

Jon Sharvill
Ofgem RIIO Gas Operations
10 South Colonnade, Canary Wharf
LONDON
E14 4PU

Wales & West House
Spoooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spoooner Close
Celtic Springs
Coedcernyw
Casnewydd NP10 8FZ

Telephone/Ffôn: **0800 912 29 99**
Fax/Ffacs: **0870 1450076**
Email/Ebost: enquiries@wwutilities.co.uk
www.wwutilities.co.uk

11th February 2022

Wales & West Utilities Limited (WWU) response to consultation on the closeout methodologies for RIIO-GD1

Dear Jon,

Thank you for the opportunity to respond to the above consultation.

In the attachment to this letter, we provide our comments on the GD1 close out methodologies in the order the points occur in that consultation.

We apply a number of redactions in relation to our response to the pre-GD1 and GD1 tax clawback sections, because of the commercial confidentiality of those parts of the response and their references to confidential discussions or correspondence with Ofgem. We have therefore provided two versions of our responses to section 8 (i.e. a redacted non-confidential version, and a non-redacted version which is confidential to Ofgem). We will also be responding with a follow up letter to Jonathan Brearley which sets out our legal position on this subject. This will be submitted in the week commencing 14th February.

We received a letter from the Ofgem regulatory finance team late on Thursday 10th February which may be relevant to some of the tax clawback matters raised in this consultation. That letter has not been considered for our response to this consultation due to the lateness of the letter, but we will seek to discuss it with you and the regulatory team in due course.

Yours sincerely,



Carly Evans
Head of Regulation
Wales & West Utilities

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Consultation questions

Question 1: Do you agree with our proposed approach to financial methodologies?

Please refer to our responses to paragraphs 1.3, 1.4, 2.11 and 2.14 set out in Appendix 1. Given the uncertainty, and in the absence of responses from Ofgem to the points raised in those paragraphs, it is not possible to answer this question.

Question 2: Do you agree with our proposed methodology for the iron mains risk reduction programme?

Yes, we fully support the proposal set out in the consultation. This is consistent with the GD1 close out obligations in the GD2 licence. We exceeded the risk removed requirement with an 8-year output of 113% of the original target. This demonstrates our commitment to the HSE programme and reducing risk for consumers.

The requirement of special condition 7.6 (Specification of network outputs) has also been met with the submission of the close out report on 31st July 2021 as part of the regulatory reporting submission.

Question 3: Do you agree with our proposed methodology for the FPNES?

We support the proposal to adjust GD1 allowances using the alternative solution documented in paragraph 4.12. Given the uncertainty that existed in the lead up to GD1 on fuel poor, the increases in targets proposed by the GDNs and the subsequent tightening of the criteria rules which occurred during the price control and made it harder to achieve those increased targets, this would be a pragmatic approach.

However, we do not support the allowance adjustment being based on actual average GD1 outturn unit costs for each GDN. The adjustment should be based on average allowed unit costs as this reflects the allowances that requires recovering.

We were given additional allowances to deliver extra Fuel poor services in the 2015 FPNES policy letter. It is not appropriate to remove the under or over delivery of workload on an actual cost basis. Fuel poor costs should be adjusted based on the allowances awarded, otherwise more value is recovered than allowances actually awarded.

Our proposal is to use the unit costs that set the allowances in 2015 for the additional fuel poor services, and any adjustment should be made in the variable value in the Legacy PCFM which will then feed into the GD2 PCFM process.

Special condition 7.12 includes an obligation to provide a FPNES close out report – this was provided as part of the regulatory return process on 31st July 2021 which documents performance and relevant justification.

Question 4: Do you agree with our proposed methodology for capacity utilisation?

In order to ensure a complete and considered response we will await the publication of the separate NOMs GD1 closeout consultation in May 2022 to comment on relevant methodology.

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Question 5: Do you agree with our proposed methodology for the reliability output?

We agree with the methodology set out and have provided relevant information in line with the licence obligation set out in section 6 of the consultation.

Question 6: Do you agree with our proposed methodology for the Shrinkage and Environmental Emissions Incentive?

We disagree with both options suggested. There has been significant discussion and consultation on the setting of targets for RIIO-GD2 and we are unclear on the desire to change these at this late stage. Whilst we understand Ofgem are looking for continuity between Price Controls, the significant change to the financial incentive between RIIO-GD1 and RIIO-GD2 has removed any comparability and therefore continuity is not possible.

We discuss both options below.

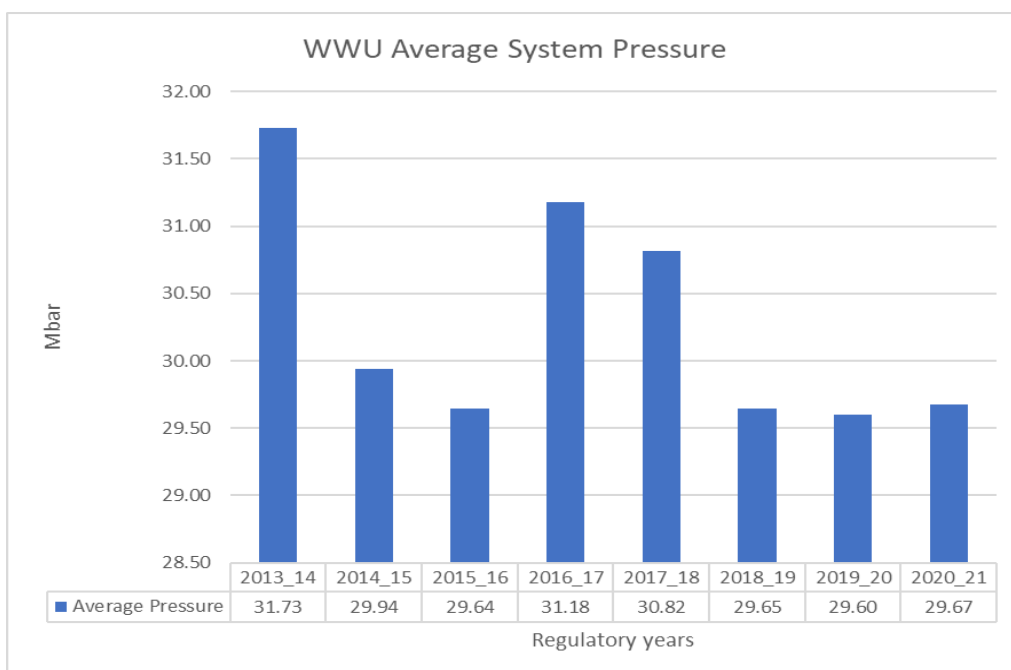
Option A - This attempts to drive continuity between price controls by changing the incentive rules and calculation for RIIO-GD1. Amending the price control outturn post-control is not part of the RIIO regime. We targeted investment in mains replacement and pressure management, innovated in technology and challenged colleagues to achieve an above target shrinkage reduction year on year for consumers. This reduced emissions at a greater rate than targeted which demonstrates that the incentive worked well in practice. To reduce the incentive following the end of the RIIO-GD1 Price Control is neither fair nor appropriate.

Option B – This is a step backward from the consulted-on methodology agreed to set RIIO-GD2 targets. The major flaw in this option is it makes an assumption that network pressures can be reduced year on year. System pressures are heavily impacted by the severity of winter. The chart below shows the annual fluctuation in pressure as a result of winter severity. This is why we elected, and Ofgem agreed in setting the RIIO-GD2 control, to use a 3-year average from RIIO-GD1 to set the RIIO-GD2 starting point, to normalise out the impact of winter severity.

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Our overall view is we should continue with the methodologies set out in the licence for relevant price controls and proceed to deliver shrinkage reductions for consumers rather than make changes to GD1 incentive or GD2 targets at this very late stage.

Question 7: Do you agree with our minded-to position in respect of the pre-RIIO-GD1 period, i.e., to correct the provisional adjustment and align the treatment of net interest on derivatives with the policy intent of the clawback mechanism as set out in the 2009 Open Letter? If not, please explain why.

Please see response in Appendix 1.

Question 8: As regards clawback during RIIO-GD1, which of options one and two do you consider to be more appropriate? Please explain why.

Please see response in Appendix 1.

Question 9: Do you agree with our proposed methodology for disposals?

We agree the disposals policy should be applied consistently with the Licence in relation to GD1 closeout as set and agreed.

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Appendix 1

<p>TAX CLAWBACK</p>	
<p>Excerpts from Ofgem’s Consultation Document.</p>	
<p>1. Background and overview</p>	<p>WWU response</p>
<p>1.3. We have based the methodologies on the approach and principles that we described in the RIIO-GD1 Strategy Decision, RIIO-GD1 Final Proposals, as implemented in the GD1 Licence relevant supplementary documents and the Price Control Financial Handbook, except where we propose to modify the GD1 Licence with retrospective effect to accommodate the proposed closeout methodology and so that proposed modifications would operate fairly.</p>	<p>We are confused by Ofgem’s statement “<i>to modify the GD1 licence with retrospective effect</i>”.</p> <ul style="list-style-type: none"> • The GD1 licence no longer exists. • In spite of this, in section 5 of the consultation document (<i>Capacity utilisation</i>) Ofgem indicates that it will propose to modify certain '<i>conditions currently in the GD1 Licence</i>' (paras 5.11 and 5.12). The reference to conditions '<i>currently</i>' in the GD1 Licence makes no sense – all of the former GD1 licence conditions have already been deleted and replaced. • If Ofgem believes the GD1 licence does exist, that belief should be explained. In addition, where modifications are proposed by it (e.g., refer to 2.11) Ofgem must undertake statutory consultations in respect of those proposed modifications that can only be made by means of changes to the licence or associated documents which have the status of licence conditions. <p>Finally, there is no reference opposite to Ofgem’s 2015 letter to WWU on tax clawback, even though Option 2 in paragraph 8.24 places reliance on it. As Ofgem is aware, WWU relied on that letter in good faith throughout GD1, but Ofgem’s Option 1 proposal in paragraph 8.24 involves a retroactive disapplication of that letter for all of GD1, contrary to the legitimate expectation created by it.</p>

<p>1.4. We have worked with the GDNs to develop the proposed methodologies and are now consulting more widely with all stakeholders. Following a decision on these methodologies, we will engage with the companies to implement the methodologies and, if necessary, consult on any required modifications to the RIIO-GD2 gas distribution licence (“the GD2 Licence”).</p>	<p>As noted in our response to 1.3, Ofgem’s approach is confusing – if Ofgem means it is GD2 (instead of GD1) licence conditions that may be subject to required modifications, Ofgem should reconcile that approach to its approach in paragraphs 5.11 and 5.12.</p> <p>We are surprised that there has been no engagement from Ofgem to work with WWU in respect of Tax clawback for GD1 or pre-GD1. In particular, Ofgem has not yet renewed the discussions it had with WWU in late 2020 and early 2021 in relation to its proposal to WWU to grandfather its 2015 letter into GD2. WWU entered into those discussions in good faith. We are also surprised that Ofgem has not explained how it has arrived at its estimates of legacy adjustments for tax clawback in paragraphs 8.23, 8.25 and 8.26 – in the absence of clarity on this matter, WWU lacks the information that it needs in order to provide a full response to the consultation.</p>
<p>2. Approach to financial methodologies</p>	
<p>2.11. Therefore, we propose to implement closeout methodologies via the Legacy PCFM by revising “yellow box” (non-variable) values as well as variable values or modifying the Legacy PCFM as necessary. This provides the greatest transparency about the nature of the ex-post adjustment, a reliable way of calculating the impact of changes, and provide a useful future data source for the final RIIO-1 performance</p>	<p>Without prejudice to our response in 1.3 above that the GD1 licence no longer exists, Ofgem has not proposed consultations in respect of modifications to non-variable values in the GD1 licence, which would be a retrospective modification, and in that regard Ofgem has not explained the legal basis on which it believes it has the power to do so.</p> <p>If such power exists, with respect to proposals to change variable values, Ofgem would need to bring forward separate consultations to make such changes – this consultation is about the methodologies for RIIO-1 close out, it is not a statutory consultation on modifications to licence conditions required to implement those methodologies.</p>
<p>2.14. In the current AIP process, the cumulative impact of all changes is included in the next MOD value. However, we propose to smooth the impact of the November 2022 AIP legacy adjustments over the remaining three years of RIIO-2 by dividing the LMOD value by three.</p>	<p>Refer to our response in 2.11 above which applies equally to modifications to non-variable values and smoothing the MOD value over three years</p>

<p>Question 1: Do you agree with our proposed approach to financial methodologies?</p>	<p>Refer to our responses to paragraphs 1.3, 1.4, 2.11 and 2.14. Given the uncertainty, and in the absence of responses from Ofgem to the points raised in those paragraphs, it is not possible to answer this question.</p>
<p>8. Tax Clawback - WWU</p>	
<p>8.1. Ofgem calculates licensees' tax allowances on a notional basis, which includes using an assumed gearing level, i.e., notional gearing. Because interest on debt is tax deductible, highly geared licensees pay less tax than the notional allowance. The tax clawback mechanism is designed to recoup part of the notional tax allowance for licensees that have higher gearing and thus pay less tax than they otherwise would. Were there to be no tax clawback policy, those licensees would receive allowances for tax they do not in fact pay.</p>	<p>No comment.</p>
<p>8.3. The clawback adjustment in the pre-RIIO-GD1 period was made ex-post, i.e., it was calculated at the end of the price control period. An adjustment would be made to reduce a licensee's tax allowance if both actual gearing and interest expense exceeded notional levels.</p>	<p>No comment.</p>
<p>8.4. In RIIO-GD1, the clawback adjustment was done annually through the TGIEt variable value, which was updated in the RIIO-GD1 PCFM at each Annual Iteration Process (AIP) and fed into the re-calculation of revenue allowances.</p>	<p>No comment.</p>
<p>8.5. The calculation of TGIE was done in a separate 'Tax Clawback Model' and compared the modelled figure for tax deductible net interest costs and the licensee's indicative RAV, which is used as a proxy for equity, from the PCFM against the equivalent actual values that licensees reported to us through their Regulatory Instructions and Guidance (RIGs) submissions. We then used two tests to determine the value for TGIE: a gearing level test and a positive benefit test.</p>	<p>No comment, except that perhaps Ofgem meant to say "enterprise value" instead of "equity".</p>

<p>8.6. In the gearing level test, the licensee's actual net debt figure as reported in its RIGs template was divided by the licensee's indicative PCFM RAV to obtain an actual calculated gearing ratio. If this ratio was greater than the notional level that was set at RIIO-GD1 Final Proposals, i.e., 65% for the GDNs, then the gearing test was met and the positive benefit test was then performed.</p>	<p>No comment.</p>
<p>8.7. In the positive benefit test, the modelled interest was subtracted from actual net interest reported and the difference, if positive, was multiplied by the corporation tax rate and the resultant revenue benefit went into the TGIE variable value to be clawed back from the licensee's tax allowance.</p>	<p>No comment.</p>
<p>8.8. In 2015, WWU sought guidance from Ofgem, amongst other things, on the composition of the net interest value used for the tax clawback calculation and requested that derivative-related costs be excluded from the calculation. Ofgem responded by letter (the '2015 Letter') (i) correctly noting that the definition of "actual interest" in the 2009 Open Letter excludes "fair value adjustments (e.g. losses on derivatives)" and (ii) incorrectly concluding therefrom that "inflation related expenses and income both accrued and actual should be excluded from the value of adjusted tax deductible net interest paid for the purposes of RIIO GD1 tax clawback adjustment calculations".</p>	<p>WWU comment redacted</p>
<p>8.9. In fact, a "fair value adjustment" has no profit and loss impact; it is distinct from the interest payments accrued and periodically incurred by the parties to a swap contract and would be readily understood by any regulatory finance professionals to be distinct. The inflation expense that WWU sought to exclude from its net interest costs is in substance a</p>	<p>WWU comment redacted</p>

<p>form of interest charge that attracts tax relief, and which therefore should be treated in the same way that interest on index-linked debt is treated, which is clearly specified in the 2009 Open Letter as being included in actual interest. This is so highly geared companies are not inadvertently perversely incentivised to enter into more index linked derivatives over index-linked debt by allowing payments on the former to be exempt from the tax clawback, thereby providing a revenue benefit to a licensee through its notional tax allowance.</p>	
<p>8.10. The 2015 Letter was sent to WWU only and was not drawn to the attention of other network licence holders. With the exception of WWU, no other network licence holder has queried the treatment of interest liabilities under derivative contracts for the purposes of the tax clawback. Ofgem has not seen any instances in which a licensee - other than WWU - has excluded interest or inflation accretion payments associated with derivatives from its "actual interest" figure reported for the purpose of the tax clawback</p>	<p>WWU comment redacted</p>
<p>8.11. In early 2019, after a review of the 2009 Open Letter and of draft network company Regulatory Financial Performance Reporting (RFPR) submissions, we considered that the guidance on what should and should not be included in net interest should be clarified beyond all possible doubt to ensure that the net interest figure reported by network companies aligned with the original policy intent of the</p>	<p>WWU comment redacted</p>

<p>clawback mechanism.</p>	
<p>8.12. Accordingly, in March 2019, we consulted on modifying the RFPR RIGs to make clear that: “We would expect Net Interest Per Regulatory (RIIO-1) definition to include all inflation derivative payments that attract tax relief (because this definition is used for tax clawback) ...” (emphasis added). WWU responded to that consultation, indicating that it appeared to conflict with the advice in the 2015 Letter.</p>	<p>WWU comment redacted</p>
<p>8.13. In April 2019, we published our decision on the modifications, which included the clarificatory text in paragraph 8.12 above. WWU contacted Ofgem shortly after querying the April 2019 decision in light of the 2015 Letter and requesting clarity on the treatment of the inflation expense on its RPI-linked derivatives.</p>	<p>WWU comment redacted</p>
<p>8.14. Ofgem did agree to a single adjustment for WWU in October 2019 so that a particular derivative payment should be reflected in the 2013/14 period and not in the 2018/19 period as WWU had originally requested, however, there was no suggestion of making the same adjustment for any other periods. Indeed, on 4 October 2019, Ofgem emailed all network licensees reminding them that it had clarified the definition of net interest and net debt in the RIIO-1 RFPR RIGs in its 30 April 2019 decision and instructing all licensees to use in their upcoming RFPR submissions the value reported as “Net Interest Per Regulatory (RIIO-1) Definition” for the purposes of the tax clawback. This was to ensure that there was no room for doubt as to the treatment of derivative inflation payments as regards the net interest</p>	<p>WWU comment redacted</p>

calculation.	
8.15. Nevertheless, WWU continued to disagree with Ofgem's view on the 2015 Letter and with the clarification of the guidance on derivative costs.	WWU comment redacted
8.16. In late 2020, WWU approached Ofgem requesting that the treatment of derivative costs set out in the 2015 Letter be applied: <ul style="list-style-type: none"> (i) retrospectively to the pre-RIO-GD1 period; (ii) for all of RIO-GD1; and, (iii) for the RIO-GD2 period. 	WWU comment redacted
8.17. Ofgem engaged in these discussions in good faith that WWU was not aware of, or did not fully understand, the change in guidance on the treatment of derivative costs following the RFPR consultation in 2019. It became clear during those discussions that WWU did in fact respond to the relevant consultation and, therefore, must have been aware of its outcome.	WWU comment redacted
8.18. Because of these ongoing discussions and the imminent need to publish the draft RIO-GD2 PCFM for consultation in December 2020 so that the final version could come into effect for the beginning of RIO-GD2 on 1 April 2021, a provisional adjustment was made to the Legacy PCFM to apply the treatment set out in the 2015 Letter to pre-RIOGD1 net interest. For the same reasons, we also did not at that stage correct the RIOGD1 TGIE values, which were based on the treatment set out in the 2015 Letter. These amounts fed into the RIO-GD2 PCFM that was	WWU comment redacted

<p>published on 3 February 2021 through the LRAV and LAR terms.</p>	
<p>8.19. However, as was made clear to WWU throughout the course of the discussions, those legacy adjustments were provisional as estimates were being used until we are able to close out the RIIO-1 price controls. This was noted in the RIIO-GD2 Draft Determinations as follows:</p>	<p>WWU comment redacted</p>
<p>8.20. Ultimately, Ofgem did not agree to the adjustments proposed by WWU and so the provisional legacy adjustments included in the RIIO-GD2 PCFM on 3 February 2021 need to be corrected.</p>	<p>WWU comment redacted</p>
<p>8.21. WWU subsequently brought an appeal to the Competition and Markets Authority (CMA) in respect of tax clawback as part of its RIIO-2 appeals</p>	<p>WWU comment redacted</p>
<p>8.22. We set out below our proposals in respect of the approach to and timing of tax clawback adjustments for WWU in respect of the pre-RIIO-GD1 and RIIO-GD1 periods.</p>	
<p>Approach to implementation - Pre-RIIO-GD1 adjustments</p> <p>8.23. For the reason in paragraph 8.20 above, we are minded to correct the variables that reflect the pre-RIIO net interest and tax clawback adjustments so that they no longer include the retrospective application of the treatment set out in the 2015 Letter. We estimate the impact of this correction to result in a £18m (in nominal terms) reduction to WWU's RIIO-GD2 allowed revenues. These changes would feed through to the LMOD and LRAV values generated once the Legacy PCFM has been run. We think this is appropriate</p>	<p>WWU faithfully relied on Ofgem's 2015 letter for pre-GD1 and GD1 and the pre-GD1 adjustment by WWU reflects that position. That 2015 letter confirmed Ofgem's policy position in respect of the treatment of derivatives set out in Ofgem's 2009 letter.</p> <p>WWU comment redacted</p>

<p>because it would align with the policy intent of the mechanism as set out in the 2009 Open Letter, and because we do not consider that licensees should receive a tax allowance for tax that they do not pay.</p>	
<p>Approach to implementation – RIIO-GD1 adjustment</p> <p>8.24. We propose two options for the correction of the RIIO-GD1 TGIE variable values for WWU, as follows.</p> <p>1) Correct the net interest values used to calculate the TGIE value for all years of RIIO-GD1, thereby removing in its entirety the erroneous treatment of net interest set out in the 2015 Letter: or</p> <p>2) Correct the net interest values used to calculate the TGIE value for part of the RIIO-GD1 price control period and allow the treatment of net interest set out in the 2015 Letter between 2014/15 and 2018/19 only.</p>	<p>WWU faithfully relied on Ofgem’s 2015 letter for pre-GD1, GD1 and expected that letter to be applied to GD2.</p> <p>WWU comment redacted</p>
<p>8.25. The effect of option one would be to increase the TGIE values for all years of the RIIO-GD1 price control period, thereby WWU’s reducing base revenues in all years and resulting in a negative LMOD adjustment. We estimate the impact of this reduction in GD1 revenues to result in a £68m (in nominal terms) reduction to WWU’s RIIO-GD2 allowed revenues.</p>	<p>See WWU position in paragraph 8.24 above.</p>
<p>8.26. The effect of option two would be to increase the TGIE values for five of the eight years of the RIIO-GD1 price control period, thereby reducing revenues in those five years and resulting in a negative LMOD adjustment, albeit the revenue impact of this would be less than the impact of option one. We estimate the impact of this reduction in GD1</p>	<p>See WWU position in paragraph 8.24 above.</p>

<p>revenues to result in a £38m reduction (in nominal terms) to WWU's RIIO-GD2 allowed revenues.</p>	
<p>8.27. For either option, we propose to review the RIIO-GD1 tax clawback calculations to ensure that the net interest and net debt values used to calculate the TGIE value are correct and comply with the policy intent of the mechanism and the most recent version of the RFPR RIGs (as applicable). Where we find that this is not the case, we will adjust those values as necessary. Any changes will feed through the TGIE value to the final revenue adjustment term (LMOD) and closing RAV (LRV) values generated once the Legacy PCFM has been run, as described in chapter two of this document.</p>	<p>See WWU position in paragraph 8.24 above.</p>
<p>Timing of adjustments</p> <p>8.28. For both the pre-RIIO-GD1 and RIIO-GD1 periods, as described in chapter two of this document, we propose to implement closeout methodologies via the Legacy PCFM by revising variable and non-variable values, as necessary, to reflect the closing position for the RIIO-GD1 price control in the closing RAV and final revenue adjustment term.</p>	<p>See WWU comments in paragraphs 1.3, 2.11, 2.14, 8.23 and 8.24.</p>
<p>8.29. The LRAV and LMOD values will be fed into the RIIO-GD2 PCFM at the next AIP, at which point they will adjust the companies' allowed revenues.</p>	<p>See WWU comments in paragraphs 1.3, 2.11, 2.14, 8.23 and 8.24.</p>
<p>8.30. We propose to implement the adjustment to the RIIO-GD1 net interest values through the Legacy PCFM in the November 2022 AIP, though note that corrections can be made in subsequent AIPs if necessary</p>	<p>See WWU comments in paragraphs 1.3, 2.11, 2.14, 8.23 and 8.24.</p>

<p>8.31. We implemented the adjustment to the pre-RIIO-GD1 net interest values through the Legacy PCFM in the recently published November 2021 AIP. The reason for making this correcting adjustment sooner was because as discussed above, this was made in the context of the discussions around potentially applying the treatment set out in the 2015 Letter, to which Ofgem did not agree. As such, it represented an error in the RIIO-GD2 PCFM, which we chose to correct at the earliest opportunity, rather than waiting for the following year's AIP.</p>	<p>See WWU comments in paragraphs 1.3, 2.11, 2.14, 8.23 and 8.24.</p>
<p>Question 7: Do you agree with our minded-to position in respect of the preRIIO-GD1 period, i.e., to correct the provisional adjustment and align the treatment of net interest on derivatives with the policy intent of the clawback mechanism as set out in the 2009 Open Letter? If not, please explain why.</p>	<p>See WWU comments in responses to paragraphs 1.3, 1.4, 2.11, 2.14, and all responses in this section 8. For the reasons outlined WWU disagree with Ofgem's minded to position in respect of the pre-GD1 period.</p>
<p>Question 8: As regards clawback during RIIO-GD1, which of options one and two do you consider to be more appropriate? Please explain why.</p>	<p>See WWU comments in responses to paragraphs 1.3, 1.4, 2.11, 2.14, and all responses in this section 8. For the avoidance of doubt, WWU's position is that Ofgem's 2015 letter must apply for pre-GD1 and all of GD1.</p>