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Electricity distribution licensees,
gas transporter licensees,
electricity transmission licensees,
and other interested parties

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Date: 31 July 2009

Dear Colleagues,

Clawback of tax benefit due to excess gearing

As outlined in the open letter issued on 5 December 2008 and following review of the responses to it, we now set out our implementation of the ex post adjustment considered in the TPCR, GDPCR and DPCR4 final proposals.[1] The adjustment claws back from licensees the revenue benefit they obtain from lower tax costs as a result of high gearing.

The clawback is triggered when in any year (i) actual gearing exceeds notional gearing; and (ii) interest costs exceed those modelled at the relevant price control. When both of these conditions are satisfied, we will clawback the tax benefit which results from the difference between actual and modelled interest costs in that year.

The December letter reviewed a number of practical issues that were not specifically addressed at the respective price controls regarding the definitions used and the timing of the clawback. In that letter we invited views on the issues. Following consideration of the responses, now we set out our methodology for implementing the tax clawback (Appendix 1). This methodology will be introduced with the first adjustments being incorporated into the DPCR5 review. Also, a summary of the responses we have received and our conclusions are set out in Appendix 2.

Yours sincerely,

Rachel Fletcher
Director, Distribution

[1] Electricity Distribution Price Control Review 4 – Final Proposals (265/04)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4

Gas Distribution Price Control Review Final Proposals Consultation Document (285/07)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=362&refer=Networks/GasDistr/GDPCR7-13

Transmission Price Control Review: Final Proposals (206/06)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses

Appendix 1: Clawback of tax benefit due to excess gearing – Final Methodology

This paper outlines the methodology for calculating and adjusting for the tax benefit licensees receive from adopting a higher level of gearing than assumed in the price control financial modelling.

As outlined in the TPCR, GDPCR and DPCR4 final proposals we will implement the ex post adjustment which claws back from licensees the revenue benefit they obtain from lower tax costs because of high gearing.

The clawback is triggered, as specified in the relevant Final Proposals, when in any year, (i) actual gearing exceeds notional gearing and (ii) interest costs exceed those modelled at the relevant price control. In the case where both of these conditions are satisfied, we will clawback the tax benefit which results from the difference between actual and modelled interest costs in that year.

The clawback calculation takes the following steps, for each network licensee, for each year of a price control. The definition of the terms highlighted in bold is given below.

1. *Step 1*: Compare actual gearing to **notional gearing**. For this purpose, we define actual gearing as **year end net debt/year end RAV**. If actual gearing is lower or equal, then no clawback applies. If it is higher, then proceed to step 2.

2. *Step 2*: Compare **actual interest** to **modelled interest.** If actual interest tax relief is lower or equal, then no clawback applies. If it is higher, then proceed to step 3.

3. *Step 3*: The excess relief is calculated as actual interest– modelled interest. This is then multiplied by the corporation tax rate applicable for that year (e.g. 30% up to 31 March 2008; 28% from 1 April 2008 and until revised by legislation) to determine the clawback adjustment.

4. *Step 4*: If the clawback adjustment is lower than the tax allowed in the financial model for that year, then the adjustment is present valued using the applicable cost of capital, and deducted from revenue allowances in the subsequent price control. To the extent that it exceeds the tax allowed (as may be the case for some of the GDNs), then the excess is instead added to the assumed regulatory tax loss for the year and carried forward. This will ultimately impact the licensee's tax allowance at the point at which we model them as having to pay corporation tax.

Notional gearing

This is primarily taken as the gearing level assumed in the WACC calculation for each price control as set out below, notwithstanding the fact that the financial model may have a slightly different gearing level depending on net cash flows in the year.

DPCR4: 57.5%
TPCR4: 60.0%
GDPCR: 62.5%

In TPCR, the two Scottish TOs were modelled under some scenarios as having to increase gearing very significantly as the proposed investment was greater than existing RAV. In such cases, where the modelled gearing each year departs significantly from the figure above, we will substitute that figure. The appropriateness of this substitution will be determined on a case-by-case basis.

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Year end RAV

For calculating the actual gearing, we use actual year-end RAV calculated in accordance with the relevant final proposals for each price control (inflated using year-end RPI), adjusted for actual expenditure in the year. As the RAV is finalised during the following price control review the calculations underlying clawback will only be confirmed at this point, but we will use the annual price control reporting publications to provide indicative calculations. For Transmission companies there is an additional issue which relates to the treatment of debt incurred and attributable for Capital Expenditure (capex) on items that are remunerated later in RAV (or otherwise) than in the current price control period.

Examples of such costs are:

- Specific projects / incremental capex
- Revenue Driver expenditure
- Transmission Investment in Renewable Generation (TIRG)
- Logged up costs (e.g. Security, BT21CN)

Currently, these items are accounted for in a "shadow" RAV until the next price control. The debt incurred to fund this capex may therefore push the licensee to breach the gearing ratio and interest payable (as modelled). To penalise a licensee because debt is included by "shadow" RAV would be asymmetric, consequently we will include the "shadow RAV" in the RAV for the purpose of the tax claw back gearing calculation. This approach is appropriate for Transmission licensees but does not currently apply in Gas or Electricity Distribution.

Year end Net Debt

Net debt includes:

- Cash at bank
- Bank overdrafts
- Short term investments
- External borrowings[2]
- Inter-company borrowings
- Short term loans to related parties (except where they have demonstrated the characteristics of being long term in nature, for example by repeated renewal)
- Long term loans to related parties only where they can be justified as for the benefit of the regulated business and are not in the nature of a distribution

Inter-company debtors/creditors/working capital: where these can clearly be identified as such, they are excluded. However, if they cannot, because the licensee does not clear these balances on a regular basis, they will be treated as effective intercompany loans and included in net debt.

Net debt excludes:

- Year end balances of fair value adjustments on derivatives in regulatory accounts (except cross currency swaps)
- Unamortised issue costs
- Fixed asset investments where not readily converted to cash
- Preference shares
- Long term loans to related parties except where they can be demonstrated as for the benefit of the regulated business and are not in the nature of a distribution
- Short term loans to related parties except where they have characteristics of long term loans

[2] External Borrowings and other loans must be adjusted to reflect the ultimate liability in sterling resulting from any cross currency swaps relating to that debt instrument and shall exclude the impact of fair value adjustments and accrued interest.

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Actual interest

Interest includes:

- Actual net interest (payable less receivable) for the price controlled business extracted from regulatory accounts, used on an accruals basis
- Interest on index-linked debt based on the charge to the income statement in regulatory accounts (i.e. on an accruals basis)

Interest excludes:

- Any interest that would otherwise be included, but which does not qualify for corporation tax relief
- Movements relating to pension fund liabilities reported in the regulatory accounts within net interest
- Fair value adjustments (e.g. losses on derivatives)
- Dividends on preference shares
- The cost of retiring long term debt early (including exceptional debt redemption costs)
- Debt issuance expenses (including amortisation charges relating to discounts on debt issuance that had previously benefitted from a deduction against taxable profits)
- The cost of maintaining committed undrawn liquidity backup lines (i.e. commitment fees)

Modelled Interest

The modelled interest that was treated as attracting tax relief can be determined from each price control's financial model. Note that it needs to be a notional interest figure. The appropriate RPI figure is that assumed in the model, rather than actual RPI, since it is the former that determines the amount of tax relief that was assumed in the model.

Other methodological points

In the specific case of NGG (or similarly for any other licensee with more than one licence), we will monitor the attributions to individual GDNs and the NTS to ensure that there attributions are equitable, consistent and reasonable; and as appropriate perform an overall sensitivity check at a group level.

Where actual years are not available, as is usually the case for the last year in a price control, forecast data may used, but we reserve the right to adjust for material changes at the subsequent price control review.

It is intended that the draft calculation will be included within the annual RRP so that the process forms part of the annual review. Thus, for those companies for which an adjustment is to be made, its review will from part of the annual cost process. The actual adjustments will be finalised as part of the subsequent price control review process.

The actual adjustments identified (plus the forecast for closing year of a price control) will be factored into the next Price Control with adjustments of greater than £0.1m to tax being considered material. The claw back adjustments will be made at the next Price Review. Large adjustments may be spread over more than the first year of the next control on an NPV neutral basis.

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Appendix 2: Summary of responses

We have received a total of eleven responses to our proposals. They are summarised below, along with our conclusions to each of them.

1.1. Interest

There was general agreement with our definitions but a suggestion that they should include amortised issue costs. In the regulatory accounts, interest payable may include amortisation charges in respect of discounts paid when issuing new debt that is tax deductible under current treatment.

One respondent suggested that debt issuance costs and commitment fees should also be treated as interest, another that it should include non-cash finance charges where these are tax deductible; and another that an approach to stripping out non-price controlled activities is required.

In determining whether any costs are interest, we are guided by our three criteria that the costs have (a) been included in the modelled interest allowance; (b) are tax deductible as interest; and (c) are clearly identifiable in regulatory accounts or other regulatory submissions.

Amortised issue costs

To the extent that issue costs are in theory included in our cost of capital they could be said to be included in the total interest modelled. However, in our view they were not explicitly modelled or included in the cost of capital, and thus do not fully satisfy all of our criteria and should be excluded.

Commitment and redemption fees

In modelling interest and tax at the price controls, we have not calculated these explicitly and they are not interest per se and should be excluded.

Non-cash finance charges where tax deductible

In our view, it will be difficult for us to understand when items are tax deductible and to include them would imply a much greater level of detail and scrutiny than currently involved. In addition, these were not modelled as interest charges and therefore will be excluded.

Interest related to non-price controlled activities

In some, but not all annual cost reporting returns and regulatory accounts segregation of interest to regulated and unregulated activities is collected. However, it may be impractical to try to segregate debt and related interest for all minor activities; and some respondents may be unable, except on an estimated basis, to perform what may be a time consuming exercise for relatively small numbers. In our view, such an exercise could be arbitrary and potentially open to abuse in the form of attempts to minimise the actual interest cost attributed to price-controlled activities and the clawback test should be performed on an entity basis. However, where the activities are clearly self financing, such as connections, NTRs, metering, etc, and exceed 2.5% of the entities' business measured by turnover (in line with the de minimis threshold in the licence) then it is reasonable and practical to adopt a methodology to exclude the related interest.

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1.2. *Debt (excluding preference shares and related parties)*

There is agreement to the definition provided with the exception of three respondents who challenged the suggestion that inter-company working capital should be included. Additionally one respondent stressed that it should exclude fair value adjustments, whilst another felt the true value should be included after adjusting for currency swaps.

Inter-company working capital

Although the companies already state the value of inter-company working capital in the Regulatory Reporting Pack (RRP), in some cases it is not possible to unambiguously distinguish true working capital inter-company trading balances from longer-term balances. It is also the case that these items build up in working capital, include treasury balances and are not necessarily cleared on a regular basis. Where we can unambiguously identify short-term working capital trading balances from long-term debt, we consider it appropriate to exclude it in the calculation. At our Annual Audit Workshop for licensees and their auditors in February 2009, we expressed the view that licensees are expected, as a matter of good governance, to clear periodically inter-company working capital balances; and at least annually prior to the regulatory financial year end. Such an exercise would assist in identifying long-term balances that should not be treated as short-term working capital.

Fair value of debt

The value that should be used is the true liability, as we do not model fair value adjustments. As such, we consider that fair value adjustments be excluded from net debt for the purposes of the clawback calculation.

Cross currency swaps

One respondent with large currency borrowings was concerned that the calculation of net debt should also reflect, in some way, the derivative assets/liabilities that relate to that debt, which was not covered in the draft definition. They suggest that this can be calculated either on an IFRS basis or on the basis in the RRP. The latter basis, which is consistent with the old UK generally accepted accounting principles (GAAP), better reflects Ofgem's own modelling. They have suggested the following wording: "External Borrowings and other loans should be adjusted to reflect the ultimate liability in Sterling resulting from any cross currency swaps relating to that debt instrument and to exclude the impact of fair value adjustments and accrued interest."

Whilst the value of currency borrowings can be quite volatile, a prudent company will hedge against this exposure. We accept that ignoring hedges will distort any gearing comparisons and that it is reasonable to include this. However, we intend to exclude accrued interest as this will reverse over time as the derivative unwinds.

1.3. Loans to Related Parties

The majority (8 respondents) specifically believe this should be included, two that it should not. One respondent suggest that a pro-rata adjustment be made to allow a portion of the internal debt based on level of equity relative to external debt.

Loans to Related Parties

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There are occasions when such balances can arise as part of normal treasury management operations. They may also arise for other business or group reasons unconnected with financing the regulated business, for example to mitigate taxation elsewhere in a group or as a substitute for paying dividends. However, our concern is that loans to related parties, if included in the gearing calculation, could lead to manipulation of the gearing ratios of companies. For the purposes of a gearing comparison, we will need to establish the rationale for a licensee maintaining long term lending to related parties before they are included in net debt.

Introducing a further calculation to apportion such loans in relation to equity adds another layer of complexity that, in our view, should be avoided.

We will include short-term loans to related parties in net debt; and exclude long-term loans and short-term loans that by their nature, demonstrated over time, have the characteristic of long-term debt, e.g. being classified as short-term or repayable on demand but rolled over annually over time.

1.4. *Preference Shares*

All but one company believed that preference shares should be excluded from net debt with two of these suggesting that the approach should be symmetric i.e. both the preference shares and preference dividends are both in or both out. One respondent specifically believes preference shares and preference dividends should be included.

Preference shares and related dividends

We note that under GAAP, preference shares are treated as debt instruments, and that some calculations of gearing (e.g. those made by credit rating agencies) include them. However, we model debt and equity very simply in the financial model, and do not specify exactly which instruments are included in each. However, we do not make reference to typical returns to preference shares in determining the cost of debt financing, and assume that all interest on debt financing is tax deductible. So, implicitly, we are excluding preference shares from our regulatory view of debt. It would be asymmetric to include them in actual net debt. We will therefore exclude preference shares from net debt and exclude preference dividends from interest.

1.5. RAV

There was limited comment on the use of RAV, although three respondents commented on the use of shadow RAV and two respondents were concerned at the possible impact of deflation on the RAV (the RAV each year is adjusted by movements in RPI but in a deflationary period this would reduce the RAV and hence increase gearing).

Shadow RAV is seen as appropriate by one DNO to cover additional spend on such items as the Electricity Safety Quality and Continuity Regulations (ESQCR) reopener. The concept of shadow RAV was introduced at TPCR4 and whilst it may become appropriate at other sectors subsequent controls it is inappropriate as part of this exercise to fetter future decisions.

Shadow RAV

We are not adverse to the application of shadow RAV, but recognise that this would bring further complexity to debate and challenge. Currently the gearing levels are such that a company is clearly under or over the threshold. It remains appropriate to maintain shadow

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RAV as a concept for Transmission companies since this reflects how prices were set. Should, in future Electricity or Gas Distribution Price Controls, a reopener be introduced we have the option to consider whether this mechanism may be appropriate to the circumstances.

Impacts of RPI

RAV, in accordance with the methodology at each control, is adjusted annually for movements in RPI and, whilst, we acknowledge the possible effect of a deflationary period on RAV we consider that such an event is an appropriate risk for each company to carry.

1.6. *Other*

There was a suggestion by one respondent that we should use the modelled inflation in calculating interest rather than actual inflation; and by another that we should adjust for the difference between actual and modelled inflation. These both seek to avoid any additional interest impact caused by inflation (which can result in a higher or lower tax benefit). In actuality, the calculation used takes the interest allowance in constant prices and adjusts to nominal prices using actual movements in RPI. In the comparison to RAV we use actual RAV additions and adjust RAV by movements in RPI to year end values to match net debt. There should not be any impact of inflation assumptions on the result.

There were several other comments made by single respondents as follows (together with our views):

- Provide companies a period to review the calculations and set out ultimately how Ofgem may share the information.

We will publish indicative calculations (bearing in mind that RAV is not finalised until the next price control review) in the annual price control review reports. This will allow ample opportunity for the companies to raise any queries. Additionally we will include any adjustments in the next price control financial model, which will be available for consultation and response. For DPCR4 adjustments, our views will be incorporated in Initial Proposals.

- A 5-year price control period be used for the comparison to enable capital expenditure to be made early in a period than as shown by the phasing of the allowances, if necessary. The intention is to adjust for any changes at the next Price Review with only large adjustments made over a 5-year period.

We recognise that the profile of spend and hence debt, interest and the value of year-end RAV will vary from that modelled. In all the current settlements, it is set out in the relevant Final Proposals that the adjustment is computed annually. Accordingly, we will abide by those settlements.

- How to address events at a year-end that might affect closing debt (e.g. delayed Distribution Use of System [DUoS] income). A suggestion that income collected within seven days of the year-end be classified in the debt calculation as cash.

In our view, such adjustments would be difficult to confirm and it is not considered practical. It is up to companies to manage their debtors. Such amounts would already be in accrued income.

- Ofgem to provide confirmation that no retrospective adjustments will be made where tax allowances have not been given, i.e. where there were forecast tax losses.

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Our view is that we will adjust "regulatory losses" as defined in the relevant price control in such circumstances.

- The open letter describes a level of materiality that will be applied. One respondent has suggested that this value should be set at a level of 0.5% of RAV.

In our view, the respondent appears to have taken the materiality threshold out of context at least in the way in which the *de minimis* amount should be computed. Our methodology will apply materiality to the final computed tax benefit adjustment, such that values under £0.1m will be ignored.

- That the modelled gearing level should be used if it is higher than the notional gearing and additionally, that we may wish to consider whether we set the gearing level each year at the nominal rate or at start of the modelled period. If set at the start of the period a large capex programme (in the absence of equity injection) would affect gearing.

Our view is that the Final Proposals are unambiguous in that they should be consistent with DPCR4, which stated that it is notional gearing (as stated in Appendix 1) would be used. We will use the headline notional gearing level as set out in the Relevant Price Control, with the exception of where modelled gearing clearly exceeds the fixed notional level in certain companies. The latter is to take account of scenarios where there are massive renewables connections.

- To aggregate all regulated members of a group as a combined gearing calculation to avoid artificial movements within a group to comply with gearing requirements.

Our view is that the Final Proposals for each Price Control apply to, and allowances are set at, a licensee level, with the exception of NGG (distribution), where the allowances were set individually for each of its four GDNs although they operate under a single licence. Therefore, it is clear that the adjustment is determined at a licensee level rather than group level. In the case of NGG or similarly for any other company with more than one licence, we will monitor the attributions to individual GDNs and the NTS to ensure that their attributions are equitable, consistent and reasonable; and optionally may check at group level.

- One respondent is concerned that the calculation should factor out differences caused by debt market conditions (arguing only the gearing change is relevant).
  The element of any tax benefit that is caused by debt market conditions can only be a subjective judgement. It can be argued that RPI above modelled level, market sentiment, supply and demand factors in the market can all have an impact.

In our view, the Final Proposals are clear on the two triggers for an adjustment and changes in debt market conditions were not specified. It is a simple test on actual interest incurred versus modelled interest. Assessing which and at what level is not considered to be practicable and we shall continue to use modelled debt and interest compared to actual. Movements in debt and interest remain a risk of the licensees in the current price controls.

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