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OUR REF  
RCB\5458499.1

YOUR REF

DATE  
9 July 2012

Mr John Barry  
Bord Gais Networks  
Gasworks Road  
Cork

BY EMAIL

**Re: Consultations on October 2012 to September 2017 Distribution and Transmission Revenue for Bord Gáis Networks**

**Response to Consultation Papers CER\12\057 and CER\12\058 ("the Consultation Papers")**

Dear Mr Barry

We are writing to provide you with our observations on the draft decision contained in the Consultation Papers and the process adopted by the CER to date in relation to the PC3 Revenue Review. The views expressed in this letter are based on our review of the material published on the CER's website in connection with the PC3 Revenue Review, the relevant legislation, your draft response to the Consultation Papers and information from you and your economic advisors regarding your interactions with the CER to date.

We understand a key area of disagreement between the CER and BGN is the treatment by CER of BGN's proposals in respect of Opex. Based on the figures referred to in the Consultation Papers, that difference is currently c. €81 million. While it is understandable that regulator and a regulated entity might have different views as to the appropriate levels of revenues in the context of a revenue review, the key concern here is the root causes of the difference between the Opex allowances sought and those proposed to be permitted by CER.

John Cronin, David Clarke, Timothy Bouchier-Hayes, Jane Marshall, Ronan McLeary, Lenan McDevell, Julian Conlon, Damian Collins, Catherine Deane, Paul Heffernan, Terence McCarrn, Mariel Walls, Roderick Bourke, Ambrose Loughlin, Niall Penderic, Kevin Kelly, Hilary Marren, Eimeann O'Hanrahan, Roy Parlan, Patricia Lawless, Barry Devereux, Geraldine Hickey, Helen Ellery, Judith Lavhass, James Murphy, David Lyden, David Myers, Sean Barron, Coim Fanning, Paul Lacey, Julie Quin, Alan Fuller, Claire Lenny, Maureen Dolan, Michele Dwyer, Hugh Beattie, Fergus Gilen, Valerie Lawlor, Mark White, Rosaleen Byrne, Eamon de Valera, Ice Fox, Ben Gelfink, Donal O'Raghallaigh, Karen Harty, Philip Andrews, Barrett Chapman, Mary Brasco, Audrey Byrne, Shane Fahy, Georgina O'Riordan, Adrian Farrell, Michael Murphy, Annette Hogan, Aidan Lawlor, Darragh Murphy, Brian Quigley  
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## Summary

The carrying out of a revenue review involves the exercise of discretionary powers on the part of the CER. The exercise of discretionary powers however is subject to a number of established legal rules designed to control the decision making powers of public bodies. These legal rules include rules to the effect that (a) the CER must not take irrelevant considerations into account in reaching its decisions, (b) it must not disregard relevant materials, (c) it must give reasons for its decisions which reasons must reflect the actual material relied upon and factors which influenced its decision (it must be transparent in the reasons it provides) and (d) it must not act in an unreasonable manner in the sense that the exercise of its discretionary powers must not depart significantly from accepted or standard practice of other regulatory bodies carrying out similar functions. Also to the extent also that CER provides notice of the approach it plans to adopt to any given decision, interested parties are entitled to expect that the CER would follow that approach. In other words an indication by the CER of its proposed approach at the outset of a process should signal the basis on which it intends to conduct its review and highlight significant changes from past practice. Failure to do so can give rise to a legitimate expectation on the part of interested parties. Finally, the CER is also obliged to carry out its revenue review exercise in a transparent manner.

Having regard to the material we have reviewed and the information provided to us, it appears to us that the CER may have contravened these rules in reaching its proposed decision. We set out below the reasons why we have formed this view.

## Benchmarking

The CER provided information at the outset of this revenue review process (in its Information Paper CER/11/070 dated 21 April 2011 and its Response Paper CER/11/173 dated 1 September 2011) about the manner in which it intended to approach the review. Given that the purpose of those papers was for the CER to inform interested parties of the approach it intended adopting to this review, it is notable that the CER did not indicate that any change would be made to the approach it had adopted to benchmarking in previous reviews, although benchmarking would typically be regarded as a key element of a revenue review. Without any notice or any objective justification whatsoever, the CER's consultants then departed from previous practice of CER by abandoning the approach to benchmarking which we understand the CER has always used and adopting a fundamentally different approach to the benchmarking exercise. It seems to us that BGN would be justified in arguing that this amounts to a breach of its legitimate expectations.

We understand that BGN's economic advisors (Frontier) spent a considerable amount of time trying to ascertain the differences in the outcomes between the benchmarking exercise they undertook and the exercise undertaken by the CER and its advisors (CEPA). It was only after a protracted period of enquiry and forensic analysis on the part of Frontier that CEPA admitted, as late in the process as 17 April 2012, that they had adopted an entirely new approach to benchmarking in this review. The result of this was that BGN made two sets of very detailed submissions (in accordance with the time frames specified by the CER) without being informed of the basis of the CER's benchmarking exercise. BGN's submissions were therefore rendered meaningless on a key issue. BGN now finds itself having to make submissions (at the end of the consultation process) on a draft decision which is informed by a flawed and unchallenged benchmarking analysis. We understand that BGN is concerned that the conclusions of the CEPA benchmarking analysis have informed and will continue to inform CER's approach to the entire review exercise.

We also understand from our discussions with your economic advisers that the benchmarking exercise actually conducted by the CER's advisers was flawed and wholly inadequate. If that is so and if the benchmarking exercise had a material impact on the review process and the revenues now proposed in the Consultation Documents or if the CER had not had regard to any benchmarking, this calls into question the reasonableness of the proposed decision.

It seems that, in light of all of the difficulties described above, CER has attempted to distance itself from the benchmarking exercise while at the same time proceeding to make a decision based on the conclusions of that exercise. If this is so and if the internal documents of the CER bear this out, we are of the view that there must be a real risk for the CER that a court would make a finding that any final decision which reflects the proposed decision would be *ultra vires* and should therefore be quashed.

#### Lack of Transparency

We understand from our instructions that it is difficult to discern in some cases what criteria were relied upon by CER in reaching the proposed decision because CER has adopted an inconsistent approach in terms of the various stages and steps of its analysis. For example we understand CER initially emphasised the importance of the benchmarking exercise as a relevant input yet when concerns about the exercise were flagged by you, CER appeared to distance itself from the exercise (certainly that exercise does not appear to be emphasised in the Consultations). We also understand that you have witnessed a pattern of CER giving the appearance (in its published documents) of taking points on board where errors have been pointed out by BGN without any changes having been made to the substance of the decision and the level of the proposed revenues. This inconsistency and opacity makes it difficult for BGN and its expert advisors to ascertain what precisely are the criteria in accordance with which the CER proposes to set the revenues (although these criteria are required by law to be transparent<sup>1</sup>) or to be satisfied that the CER has had regard to the submissions of BGN (as it required to do by law<sup>2</sup>).

We understand you also have a concern that the CER appear to have made an arbitrary decision as to the level of efficiencies they require BGN to achieve and have arrived at revenues which achieve this level of efficiency gains rather than taking all of the usual steps involved in revenue review decisions out of which cost reflective and efficient revenues would evolve (the usual steps would involve a proper bottom up analysis of historic and future costs, together with appropriate top down benchmarking).

#### Taking irrelevant material into account and failing to take relevant material into account

In the midst of this lack of transparency, the Consultation Documents and the information provided to us suggest that the CER has:

- sought to reduce the level of allowed expenditure arbitrarily by reference to some undefined notion of what is necessary "*given the difficult economic circumstances and the many challenges facing consumers*" rather than carrying out a true bottom up analysis. This is not a proper basis for a revenue review.
- placed improper reliance on a flawed and wholly inadequate benchmarking exercise

<sup>1</sup> Article 41(1) of the Third Gas Directive

<sup>2</sup> Section 10A(17)(b) of Gas Act 1976

- not carried out any benchmarking of its consultants' bottom up analysis about which we understand your economic advisers also have serious reservations
- placed improper reliance on the position of ESB and the outcome of a review of ESB revenues
- relied on inappropriate (and also inconsistent and selective) comparisons with other utilities including ESB and distribution networks in Great Britain.

In addition to factors or matters which the CER appears wrongly to have taken into account, the CER does not seem to have had any, or any proper, regard to factors which appear relevant such as

- the growth of 21% in BGN's network since the last revenue review
- the development of the services which BGN provides and service standards to which BGN performs since the base year for the CER's consultants' bottom up analysis.
- BGN's statutory obligations, pursuant to a framework agreed with and monitored by CER, in respect of safety.

We also understand from you that senior personnel within CER have admitted to not having read relevant material submitted by BGN as part of the process. If correct, that may be present a difficulty for the CER in any challenge to its decision.

#### Breach of Statutory Duty

We are also of the view that the effect of the proposed decision, if adopted, may amount to a breach by CER of its own statutory duties, including its duty, when carrying out its functions, to have regard to the need to secure that licence holders are capable of financing the undertaking of the activities which they are licensed to undertake and the need to promote safety and efficiency on the part of natural gas undertakings<sup>3</sup>. The CER also has a duty to act in as consistent a manner as practicable when carrying out its functions<sup>4</sup> and the approach it has adopted to benchmarking does not appear to us to be consistent with this duty.

#### Conclusion

These issues taken together could result in a finding by a court that the proposed decision, if adopted, would be *ultra vires* the powers of CER. The proposed decision, if adopted, may also amount to a breach of BGN's legitimate expectation, as outlined above. Further, the proposed decision does not appear to be adequately reasoned and where reasons are provided they are inconsistent with reasons and inputs communicated to BGN as part of the process.

In the event that CER proceed with a final decision along the lines of the proposed decision in the Consultation Papers and if BGN decided to challenge that decision by way of Judicial Review, CER would be obliged as part of its defence of any such challenge, to put before the court all of the material relied upon by the decision makers. In addition, it would be open to BGN to seek discovery of documents from CER relating to the decision making process to the extent that it could be

<sup>3</sup> Section 9 (4)(a) of the Electricity Regulation Act 1999

<sup>4</sup> Section 9 (6) of the Electricity Regulation Act 1999

demonstrated that such documents (or particular categories of such documents) were relevant and necessary for the determination of the issues in the proceedings.

If you have any queries arising from the above or if we can assist further, please let us know.

Yours sincerely



Patricia Lawless \ Rosaleen Byrne

McCann FitzGerald

