulted on two possible options regarding the structure of the appeals mechanism – an adjudicative approach and investigatory approach.
>
> In practice, both types of appeal follow similar processes in so far as the appeal body would consider evidence submitted by the appellant, Ofgem, and potentially other parties, and weigh up the arguments and

evidence to reach a decision. The appeal body would have the power to require the submission of information and to hold hearings. However, an investigative appeal would be more in-depth and longer. Therefore there may be a greater cost on business, Ofgem and the CC as they may require more time, legal resources and documentation. There may also be further duplication of Ofgem's work due to additional analysis and consultation. However, an investigative appeal would allow for greater scrutiny of the economic considerations that underpin the regulator's decision, which go to the heart of a business operation.

Price control arrangements are mainly contained in special licence conditions and apply to individual network companies. Due to the complex nature of these decisions and the significant impact they have on companies, the government has decided that they should be subject more in-depth scrutiny. This was also the view of the majority of respondents to the consultation. While taking an in-depth, investigative approach to price controls seems likely to make these appeals more expensive, it would ensure a thorough review of decisions very fundamental to monopoly companies' financial positions. Appeals against standard licence condition modification decisions will follow an adjudicative process.

The government will allow parties to appeal individual elements of a price control as this may reduce the cost of appealing. However, as price control decisions are essentially a package of balancing measures, there is the potential that the upholding of an appeal on a single element could have a knock-on effect on other elements of the package and upset the balance of the package. The CC would therefore have discretion to consider additional elements or the whole package of the price control decision if the evidence submitted shows that reviewing individual elements is likely to upset the balance of the whole package.

. . .

The government intends to introduce a carefully defined right of appeal on the merits, in relation to the specified grounds. We believe that this balances the costs and benefits of the different options best. This grounds would be broadly similar to those contained in the Energy Act 2004 which provides the procedure for reviewing amendments to industry codes."

67. Miss Carss-Frisk KC, on behalf of SSEN-T, supported the arguments made by WWU. The CMA's approach had been excessively deferential to GEMA. Given the statutory framework, the characteristics of the decision-maker and the appellate body (which consisted of experts), and the issue in respect of which GEMA was said to have erred – an exercise of judgment about competing approaches to determining the inputs of a formula for setting price controls - Miss Carss-Frisk KC submitted that the CMA should have decided for themselves what they regarded as the appropriate or correct formula.

68. It was not suggested by Miss Carss-Frisk KC that there needed to be a *de novo* hearing

before the CMA. The CMA does not start from scratch, but it has to focus on GEMA's decision and whether the statutory grounds of appeal are satisfied. But, there has to be an intensity of scrutiny, and the CMA needs "to roll up its sleeves" and decide what it regards as the appropriate or correct solution.

69. Miss Carss-Frisk KC submitted that only if there were a number of equally good approaches and the one chosen by GEMA was among these, would GEMA's decision not be wrong even if the CMA would have chosen a different approach: that was an appropriate application of the margin of discretion or appreciation. The CMA's approach was an error as it concluded that GEMA's decision would prevail unless there was a "clearly superior" alternative. This places too high a hurdle on the appellant; it was sufficient to decide whether the alternatives are equal, or if one is "better" than the other, and the CMA should have decided for itself which approach was "better".

70. The CMA resists this ground of appeal. Mr Lask KC submitted that section 23D(4) of the 1986 Act empowers the CMA to allow an appeal <u>only</u> to the extent that it was satisfied that the decision which has been appealed against was wrong on one or more of the specified grounds. The statutory scheme provides for a carefully defined right of appeal that requires the CMA to review GEMA's decision through the prism of the specific errors alleged by the appellant in its notice of appeal. In deciding whether GEMA's decision was wrong, the CMA can assess the merits of the decision (depending on the error that is alleged). This does not, however, entail the CMA stepping into GEMA's shoes and assuming the role of primary decision-maker, or entitle it to allow an appeal simply on the basis that the CMA would have taken a different view of the matter if it was the energy regulator. The appellate regime does not call for a *de novo* redetermination by the CMA.

71. Mr Lask KC submitted that the purpose of section 23D(2) of the 1986 Act - that is, "In determining an appeal the CMA must have regard, to the same extent as is required of the Authority, to the matters to which the Authority must have regard") - means that the CMA must have regard to the same matters as GEMA, as part of the appellate function and not as the primary decision-maker. The range of matters to which GEMA must have regard are policy matters, and the purpose of section 23D(2) is to ensure that the same framework is applied by the CMA so that the prescribed policy considerations are not undermined or ignored. The provision, therefore, seeks to ensure that the CMA does not, on appeal, cut across the interests protected and duties imposed pursuant to sections 4AA, 4AB and 4A of the 1986 Act.

72. With respect to the different types of "wrong" decisions that are referred to at section 23D(4) of the 1986 Act, Mr Lask KC drew a distinction between questions of statutory construction which are binary matters: GEMA is either right or "wrong". In other cases, the matter will be more nuanced, and GEMA's error must be material before its decision can be said to be "wrong". As for whether the weight given by GEMA to any matter is "appropriate", that is a matter of degree: the weight given must be sufficiently inappropriate. It was pointed out by Mr Lask KC that the language of section 23D(4)(b) is not that GEMA failed to give the weight that the CMA would have given.

73. With respect to the approach to the margin of appreciation, Mr Lask KC submitted that the approach taken by the CMA was unimpeachable and consistent with the cases on which the regime under section 23D is based. The CMA would only interfere with decisions involving value judgments based on competing considerations where it was satisfied that the decision was wrong (see paragraph 3.76 of the final determination).

Where GEMA has exercised regulatory judgment in selecting amongst various alternative solutions to a regulatory problem, the CMA would not substitute GEMA's assessment for its own unless it was satisfied that GEMA's approach was wrong, because, for example, there was a clearly superior approach: see paragraph 3.77 of the final determination.

74. Mr Lask KC emphasised that the "clearly superior" alternative referred to by the CMA was not a "hard-edged test" that had to be satisfied before an appeal could succeed. At paragraphs 3.43 and 3.77 of the final determination the CMA explained that "where the alternative options each have competing pros and cons, and none is clearly superior, it will be **more difficult** to persuade us that GEMA has erred" (emphasis added). Mr Lask KC contended, therefore, that this allowed for flexibility in the CMA's approach.

75. The CMA's task was to assess whether GEMA's decision was wrong and not to conduct a *de novo* redetermination. The mere fact that GEMA has, in the exercise of its judgment, rejected an approach that the CMA may have preferred had it been the primary decision-maker does not make GEMA's decision wrong, let alone wrong on one of the statutory grounds. Mr Lask KC contended that if there was little to choose between two competing alternatives, both of which have pros and cons, it stands to reason that it will be more difficult to establish that the chosen alternative was wrong. On the other hand, GEMA's decision is more likely to be wrong if it rejected an alternative that was clearly superior to GEMA's chosen option.

76. Mr Lask KC also took issue with the assumption that there will either be only one correct solution to a problem, or several equally good solutions. In reality, there may be several alternatives, all of which have pros and cons, and all of which lie inside the bounds within which reasonable disagreement is possible.

77. In submissions on behalf of GEMA, Mr Cashman explained that the energy licence modification appeal framework had been introduced by the 2011 Regulations, and was intentionally and closely based on the appeal standard in the Energy Act 2004. In an appeal brought under that Act - E.ON UK Ltd v GEMA (10 July 2007) -- to the Competition Commission, it was held (at paragraphs 5.11-13) that it was not the role of the Commission "to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator. … our role is to determine whether GEMA's decision is wrong … this test clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds". The same applied to an appeal under the 1986 Act.

78. Mr Cashman submitted that the CMA was right to reject the submission made by WWU on the appeal that the CMA should assume GEMA's role, reconsider the case as if it was the primary decision-maker, and reach its own judgment as to what constitutes "proper" regard or "appropriate weight" in respect of any matter. The CMA was right to decide that "the standard of review falls short of a full rehearing. We are required to consider the merits of the Decision but only through the prism of the specific errors alleged by the appellants" (paragraph 3.31 of the decision).

Ground 2: The CMA misdirected itself with respect to the Financing Duty

79. Mr Thompson KC contended that, in upholding GEMA's approach to the cost of debt allowance, the CMA misconstrued the nature of the duty at section 4AA(2)(b) of the 1986 Act, deciding that an individual approach to each company's financeability was

not required, and that it was sufficient for consideration to be given to a notional licensee or to the average of all licensees.

80. In the Statement of Facts and Grounds, and in the skeleton argument, WWU submitted that the CMA had also erred in deciding that the duty does not involve a duty of outcome. This point was not pursued in oral argument: Mr Thompson KC accepted that the duty to have regard could not be contravened because the outcome was not achieved. This was an entirely appropriate concession given the statutory language.

81. Mr Thompson KC submitted that, as a matter of statutory construction, the statutory scheme calls for consideration of each licence holder individually. Section 4AA(2)(b) of the 1986 Act refers to "licence holders" but, applying section 6(c) of the Interpretation Act 1978, the plural can include the singular. Mr Thompson KC contended, therefore, that it is not sufficient to discharge this duty by ensuring that a "notional" or average licence holder can finance a notional set of obligations.

82. Further, Mr Thompson KC submitted that it would not be in the interests of consumers if actual licence holders were placed at risk of being unable to finance their actual obligations due to an assessment of financeability based on a notional or average basis. This was reflected in the *Explanatory Notes* to the legislation introducing the licensing regime. At paragraph 22, it was stated that:

> "This duty to further the principal objective incorporates the matters which form the regulators' existing primary duties. The Authority must have regard to the need to secure that all reasonable demands for the relevant utility are met. In the case of gas, this duty applies to the extent that it is economically feasible for demand to be met. Likewise, the Authority must recognise that, to the extent that the utilities legislation places obligations on utility companies (whether directly, through licence conditions or otherwise), such companies must be able to finance those obligations."

83. Mr Thompson KC contended that the duty at section 4AA(2)(b) of the 1986 Act was to "have regard" to the financeability of each licence holder and this meant that all relevant circumstances, which necessarily includes the actual circumstances of an individual company, must be considered so as to satisfy GEMA's and then the CMA's public law duties. This was also called for by the principle of equality of treatment.

84. Mr Thompson KC submitted that there would be situations where the use of notional licence holders could be reasonable: taking account, for instance, of generalised features. However, that was not the case here. The approach taken by the CMA in upholding an assessment of financeability on an averaged or notional basis for licence holders as a whole, meant that the impact of GEMA's decision on WWU's financial circumstances was treated as irrelevant. The evidence before the CMA was that GEMA's approach to cost of debt would leave WWU with a "significant shortfall in its efficient cost of debt of approximately £20m a year over the RIIO-GD2 price control period". This was not given any weight.

85. In summary, Mr Thompson KC submitted that both GEMA and the CMA needed to consider the reasonableness of individual financing arrangements made by licence holders and the financial impact on individual licence holders of GEMA's price control

formula decisions, and this was not done. In this regard, Mr Thompson KC referred specifically to the evidence of Oxera, an economics and finance consultancy instructed by WWU. Evidence from Oxera was admitted by the CMA; it explained the reasonableness of the financing strategy pursued by WWU; and yet that evidence was seemingly ignored by the CMA when it came to make its determination.

86. The CMA resists this ground of challenge. Mr Lask KC noted that the appeal that had been brought by WWU was not advanced on the basis that GEMA had given inappropriate weight to the financing duty, but that GEMA had misconstrued that duty or acted irrationally. The final determination of the CMA had to be understood through this lens, as that was the way in which the appeal to the CMA was advanced.

87. Looking at what the duty requires, Mr Lask KC submitted that section 4AA(2)(b) of the 1986 Act does not require an individuated approach. First, the reference to "licence holders" in section 4AA(2)(b) does not refer to each individual licensee. The statute contains references to "licence holder" in the singular, and had Parliament intended to mandate a focus on individual licence holders it would have used different language. This was a view that GEMA was entitled to form. A contrast was made by Mr Lask KC with the statutory language at section 33DB(3) of the 1986 Act which concerns the provision of information relating to complaints handling standards, and which states (with emphasis added) that:

> "At such times as the Authority may direct, each of those licence holders must give the Authority such information as the Authority may direct with respect to the levels of compliance with the standards which **the licence holder** has achieved."

88. Second, the duty at section 4AA(2)(b) of the 1986 Act is not to achieve an outcome. In those circumstances, it was inherently unlikely that there was an obligation on GEMA to scrutinise the circumstances of individual licence holders in every case.

89. Third, Parliament had left it to GEMA to decide what regard to have to financeability. Whether individual circumstances will be relevant will depend on the facts and circumstances of the particular case.

90. Fourth, the financing duty is one of several factors to which GEMA is required to have regard. The statutory provisions require GEMA to look at broad factors which may actually be in conflict, not just for price controls but for all of their functions. This points against an obligation to have regard to the impact on every licensee in every case.

91. In any event, GEMA and the CMA did consider individual circumstances when assessing financeability, and took account of certain individual circumstances, namely those which were not in the licensees' control to avoid unfairness. The real complaint was not that GEMA or the CMA ignored WWU's circumstances; rather, it is that they chose not to give WWU an additional allowance.

92. Further, Mr Lask KC pointed out that GEMA's view was that consumers' interests would be threatened by the approach taken by WWU, which offered no or minimal incentive to licensees to manage risks prudently.

93. On behalf of GEMA, Mr Cashman pointed out that the "principal objective" of the regulator is to protect the interests of existing and future consumers in relation to gas

conveyed through pipes. The financing duty at section 4AA(2)(b) is not a duty of "outcome", but is something to which GEMA shall have regard in performing its duties. What that requires depends on "that which is appropriate or due to be given in the circumstances of the particular case": see CAO v Secretary of State for the Home Department [2025] AC 1117 [75].

94. The approach taken by GEMA in setting up the "notional efficient licensee" as the focus of the financing duty, rather than the particular circumstances of the individual licensee, reflects GEMA's long-standing regulatory practice over nearly two decades. This approach is also widespread in regulated sectors.

95. This approach was also said to further the obligation in section 4AA(5)(a) of the 1986 Act to promote efficiency and economy on the part of the licensees. Mr Cashman submitted that the use of the notional licensee sets incentives to beat the average, thereby squeezing cost efficiencies. The approach suggested by WWU would, by contrast, not incentivise companies to manage risk efficiently and prudently but would expose the consumer to moral hazard.

Ground 3: The CMA erred in its approach to WWU's cost of debt appeal

96. WWU submitted that the use by GEMA of an average for the cost of debt was irrational and discriminatory.

97. Miss Leventhal KC made the oral submissions on behalf of WWU on this ground. She contended that GEMA had based its approach on the notional concept of the reasonable operator. Two elements were used. The first was an external index representing the market rate cost of debt: iBoxx. This index is used in the utilities market, and is based on the market average for bond debt. A trailing average of the iBoxx index for a period of 14 years was used. This part of the approach was not challenged by WWU. The second element of the approach was challenged and was said to be in error: GEMA's approach was to calibrate this index against the sector average cost of debt, rather than the financing costs of individual licensees.

98. Miss Leventhal KC submitted that GEMA's approach, which was upheld by the CMA, was irrational in that the companies included in the "sector" which was being compared with iBoxx, had different fundamental characteristics, making them unsuitable for comparison and resulting in an average which did not generate an objective benchmark for efficiency. Furthermore, the calibration to sector averages was done on an *ex ante* basis, using a bottom-up approach to estimating average actual electricity transmission, gas transmission and gas distribution company debt costs, with a minor adjustment for company size. This was said to be unlawful.

99. It was argued that there were four factors that were problematic:

(1) *The breadth and difference within the sector*: The "sector" included companies from different industrial sectors, for example National Grid Electricity Transmission Plc ("NGET") and National Gas Transmission Plc ("NGT"), which undertake activities and have corporate characteristics quite different from much smaller gas distributors like WWU;

(2) *The cost of debt index was dominated by two corporate groups*: The average indexed cost of debt across the "sector" was driven primarily by the actual costs of debt of National Grid which drove 47%, and Cadent which drove 23%;

(3) *The circumstances of each company were different*: the "sector" included companies which incurred their debt at very different times, and this was a significant factor in the cost of debt for each company; and were factors outside of WWU's control;

(4) *The approach adopted was arbitrary*: The approach adopted by GEMA was largely based on historic outcomes for this disparate group of businesses, rather than determined prospectively, e.g. to reflect administrative guidance from GEMA. The effect of this was that it would have been impossible for WWU to have been able to predict with any reasonable degree of confidence what allowance would be given for cost of debt in the RIIO-2 price control period from April 2021 to March 2026, or to determine its financial strategy on that basis.

100. Miss Leventhal KC argued that the approach was discriminatory in the sense that two different persons or entities were unjustifiably treated the same: see R (Rotherham Metropolitan Borough Council) v Secretary of State for Business, Innovation and Skills [2015] UKSC 6 at [26], and the CMA had not grappled with the discriminatory impact of the approach adopted.

101. Miss Leventhal KC contended that the cost of debt approach was discriminatory by design and outcome. Cadent, which serves half of Great Britain's gas consumers, obtains an estimated £50m windfall each year from its customers (without any rational justification in terms either of Cadent's actual cost of debt or its relative efficiency), while the expected (and equally unjustified) under-recovery by WWU was £20m a year. There was, however, no finding that Cadent was more efficient or financially prudent than WWU.

102. Miss Leventhal KC pointed out that GEMA had explained that all sectoral averages give rise to skewed results, and discrimination was avoided by considering "factors ... outside of the management's control and adjust[ing] allowances accordingly". However, the allowance set by GEMA was derived from a sectoral average which was very largely determined by the financial circumstances and decisions of other companies which were obviously outside of WWU's control and unforeseeable, and yet these factors were not taken into account.

103. The two small adjustments made by GEMA were acknowledged by Miss Leventhal KC, including the one which was to WWU's benefit: reflecting the operator's smaller size and the infrequency of issuing debt. However, this was not based on individualised assessment and provided only minimal mitigation to the very substantial shortfall experienced by WWU.

104. Miss Leventhal KC noted that the CMA had acknowledged that the approach adopted by GEMA "may lead to companies sitting above or below the average during any one price control, this is only a concern if companies are subject to **structurally** higher or lower costs" (emphasis added). Miss Leventhal KC questioned, however, why "structural" matters only represented a concern that needed to be addressed through adjustments, contending that this was arbitrary. Ruling out non-structural matters meant that efficiency was not judged, even though GEMA (and the CMA) were required to do this as part of the Financing Duty, and the evidence available (supported by the consultants, Oxera) was that WWU's debt financing strategy had been adopted on an efficient and prudent basis.

105. Miss Leventhal KC pointed out that WWU had put forward an alternative approach

which was a less intrusive way of achieving the appropriate cost of debt. This approach, which was based on the actual financing decisions made by the licence holders, did not involve evaluating efficient outcomes, and was not based on arbitrary distinctions. This approach was regarded as "plausible" by the CMA, but it was not preferred by the CMA as it said that it exposed customers to the "specific financing choices of their regional monopoly energy network". However, Miss Leventhal KC argued that GEMA's approach, which was preferred by the CMA, meant that customers were exposed to risk: (i) they may pay more than the efficiently incurred costs of debt; and (ii) they may pay the costs of inefficient future financing decisions.

106. Miss Leventhal KC contended that the exclusion of derivatives was irrational and discriminatory for a number of reasons:

(i) GEMA does count some derivatives in its assessment of actual costs, but irrationally excludes others;

(ii) it was inconsistent to exclude derivatives for the cost of debt analysis, but then include them for the tax clawback analysis: this results in an unfair asymmetry;

(iii) it was irrational for the CMA to accept that the use of derivatives constituted normal business practice -- a normal utility operator will use derivatives as part of its normal business practice: derivatives are a generally accepted and widely used tool within corporate treasury departments - but then to place no weight on this when accepting GEMA's submission that analysis of derivatives was so complex that they should be excluded from the cost of debt assessment;

(iv) it was irrational for the CMA to accept that it was sufficient for GEMA to have considered the impact of derivatives at a sectoral average level. CMA found that WWU's case on derivatives made no difference when looking at matters on an average basis, but this ignored the fact that WWU's individual position was severely prejudiced;

(v) no assessment was made by the CMA as to whether WWU's approach was imprudent or inefficient;

(vi) the CMA found that the "most useful derivative instruments" to include are "those that are used to synthetically replicate debt instruments, such as index-linked debt" but went on to say that WWU's use of derivatives was "clearly not an example" of this. This was based on an error of fact: WWU's derivatives were to a very large extent "used to synthetically replicate debt instruments" and reflected GEMA's own contemporary guidance; and

(vii) the exclusion of "synthetic" and "esoteric" derivatives went too far. Furthermore, GEMA and the CMA were capable of analysing complexity and the CMA had the expert evidence before it from Oxera which would have enabled this - there was a section of the Oxera report on the exclusion of derivatives – and the CMA should have carried out further investigation itself. In addition, in the exercise of its regulatory role, GEMA has access to extensive information concerning individual licence holders, including annual data submissions that contained extensive information on debt and derivatives.

107. With respect to point (vi), Miss Leventhal KC submitted that the test in E v Secretary of State for the Home Department [2004] QB 1044 for mistake of fact was made out: there was a mistake as to an established fact which was uncontentious and

objectively verifiable (the CMA failed to recognise that 70% of the derivatives used by WWU were of the "synthetic" type and what the CMA was referring to in paragraph 14.251, and the risk of manipulation, relates to approximately 30% of the derivatives and what was done by WWU with respect to them in 2019); WWU was not responsible for the mistake; and the mistake had played a material part in the CMA's reasoning.

108. With respect to point (vii), Ms Leventhal KC contended that it had been pointed out to the CMA in submissions made by WWU following the provisional determination that it was a "striking coincidence" that when the aggregate of derivatives was included in the cost of debt analysis this made no difference to when it was excluded. The CMA was asked to interrogate this further, but it failed to do so. This was not something which WWU could do, as it did not have the information and it was not in its powers to obtain it. The CMA could have obtained that information had it exercised its functions properly.

109. The CMA contested this ground. Mr Lask KC emphasised that WWU had argued both irrationality and discrimination on its appeal from GEMA's decision and there was no public law error in its rejection of the argument.

110. The CMA found that it was not irrational for GEMA to aggregate the debt costs of a range of companies. Companies in the same regulated sector were likely to face broadly the same <u>potential</u> (i.e. attainable) costs on the debt markets, and structural differences were taken into account by GEMA through adjustments. The sector was broad enough to mean aggregate debt costs provided a good indication of efficiency. It was clear that WWU could access debt over the relevant period, and in the same way as other operators within the gas and electricity sectors.

111. The CMA had found at paragraph 14.162 that WWU "was, or should have been, sufficiently aware of GEMA's historical approach to the cost of debt allowance and there was no indication that this was likely to change in the future. In deciding to lock-in costs for multiple decades, despite operating in a regulatory regime that updates the revenue allowances designed to cover those costs at regular intervals, WWU was taking a clear and obvious risk". GEMA's approach was consistent with its long-standing practice of setting the allowed return on debt based on market rates rather than individual company costs, and companies could significantly mitigate against the absence of an *ex ante* benchmark by issuing debt incrementally.

112. Mr Lask KC pointed out that WWU had benefited from its strategy for the first six years when interest rates were high and its combined debt and derivative costs were lower than the allowed return on debt, but that the risk which WWU bet against – i.e. the risk of a significant sustained fall in rates – had subsequently materialised. Further, WWU could still benefit in aggregate from its derivatives strategy in the future depending on circumstances.

113. Furthermore, Mr Lask KC argued that GEMA's approach was consistent with its statutory duties and the interests of consumers, and had the benefit of "ensuring no customer is faced with extreme outcomes resulting from decisions taken by a single local monopoly that they cannot substitute away from": see paragraph 14.187.

114. Mr Lask KC contended that the approach adopted by GEMA was based on a measure of efficiency which it was entitled to use, given that there was no statutory definition of "efficiency" in the 1986 Act. GEMA's measure of efficiency was based

on its use of the iBoxxindex and a comparison with the average cost of debt within the sector. The approach proposed by WWU would not promote efficiency, merely because it was based on market rates at the time when the financing was carried out. The effect of this would be that "almost all financing approaches, however esoteric, would be very likely to be allowed and thus funded by customers"; and, as with WWU, consumers could be saddled with a management decision to lock in debt many years earlier merely because it was in line with market rates at that time. The CMA accepted GEMA's assessment that financing choices, and the risk and rewards that come from those choices, sit most appropriately with companies and their owners.

115. With respect to the argument on discrimination, Mr Lask KC submitted that this was also addressed by the CMA in its final determination, and no error was made. GEMA did not discriminate against WWU by treating all of the licence holders the same: GEMA recognised that it was different from some others and made allowance for that. The fact that further allowance was not made to compensate for the derivative strategy that WWU had chosen to adopt did not render the CMA's decision irrational.

116. In any event, any discrimination was justified. The baseline adopted by GEMA (the 10-year average of the yield on the iBoxx GBP 10yr+ Utilities index, which tracked and collated bonds issued in GBP by the network companies) was consistent with its long-standing practice, reflecting GEMA's reasonable assumption that a notional efficient operator would raise and refinance debt regularly, and thus would spread rate-fixing risk and refinancing risk over time.

117. An additional allowance was provided to certain companies, including WWU, to account for individual circumstances which they were not in a position to control: its small size and therefore the expectation that it would issue debt in smaller sizes or less frequently than other networks. GEMA did not accept WWU's request to provide a further uplift to cover the high-cost long-term derivatives that WWU had taken out in 2007: these contracts were the result of management decisions and so were a factor within WWU's control and GEMA considered the risk of those decisions should lie with WWU's shareholders and not its customers. That approach created strong incentives on the part of licensees to manage company debt prudently and efficiently and protected customers from the risks of companies' financing decisions. WWU's preferred approach of focussing on whether its costs reflected (then prevailing) market rates would not provide licensees with sufficient incentives to manage their debt costs efficiently, because it would mean that almost all financing approaches would be very likely to be allowed and thus funded by customers.

118. Mr Lask KC contended that the CMA's finding that GEMA's approach, which excluded derivatives, was not irrational was soundly based for a number of reasons: (i) the allowance GEMA set could be achieved using standard debt instruments; (ii) the evidence that derivatives were also used for purposes other than replicating debt, which raised a concern that companies might "report derivative costs which differ from the true underlying financing costs"; (iii) the complexity of separating out derivatives which did seek synthetically to replicate actual debt instruments from those which did not; and (iv) the fact that, in aggregate, derivatives did not make a material difference to the actual cost of debt across sector.

119. With respect to point (iii) – complexity – Mr Lask KC addressed a submission that Oxera had examined WWU's derivatives and so it would not have been complex

for GEMA or the CMA to have done the same. Mr Lask KC contended that this missed the point: GEMA's evidence was about the whole market, and the risk of manipulation; Oxera was only looking at one company, whereas GEMA (or the CMA) would have had to look at more than one company. Mr Lask KC addressed the issue of whether Oxera's evidence was taken into account by contending that GEMA actually rejected it, and explained why, referring to paragraphs 14.210 and 14.218 of the final determination.

120. With respect to the error of fact argument, Mr Lask KC submitted that the CMA's finding at paragraph 14.251 was made in the context of the CMA's broader observation at paragraph 14.250 that, whilst it may be useful to count some derivatives when calculating the average cost of debt, that may not be practical or desirable where companies use derivatives in a non-standard way.

121. Further, Mr Lask KC contended that there had been no failure to consider the impact on WWU; this was grappled with. WWU had made representations about the impact on it and that its investment grading was under threat. This was disputed by GEMA, and the evidence was that WWU continued to make distributions to its shareholders. Moreover, there were steps that WWU could have taken to mitigate.

122. As for the suggestion that the CMA erred by failing to investigate what was described by Oxera as the "coincidence" that the simple weighted average cost of debt with and without derivatives was the same, Mr Lask KC submitted that this was misconceived. This had not been raised in the Notice of Appeal against GEMA's determination. It was not irrational for the CMA not to interrogate the evidence when it had not been challenged on appeal.

123. In any event, the fundamental point advanced by WWU in this judicial review was that GEMA's approach was wrong in principle, whether or not the average position was as stated by GEMA: neither GEMA nor the CMA had conducted an assessment of the impact on individual licence holders of including or not including derivatives. That was, according to Mr Lask KC, wrong as the impact on WWU was known as this was advanced as part of the appeal.

124. Mr Cashman, on behalf of GEMA, submitted that the approach that it had adopted was constructed in the exercise of GEMA's regulatory discretion, with the aim of distinguishing differences that were "heavily influenced by regulatory decisions and regulatory requirements for investment" from those company adjustments "which were to a much greater extent driven by management or shareholder decisions on capital structure, M&A activity, dividend policies, and type and timing of debt". WWU was not discriminated against. In fact, adjustments were made in its favour.

125. Mr Cashman pointed out that WWU had chosen to "lock in its costs for several decades despite it being highly likely that the absolute level of debt allowances would change in each price control". As the CMA found, it was not wrong for WWU to "take responsibility for it, as we expect that it would have if such a decision had proven to be financially advantageous". The decision as to which measures to take to remediate risks, once they had materialised, was a matter for WWU's management and shareholders.

126. With respect to derivatives, Mr Cashman argued that the CMA was right to decide

that GEMA was entitled to take the view that if companies choose to use derivatives it was because they considered it advantageous to do so, and they should not require additional compensation. Indeed, including derivatives for the whole sector would have suggested a lower allowed cost of debt. In this context, GEMA's exclusion of derivatives did not lead to a cost of debt allowance that was too low.

Ground 4: The CMA erred in its approach to WWU's tax clawback appeal

127. Miss Leventhal KC submitted under this ground that, in the alternative, it was highly inconsistent and irrational for the CMA to find that "it was not wrong" for GEMA (i) to assess the finance costs of licensees on an individual basis for its tax clawback policy or (ii) to include derivatives specifically because "[t]ax clawback calculations rely on a measure of the financing costs of debt", while excluding them from the cost of debt assessment. It was argued that there can be no rational justification for GEMA to adopt a "notional" approach for one side of an equation but an "individual" approach for the other side, or for making a comparison on an inconsistent basis that causes substantial prejudice to individual licensees. It is not a like-for-like comparison, as the costs of derivatives are excluded from one side of the comparison but included in the other.

128. In support of WWU's challenge, Miss Leventhal KC presented the Court with a "worked example":

Step 1 – Ofgem's notional tax allowance for company X (*excluding* derivative costs)

Profit before interest: £100m
Notional interest deduction (loans only, no derivatives): £40m
Taxable profit = £60m
Notional corporation tax @ 19% = £11.4m
→ Ofgem sets a revenue allowance for this notional tax; the allowance is a grossed-up number, i.e. £11.4m/(1-0.19) = £14.1m

Step 2 – Company X's actual position (*including* costs of derivatives)

Profit before interest: £100m
Actual loan interest: £40m (tax-deductible)
Actual derivative costs: £20m (also tax-deductible)
Total tax-deductible interest: £60m
Taxable profit = £40m
Actual corporation tax @19% = £7.6m

Step 3 – Clawback

If X company exceeds the gearing test [GEMA specifies a permitted level of gearing (debt/RAV) as a matter of its regulatory policy], then tax clawback will apply as below
Tax allowance set by GEMA (based, inter alia, on notional cost of debt policy excluding derivatives): £14.1m. After tax is applied, the Company has £11.4m.

Actual tax paid to HMRC (based on actual costs of interest and derivatives): £7.6m
Difference = £3.8m
Under clawback, Ofgem reduces company X's permitted future revenues by £4.69m: (£3.8m/(**100 19%**)). After tax is applied, this is £3.8m.

Step 4 – The asymmetry problem

Company X gets no allowance for the £20m derivative costs actually incurred in Ofgem's cost of debt calculation because Ofgem excludes such costs.

Ofgem then inconsistently takes account of those same actual costs to reduce the allowance for tax in the exercise of its tax clawback policy. This is the asymmetry at the heart of WWU's complaint.

129. This ground of challenge was resisted by the CMA. Mr Brown made oral submissions on behalf of the CMA on this ground. He explained that the purpose of the tax clawback is to ensure that the tax allowance calculation broadly reflects the tax that individual companies would in fact be required to pay, given their actual financing costs. In so doing, it removes the incentive (which would otherwise exist) for licensees to increase their gearing and lower their actual tax costs while retaining the full tax allowance: this aim was not challenged by WWU.

130. Mr Brown submitted that, by contrast, a notional company approach would risk companies receiving an allowance for tax that they are not in fact paying (i.e. if their debt costs are higher than those of the notional company). It is inherent in the tax clawback mechanism that it addresses the position of the individual company.

131. In adopting this approach, Mr Brown argued that GEMA was applying a different policy consideration to its approach to the cost of debt allowance: that the risks attaching to derivatives should lie with the companies in question. The allowances were therefore entirely different in nature and it was not irrational to apply a different approach.

132. For GEMA, Mr Cashman submitted that there was no irrationality. The two policies – (i) not to include derivatives in the cost of debt allowance, and (ii) to include derivatives in the tax clawback – serve different purposes. Mr Cashman explained that under the price control settlement companies receive an allowance for tax, which can be passed on to customers and ultimately consumers in energy bills. This allowance is set at a level consistent with the level of borrowing of a notional company. However, since interest on debt is tax-deductible, companies with higher levels of debt can reduce their tax bills below the notional level. This means that, absent tax clawback, companies would receive an allowance for tax that they are not in fact paying. The purpose of tax clawback is to ensure the licensee does not retain the unearned benefit of the tax allowance.

133. Mr Cashman also explained that there are real difficulties in assessing derivatives at the stage of calculating the allowed cost of debt, as derivatives can be used to shift financing costs and receipts from one period to another. Valuing certain derivatives

properly would require the entire trade history and all related flows (including all historical cash movements) to be discounted at the rate indicated by the appropriate yield curve at the precise time of the derivative trade. It would be disproportionately time consuming, expensive and difficult for a regulator to value certain derivatives properly.

134. Mr Cashman explained that these complexities do not arise in respect of tax clawback. The tax benefit is a function of actual tax-deductible interest, and so if derivatives are present and are affecting the actual figure, then GEMA's calculation of the tax to be clawed back will also take account of them. WWU's alternative may incentivise higher gearing, and highly-geared companies would be incentivised to enter into inflation-linked derivatives instead of bonds.

VI. Discussion

135. I shall consider each of the grounds of appeal in turn.

Ground 1: Did the CMA err in its approach to the appeal?

136. Mr Thompson KC sought to tie this ground of challenge to the CMA's approach to the cost of debt and treatment of derivatives arguments that were made on appeal by WWU, contending that the CMA erroneously applied a rationality test to those matters. In my judgment, that submission was misconceived. The appeal brought by WWU on those matters was that GEMA had acted irrationally in the approach to the cost of debt and the treatment of derivatives: see paragraph 14.15 of the final determination. It was entirely appropriate, therefore, for the CMA to apply a test of rationality to those matters, and I shall deal with those arguments when considering the subsequent grounds of challenge below.

137. The argument made by the parties as to the proper approach that the CMA should take to an appeal from GEMA is therefore, academic, but as I heard detailed submissions on the subject, and as the matter may be of assistance to the CMA, and to gas utility operators who may seek to invoke the appellate mechanism in the future, I will address some of the key points that were raised.

138. In my judgment, the CMA was absolutely right to say, as it did at paragraph 3.31 of the final determination, that an appeal did not give rise to a re-run of the original investigation or to a *de novo* hearing of all the matters that were before GEMA.

139. Further, the CMA was absolutely right to say that it was required to consider the merits of GEMA's decision "but only through the prism of the specific errors alleged by the appellants". The CMA needed to consider whether GEMA made a decision that was "wrong" on one of the prescribed statutory grounds.

140. This is clear from a reading of the statutory wording of section 23D of the 1986 Act. There is no mention in that section of the appeal being a *de novo* hearing. Rather, what the CMA is asked to do is to consider whether GEMA's decision was "wrong" on one of the five prescribed grounds: (a) to (e), and not whether GEMA's decision was merely "wrong". Had section 23D(4) not gone on to list the different grounds on which GEMA could have been "wrong", then a proper construction of the appellate power would have been for the CMA to conduct its own investigation and make its own determination as if it was the primary decision-maker. That is not, however, the statutory language, and therefore not the role of the CMA.

141. The different grounds on which the CMA may find that GEMA's decision was "wrong" necessarily require consideration of the way in which the appeal is put, based on the conclusion reached by GEMA and the findings of fact and analysis that led to that conclusion. In this regard, the CMA were right to regard themselves as being in the position described by Green J in Hutchison 3G UK Ltd and British Telecommunications PLC and others v Ofcom [2017] EWHC 3376 (Admin) at [40] that "there is no blank canvas upon which the parties can paint a new picture which fails to heed the reasoning in the decision under challenge".

142. Looking more closely at the specific grounds upon which the decision could be "wrong", section 23D(4)(c) of the 1986 Act - that the decision was wrong on the ground of an error of fact – will be a working out by the CMA of the well-known test in E v Secretary of State for the Home Department at [66]:

> First, there must have been a mistake as to an existing fact, including a mistake as to the availability of evidence on a particular matter. Secondly, the fact or evidence must have been "established", in the sense that it was uncontentious and objectively verifiable. Thirdly, the appellant (or his advisers) must not been have been responsible for the mistake. Fourthly, the mistake must have played a material (not necessarily decisive) part in the tribunal's reasoning.

143. The ground of appeal at section 23D(4)(d) - that the decision is wrong on the grounds that "the modifications fail to achieve, in whole or in part, the effect stated by the Authority by virtue of section 23(7)(b)" - requires the CMA to determine whether, in fact, the effect was achieved as outlined by GEMA. This may, depending on the circumstances, call for the CMA to carry out its own investigation.

144. The ground of appeal at section 23D(4)(e) that GEMA's decision was "wrong in law" will involve the CMA determining whether there has been an error in construction, or whether GEMA has reached a conclusion that was irrational: including whether GEMA reached a conclusion that was not open to it on the evidence.

145. With respect to section 23D(4)(a) - "that the Authority failed properly to have regard to any matter mentioned in subsection (2)" - and section 23D(4)(b) - "that the Authority failed to give the appropriate weight to any matter mentioned in subsection (2)" - these grounds of appeal require the CMA to scrutinise GEMA's approach to matters that involve an element of judgment or evaluation. Subsection (2) refers to sections 4AA, 4AB and 4A of the 1986 Act.

146. Section 4A of the 1986 Act concerns "Health and safety", and obliges GEMA to "take into account any advice given by the Health and Safety Executive about any gas safety issue" (subsection (2)). The extent to which that advice is factored into GEMA's decision-making is not prescribed. It necessarily involves a matter of judgment or evaluation depending on the decision in question and the relevant facts and circumstances. Similarly, the duty to have regard to guidance on social and environmental matters pursuant to section 4AB of the 1986 Actinvolves a matter of judgment or evaluation.

147. Section 4AA concerns "The principal objective and general duties of the Secretary of State and the Authority". The principal objective of the Authority is "to protect the interests of existing and future consumers in relation to gas conveyed through pipes" (subsection (1)). Those interests are defined at subsection (1A). Subsection (1B) obliges

GEMA to carry out its functions in the manner which it "considers is best calculated to further the principal objective", which involves an element of judgment or evaluation.

148. Subsection (1C) requires GEMA to consider various matters before carrying out its functions. Subsections (2) and (3) imposed a duty to have regard to" certain matters. I shall discuss subsection (2) in more detail below but can say, at this stage, that what the "have regard to" duty requires will depend on the facts and circumstances and involves an element of judgment by GEMA. Other duties within section 4AA also involve judgment or evaluation by GEMA.

149. Accordingly, the appeal grounds set out at section 23D(4)(a) and (b) involve whether GEMA got it "wrong" on matters of evaluation or judgment. I do not consider that this is limited to GEMA making an *irrational* evaluation or judgment: that is, an evaluation or judgment that was simply not open to GEMA; an evaluation or judgment that no reasonable regulatory authority could have arrived at. That approach would not reflect the statutory language.

150. First, I note that section 23D(2) of the 1986 Act provides that "In determining an appeal the CMA must have regard, **to the same extent as is required of the Authority**, to the matters to which the Authority must have regard" under sections 4AA, 4AB and 4A (emphasis added). This obligation calls for the CMA to view an appeal through the lens of its own duties to apply the policy framework as set out at sections 4A, 4AB and 4AA.

151. Second, the language of the CMA determining whether GEMA has "failed **properly** to have regard" (section 23D(4)(a)), and/or has "failed to give the **appropriate** weight (section 23D(4)(b)) (emphasis added), calls for the CMA to do more than assess whether GEMA has acted rationally (c.f. <u>Tesco Stores Ltd. v Secretary of State for the Environment</u> [1995] 1 WLR 759, 780 F-G). Rather, the language calls for the CMA to make its own assessment as to what is "proper" regard and "appropriate" weight.

152. Third, the CMA contains members with relevant expertise, and has powers to call for evidence. This provides institutional support for a more intensive scrutiny of GEMA's evaluation or judgment.

153. The statutory language of section 23D(4)(a) and (b) does not, however, indicate that the CMA simply stands in the shoes of GEMA, and makes the decision afresh where an appeal is brought under those subsections. More prescriptive language would be expected if that was to be the case. Furthermore, GEMA is a specialist body which is expected to have great familiarity with the sector for which it is the regulator. Price control decisions, such as those involved in the appeals that were considered in this case, take time to determine and will involve a great degree of analysis. In the circumstances, the statutory scheme requires that some deference needs to be shown by the CMA to GEMA's evaluation or judgment.

154. The test that the CMA has adopted, and which is the subject of the challenge brought by WWU and supported by SSEN-T, is stated at paragraph 3.43 of the final determination:

> our starting point will be to consider the adequacy of GEMA's chosen approach rather than considering which approach we ourselves might have chosen had we been in GEMA's position. However, we agree that,

> 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 appellants. If, out of the alternatives available, we conclude that some alternatives clearly had greater merit than the solution chosen by GEMA, then we are more likely to be persuaded that GEMA has erred. On the other hand, where the alternative options each have competing pros and cons, and none is clearly superior, it will be more difficult to persuade us that GEMA has erred.

155. I consider that the first part of this test is a correct statement of the CMA's powers. The statutory scheme does not require the CMA to start from scratch, adopting its own approach and then comparing the merits of that approach with that of GEMA. This respects the principle that GEMA is the primary decision-maker.

156. I consider, however, that the second part of the test – the threshold for evaluating GEMA's approach with that of any reasonable alternatives advanced by the appellants – runs the risk of affording too much deference to GEMA. The language of "clearly superior" calls for the alternative approach to be *much better* and not just *better* than the one adopted by GEMA if it is to persuade the CMA to intervene. In my judgment, that puts the matter too high.

157. I appreciate that the way in which the matter is put – that forensically an appellant will have a better chance of succeeding if it can show that its approach is "clearly superior" – is somewhat nuanced, but there is a real risk that this language will be regarded by a putative appellant as the hurdle that it must jump over, and will crystallise into the test that will actually be applied by the CMA. Moreover, the way in which the matter is put indicates that anything less than a "clearly superior" approach will have no real prospect of persuading the CMA that it should be adopted as compared to GEMA's approach.

158. In my judgment, what is required is that the alternative approach is "materially" better than GEMA's approach: that is, the alternative approach is one which, weighing up the pros and cons of the different approaches, offers *something more* than GEMA's approach. That is all that is required for the CMA to adjudge that GEMA got it "wrong".

159. If, however, GEMA's approach is equally good to the other approaches then it should be upheld by the CMA, even if the CMA would have preferred one of the other approaches.

<u>Ground 2: Did the CMA misconstrue the Financing Duty?</u>

160. Section 4AA(2)(b) of the 1986 Act provides that "In performing the duties under subsections (1B) and (1C), . . . the Authority shall have regard to… the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by" various statutory provisions.

161. In my judgment, this duty requires regard to be had to the need of *each* licence holder, and not just licence holders as a collective or group, to be able to finance their activities. The CMA was in error, therefore, in itsconstruction of the section and in deciding that this was not what the duty required. However, on the facts, the CMA did

not actually err: GEMA and then the CMA did have regard to the need of each of the licence holders, including WWU.

162. Insofar as this ground of challenge involves a challenge to GEMA's approach to the cost of debt – whether the CMA was wrong to find that the approach was not irrational and/or discriminatory - that goes to Ground 3, which I will discuss further below.

163. It is well accepted that "…the modern approach to statutory interpretation in English (and UK) law requires the courts to ascertain the meaning of the words used in a statute in the light of their context and the purpose of the statutory provision": see News Corp UK & Ireland Ltd v Commissioners for His Majesty's Revenue and Customs [2024] AC 89 at [27] and the cases cited therein. Words, context and purpose must, therefore, be considered.

164. Looking at the words: the language of section 4AA(2)(b) of the 1986 Act refers to "licence holders" in the plural, but this is not determinative. The 1986 Act has to be interpreted in the light of the Interpretation Act 1978 which provides at section 6(c) that "unless the contrary intention appears… words in the singular include the plural and words in the plural include the singular". There is, in my judgment, nothing in the 1986 Act to indicate that "the contrary intention appears": that is, that section 4AA(2)(b) should be read as applying to the "plural", to the collective or group of licence-holders as a whole.

165. I accept that there are places within the 1986 Act where there is a reference to "licence holder" in the singular: see section 33DB(3). This does not mean, however, that the use of the plural "licence holders" elsewhere in the statute cannot include the singular. It is necessary to consider the broader context and purpose of the provision in question.

166. When looking at the context and purpose of section 4AA(2)(b), the rest of section 4AA must be considered, as section 4AA(2)(b) applies "In performing the duties under subsections (1B) and (1C)". Subsections (1B) and (1C) relate back to subsection (1A)(b), which sets out the overriding purpose – described as the "principal objective"– of GEMA: that is, to protect the interests of consumers in relation to gas conveyed through pipes. Those interests include the interests of existing and future consumers in "the security of the supply of gas to them": subsection (1A(b)).

167. It is difficult to see how "the interests of existing and future consumers" can be protected if the interests of each licence holder to be able to finance its activities is not considered. If a particular licence holder cannot finance its activities, that is likely to have an impact on the interests of consumers, including their interests in the security of the supply of gas to them.

168. This construction does not, contrary to the suggestion of Mr Cashman, expose the consumer to moral hazard: that would only be an issue if the duty was to secure an outcome of financeability rather than, as here, a duty to have regard. Nor does it prevent the use by GEMA of the "notional efficient licensee" as a general benchmark.

169. In the circumstances, therefore, I consider that the context and purpose of the duty at subsection 4AA(2)(b) must include at least some consideration of the individual licence holder; and, as already explained, that is consistent with the statutory wording.

170. This does not mean that the duty is to ensure that each licence holder can finance its activities. Nor does it mean that the duty cannot include consideration of the licence holders as a group as well.

171. As for what the duty involves, the language of subsection 4AA(2)(b) is one of "have regard to the need". What this requires will depend: it will be that which is "appropriate or due to be given in the circumstances of the particular case": see CAO at [75].

172. In CAO, the Supreme Court was concerned with interpreting the duties under the immigration, asylum, nationality and customs functions of the Secretary of State or officials with respect to the welfare of children. Section 55(3) of the Borders, Citizenship and Immigration Act 2009 ("the 2009 Act") provided that: "A person exercising any of those functions must, in exercising the function, have regard to any guidance given to the person by the Secretary of State for the purpose of subsection (1)", which was itself concerned with the duty to make arrangements with respect to the "need to safeguard and promote the welfare of children who are in the United Kingdom". In construing section 55(3) of the 2009 Act, Lord Sales and Dame Siobhan Keegan LCJ drew an analogy with the "due regard" duty under the Race Relations Act 1976, and decided that "No significance attaches" to the different phrases "due regard" or "have regard". There is no reason why the same would not apply here.

173. In the instant case, the statutory construction placed on section 4AA(2)(b) by the CMA was that there was no duty to have regard to the financing need of any particular licence holder. That was a misdirection of law. In spite of that misdirection, however, it is clear that there was in fact a focus on individual licence holders, their financial position and the specific impact on them of the cost of debt formula that fed into the price control decision.

174. It is clear that although GEMA, and subsequently the CMA on appeal, looked at the cost of debt for the "notional" licence holder, applying an aggregate/average approach, they both looked at, and gave serious consideration to, the individual licence holders. A specific approach was adopted to SSEN-T as a result of its particular circumstances. Furthermore, an adjustment to the cost of debt formula was made to individual licence holders, including WWU, so as to account for their size and the frequency with which they would be expected to go to the debt market.

175. GEMA, and subsequently the CMA on appeal, also gave very careful consideration to the impact on WWU of the exclusion of derivatives. WWU clearly disagrees with the decision that was taken – and this will be addressed under Ground 3 below – but I see no basis for a complaint that conscientious and rigorous consideration was not given to this point.

176. Accordingly, I find that the CMA misdirected themselves on the construction of section 4AA(2)(b) of the 1986 Act, but this made no difference to the outcome and so relief is refused pursuant to section 31(2A) of the Senior Courts Act 1981.

Ground 3: Did the CMA err in law in upholding GEMA's cost of debt approach

177. In considering this ground of challenge, the Court has to consider whether the CMA erred in law in deciding that GEMA's approach to the cost of debt– essentially the formula adopted by GEMA, as opposed to the approach that was suggested by WWU,

and the exclusion of derivatives from the formula – was not irrational, and was not discriminatory towards WWU. It is not for the Court to make up its own mind as to what formula should have been adopted for the cost of debt, but whether it was open to the CMA to have come to the conclusion that it did. In making this decision, I am mindful that the CMA is an expert and specialist body, with its own specific obligations under the statutory regime, and so a degree of respect needs to be according to its findings and conclusions, and this Court should be slow to interfere: c.f. Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading [2002] 4 All E. R. 376 at [34] (appeal from Competition Appeal Tribunal).

178. The discrimination challenge is in substance based on the proposition that unless there is proper justification for the treatment, like cases should be treated alike, and unlike cases should be treated differently: see Rotherham MBC at [26]. Further, that the discriminatory impact of the approach that was adopted needed to be grappled with properly.

179. In my judgment, it was entirely permissible for the CMA to decide that there was nothing irrational or discriminatory about the approach adopted by GEMA to calculating the cost of debt. The CMA considered the different ways in which the cost of debt was challenged by WWU: (a) inherent irrationality; (b) no basis in economic theory; (c) skewed results; (d) unlawful discrimination; and (e) retrospective imposition of an interest rate policy; taking careful note of the various arguments made on each basis for challenge and set out their reasons in a coherent and logical manner. I have set out the analysis of the CMA in considerable detail above, and will not repeat it here.

180. The CMA accepted that it was inherently rational for GEMA to adopt an approach to the cost of debt which was based on the "average cost faced by companies within a sector" (paragraph 14.144). This finding cannot be impugned. It was entirely reasonable for the CMA to accept that the formula could be made up of companies within the same regulated sector, as they were likely to face broadly the same potential costs on the debt markets as each other, especially where allowance was made for matters such as the size of particular operators (paragraphs 14.153-154), in the full knowledge of the higher level of concentration in the energy networks (that is, the domination by a couple of companies) than in the water sector (paragraph 14.146).

181. The CMA acknowledged that the average approach adopted by GEMA meant that there could be "winner" and "loser" consumers relative to the actual costs within their area, but found that this was preferable to the approach put forward by WWU which would result in the actual financing costs being paid for by the consumers, with the consequence that consumers would be "directly exposed to the financing decisions of each company without material protection from the regulator" (paragraph 14.149). That could not be an irrational conclusion.

182. The CMA's decision that GEMA was entitled to make allowance for "structural" issues faced by specific operators by way of adjustment from the average cost, but not for matters that were within the control of the management of the particular operators (paragraph 14.154) cannot be impugned. There is an entirely coherent reason for this distinction. With respect to "structural" issues, the management and owners of an operator have no control over a particular matter and so it would be unfair to burden or penalise them with its consequences. There is no moral hazard involved. On the other hand, where the operator is responsible for specific decisions, the management and

owners take the risk and can reap the rewards, and it would not be unfair or unreasonable to burden or benefit them with the consequences of those decisions.

183. In the instant case, the CMA specifically investigated whether or not WWU's costs were the result of structural or unavoidable factors, but were informed by WWU that the treasury approach taken was the choice of management and owners (paragraph 14.155). The CMA cannot be criticised for taking this response at face value.

184. The CMA examined whether there was any unfairness in applying an approach which did not have "an explicit ex-ante benchmark to frame" the decisions taken by companies, and concluded that whilst WWU could not have predicted the path of future interest rates or the exact future cost of debt allowance allowed by the regulator, there had been a broad consistency of approach from GEMA from well before WWU came into existence, and WWU could not have expected "a multi-decade fixing of interest costs to be specifically remunerated" by GEMA (paragraphs 14.161-14.162). The conclusion reached by the CMA that "In deciding to lock-in costs for multiple decades, despite operating in a regulatory regime that updates the revenue allowances designed to cover these costs at regular intervals, WWU was taking a clear and obvious risk" (paragraph 14.162) is an entirely sound one.

185. As for the discrimination argument, it is not correct that unlike cases were treated the same way: there was specific consideration given to the fact that some of the utility operators (such as WWU) were small and would issue debt in smaller sizes and may come to the market less frequently than the larger operators, thereby rendering them less able to spread their risk as compared to those larger operators. An adjustment was made to reflect this.

186. The CMA was entitled to conclude that the particular use by WWU of derivatives was within the control of its management, and was therefore not "structural", thereby calling for further adjustment. As the CMA pointed out in their provisional determination at 14.145: "We agreed with GEMA that financing choices, and the risk and rewards that come from those choices, sit most appropriately with companies and their owners". At 14.155, the CMA observed that WWU had confirmed that "its treasury approach was the choice of [its] management and owners and was not subject to factors outside of the company's control. . . . We agreed with GEMA that financing strategy, and the associated risks and rewards, should continue to sit with companies and not be transferred to regulators and consumers."

187. Furthermore, as the CMA noted at paragraph 14.161, there was no evidence that WWU "could have expected that a multi-decade fixing of interest costs" would be "specifically remunerated by GEMA through a cost of debt allowance". There was evidence that GEMA had adopted a broadly consistent approach since 1999, which was well before WWU was hived-down from the National Grid and obviously well before they entered into the derivative arrangements.

188. As a result, the CMA was entitled to conclude at paragraph 14.162 that WWU "was, or should have been, sufficiently aware of GEMA's historical approach to the cost of debt allowance and there was no indication that this was likely to change in the future. In deciding to lock-in costs for multiple decades, despite operating in a regulatory regime that updates the revenue allowances designed to cover those costs at regular intervals, WWU was taking a clear and obvious risk. WWU could have, and could still, benefit in aggregate from taking this risk."

189. The CMA rejected the contention that GEMA's approaches to the calculation of its cost of debt allowance before 2007 "would have given any reasonable expectation that future licence modification exercises would result in company-specific cost recovery" (paragraph 14.185); and no legitimate expectation argument was made in the hearing before me.

190. What WWU had chosen to do was effectively to "fix the interest costs on the majority of its debt a single point in time; and to apply this fix over several decades and multiple price controls" (paragraph 14.196).

191. From the CMA's findings, it is clear that there was ample basis for them to conclude that, even if there was discrimination towards WWU, it was justified. The approach advocated by WWU – which would result in a "pass through" of whatever debt was incurred by the operator and whatever financing strategy was adopted – would offer no or minimal incentive for licensees to manage their debt portfolios efficiently. As the CMA noted, WWU's proposed approach "would reduce incentives to ensure that companies drive best practice, ensure efficiency and do not take inappropriate risks in their treasury management practices" (see paragraph 14.147). The transfer of such risk to consumers would not further GEMA's principal objective in section 4AA(1) of the 1986 Act.

192. The real dispute in this case, as acknowledged by Miss Leventhal KC in oral argument, was about the exclusion of derivatives from the cost of debt index. I do not consider, however, that the CMA misdirected themselves in rejecting the argument that that exclusion was irrational or discriminatory.

193. The CMA gave a number of reasons, at the provisional determination stage, for rejecting the submission that GEMA's exclusion of derivatives was not irrational in principle. In my judgment, these reasons were sound.

194. First, the CMA found that GEMA had set a debt allowance that could reasonably be achieved using standard debt instruments, and so if companies chose to use derivatives it must be to their advantage and should not require additional compensation. Indeed, the evidence was that WWU's debt, if derivatives were stripped out, was at a cost below the allowance set by GEMA.

195. Second, the CMA noted that derivatives that were designed to move cashflows between periods had been used, including by WWU. This could require the regulator to have to assess the merits and appropriateness of a large number of derivative contracts, and raised legitimate concerns for the CMA that companies might be in a position to report derivative costs which differ from the true underlying financial costs. Merely because GEMA might have been in a position to carry out the assessment, it was not irrational for the CMA to decide that they ought not have to go through that process, and expend resources on it, when there was a different method available to assess the cost of debt.

196. Third, the CMA found that there was nothing irrational about GEMA counting certain derivatives – those related to currency swaps which were commonly used by companies – but not others which had more esoteric or high cost characteristics. A sound reason was therefore given for drawing this distinction, and so it cannot be interfered with.

197. The CMA also considered the impact of excluding derivatives: whether it led to GEMA's cost of debt allowance being too low. In other words, the CMA considered the impact of the approach that GEMA was taking. This enabled the CMA to assess whether the approach taken by GEMA was having an unjustified discriminatory effect on WWU. The CMA's provisional conclusion was that the practical impact of GEMA's decision to exclude derivatives from its calculation was "immaterial". There was evidence that the type of derivatives used by WWU were expensive relative to derivatives used elsewhere in the sector, and that WWU's costs were higher as a result of its decision taken in 2007 to lock-in long-term interest rates. In addition, there was evidence from GEMA that, at an aggregate level, the sector's actual cost of debt including derivatives was not significantly different to the measure excluding derivatives.

198. WWU has taken issue with the latter finding and has contended that the CMA erred by not investigating further the "coincidence" that the actual cost of debt including derivatives on an aggregate level was not significantly different than if derivatives had been excluded, and that this point was specifically raised by WWU in its submissions in response to the provisional determination. I consider that the CMA was not under a specific obligation to carry out any further such investigation. This was essentially a matter of case management. Whilst there was power for the CMA to investigate the matter further, whether it did so fell within their wide area of discretionary judgment.

199. Indeed, the failure to investigate the matter further was not irrational: in particular, I do not find that it evidenced a failure of the CMA to grapple with the facts. It is clear that the conclusion reached by the CMA at the provisional stage was not based solely on their finding that GEMA's decision to exclude derivatives from its calculation was immaterial. There were a number of other findings, which were building blocks for the CMA's conclusion, and these are not challenged by WWU. Indeed, they seem to be obvious: WWU had taken out derivatives which had fixed real interest rates for a multi-decade period. For the first six years, this had been to WWU's advantage (because the fix that it had made was at rates lower than the market rates), but that turned to disadvantage when interest rates fell dramatically and stayed low for many years. It was not the fact that derivatives had been used, but the rate at which they had been fixed which caused the difficulty for WWU.

200. In its final determination, the CMA looked again at the question of whether "the exclusion of derivatives led to GEMA's cost of debt allowance being too low". This was addressed at paragraphs 14.256-14.257. In those paragraphs, the CMA rejected the argument from WWU that derivatives are vital risk management tools and the allowance cannot be achieved without derivatives. At paragraph 14.258, the CMA referred to GEMA's evidence that

> when measured at an aggregate level, the sector's actual cost of debt including derivatives is not significantly different to the measure excluding derivatives – and that both 'actual' measures sit below the index-based allowance used by GEMA. **WWU has not disputed this fact with new evidence** . . . As a result, we continue to conclude that the exclusion of derivatives did not lead to GEMA's cost of debt allowance being too low.

(Emphasis added).

This was correct: WWU had not presented any new evidence as part of its representations. In the cost of debt report prepared by Oxera, on behalf of WWU, it was stated that it was "a coincidence that the estimates of the average cost of debt with and without derivatives are not too different", but no further evidence was adduced. Further, in the representations on the provisional determination of the CMA, WWU stated that it challenged what GEMA had said and requested the CMA not to rely on it unless it was "properly interrogated", but no further evidence was adduced.

201. In its final determination, the CMA addressed the various arguments that had been made by WWU following the delivery of the provisional determination. WWU takes particular issue with paragraphs 14.250-14.252, contending that this amounted to a mistake of fact, and was therefore unlawful. The submission is that the CMA assumed that all or a large proportion of the derivatives used by WWU were not "an example of synthetically replicating a debt instrument that was not otherwise available", but were "more complex derivatives" used "to improve financeability for GD2": deferring income from GD1 to GD2 and accelerating costs from GD2 to GD1. As a result of this mistake, for which the CMA was responsible, a decision was made that the exclusion of derivatives from the cost of debt formulation was not irrational.

202. In my judgment, it is simply not possible to find that an error of fact was made at all at paragraphs 14.250-14.252. It is contended that the CMA failed to recognise that 70% of the derivatives used by WWU were of the "synthetic" type and what the CMA was referring to in paragraph 14.251, and the risk of manipulation, relates to approximately 30% of the derivatives and what was done by WWU with respect to them in 2019. There is, however, nowhere in those paragraphs to say that it was the CMA's assessment that all, or even a substantial proportion, of the derivatives used by WWU were of this type. Accordingly, it cannot be said that an "uncontentious and objectively verifiable" fact had been established that all, or even a substantial proportion, of the derivatives used by WWU were of this type.

203. At 14.251, the CMA was referring back to what WWU had said about its use of derivatives, as referred to at 14.234 of the determination:

> WWU submitted that if the CMA was instead referring to the decision by WWUto defer income from GD1 to GD2 and accelerate costs from GD2 to GD1 by altering certain payment and receipt legs **on a relatively small number of RPI swaps**, that this was the exact opposite of lending through the swap."
>
> (Emphasis added).

The CMA well understood, therefore, that the deferral of income from GD1 to GD2 was not on all of WWU's derivatives, or even a large proportion of them. Rather, it was "on a relatively small number".

204. This was also consistent with evidence that had been submitted to the CMA by Jessica Friend, a Senior Adviser at GEMA, in her First Witness Statement dated 23 April 2021. She stated at paragraph 139.3 that:

> Derivatives can be used to shift financing costs and receipts from one period to another so we are not convinced that taking a snapshot of embedded derivatives at one point in time would give us an accurate picture of their costs or benefits over the long-term. An example of the

> ability to shift financing costs and receipts from one period into another is illustrated by WWU's own recent swap reprofiling, . . . This particular reprofiling was undertaken to provide greater receipts in 2023-2026 (which may aid debt covenant compliance during that period) but it serves to illustrate that it would be very difficult for a regulator to accurately assess the correct rate to include in its calibration exercise. It would also be very difficult to determine whether this bespoke derivative was undertaken at market rates or whether there had been any value leakage. Valuing this derivative properly would require the entire trade history and all related flows (including all historical cash movements) to be discounted at the rate indicated by the appropriate yield curve at the precise time of the derivative trade. Banks typically have proprietary software for this task but it would be disproportionately time consuming, expensive and difficult for a regulator to replicate this, particularly months or years after the event.

205. The CMA also disagreed with the notion advanced by WWU that derivatives are vital risk management tools and that GEMA's allowance could not be achieved without derivatives. This was found to be flawed by the CMA because GEMA's approach was based on the actual costs incurred without derivatives; and meeting the current cost of debt allowance was not the driver of WWU's decision to use derivatives within its treasury strategy. These reasons are soundly based.

Ground 4: Did the CMA err in its approach to WWU's tax clawback appeal

206. This ground challenges the finding by the CMA that GEMA's approach to tax clawback was not irrational in light of the fact that it included the cost of derivatives. In my judgment, the CMA was entitled to reach this conclusion.

207. It was open to the CMA to find that there was no inconsistency in GEMA including the cost of derivatives within the formula for the tax clawback, but excluding it from the cost of debt. The purposes of the tax clawback and cost of debt formulae are different and this provides a rational justification for the way in which the cost of derivatives is dealt with in the different formulae.

208. In summary, the tax clawback is designed to calculate and clawback for consumers the tax benefits that each utility operator has *actually* gained from the financing actions it has taken. For that reason, it is necessary to look at all of the financing measures for which interest is charged – and this will include derivatives – as this is relevant to the assessment of the utility operator's actual tax liability.

209. This was all articulated by the CMA in the reasoning set out in its final determination: see paragraphs 16.89 to 16.106. That reasoning was logical and coherent: (i) interest on debt derivatives were as much a part of the measure of interest as the interest on primary debt instruments; for tax purposes, interest on derivatives is included within the measure of interest used by firms when assessing their tax liability; (ii) the tax clawback policy is designed to adjust the tax allowances to reflect the actions of actual (and not notional) firms; (iii) the objective of the policy is to calculate and clawback for consumers the tax benefits that the actual firm has gained from the financing actions it has taken; and (iv) the tax benefit to a firm from deducting interest is a function of its actual interest charge, which will reflect actual financing, including derivatives, rather than the notional financing used in setting the cost of debt.

210. This is very different from the cost of debt formulation. In designing that formula, GEMA has rejected the use of the actual cost of the utility operator's financing measures (including derivatives), and its reasons for doing so are solid and sound, as discussed above.

Conclusion

211. For the foregoing reasons, therefore, this application for judicial review is dismissed: ground 1 is misconceived insofar as it is tied to the CMA's determination of the cost of debt appeal, and is otherwise academic; ground 2 identified a misdirection in the CMA's construction of section 4AA(2)(b) of the 1986 Act, but no relief is awarded as individual circumstances were taken into account; and grounds 3 and 4 are not made out.