Consultation

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Consultation on the closeout methodologies for RIIO-GD1

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We are consulting on the closeout methodologies for RIIO-GD1. This document outlines the scope and purpose of the consultation, asks the questions on which we are consulting and explains how you can get involved. Once the consultation is closed, we will consider all responses. We want the consultation process to be transparent.

We will publish the non-confidential responses we receive alongside a decision on next steps on our website at **Ofgem.gov.uk/consultations.** If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential and, if possible, put the confidential material in separate appendices to your response.

Any enquiries related to the text of this publication should be sent to Ofgem at:
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Executive summary

The RIIO-GD1 price control ran from 1 April 2013 until 31 March 2021 (an 8-year period). The RIIO-GD1 licence (the GD1 Licence) makes provision in relation to several areas which, due to their uncertain nature, could only be settled once all costs and actual RIIO-GD1 performance are known. This means that some elements of the price control need to be subject to "closeout" once the price control has ended and all the relevant information is available or can be forecast with sufficient accuracy.

We are proposing methodologies to closeout elements of the RIIO-GD1 price control in two broad areas:

1) The calculation of financial adjustments under the Incentives Framework[1] for GDNs' output delivery against the relevant performance targets, which they were funded to deliver in RIIO-GD1.

2) Adjustments to RIIO-GD1 allowances that can be calculated with reference to GD1 Licence definitions and price control algebra, but where final assessment of the relevant information (e.g., actual expenditure incurred/actual output delivered) is required to calculate those adjustments.

We have based the methodologies on the approach and principles that we described in the RIIO-GD1 Strategy Decision and RIIO-GD1 Final Proposals, and 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. We have also considered elements of the GD2 Final Determinations where relevant. This document consults on the methodologies required to close out RIIO-GD1.

We have not included the closeout of Network Output Measures (NOMs) within the scope of this consultation exercise; NOMs closeout will be consulted upon separately due to its cross-sector scope.[2]

We have worked with the Gas Distribution Networks (GDNs) to develop these proposed methodologies and, subject to the outcome of wider consultation, a final version will be included in the RIIO-GD2 Price Control Financial Handbook. We welcome views from stakeholders on our suggested approaches outlined in Chapters 2 to 9.

[1] These are: Special Condition 7.8 Closeout of the Discretionary Reward Scheme ($LDRW_t$); Special Condition 7.9 Closeout of the Broad Measure of Customer Satisfaction Incentive (LBM_t); Special Condition 7.13 Exit Capacity Cost Adjustment (LEx_t);

[2] NOMs Closeout Submission Instructions and Guidance (May 21) and Direction to changes to the NOMs Incentive Methodology (Jun 21) have already been published.

Related documents

RIIO-GD1 Strategy Decision,
https://www.ofgem.gov.uk/publications/decision-strategy-next-gas-distribution-price-control-riio-gd1

RIIO-GD1 Final Proposals
https://www.ofgem.gov.uk/publications/riio-gd1-final-proposals-overview

Supplementary documents to the RIIO-GD1 Final Proposals
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/3_riiogd1_fp_finance_and_uncertainty_0.pdf
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiogd1_fp_outputsincentives_dec12_0.pdf

Price Control Financial Handbook
riio-gd1-price-control-financial-handbook_0.pdf (ofgem.gov.uk)

RIIO-2 Final Determinations Transmission and Gas Distribution Network Companies
www.ofgem.gov.uk/publications/riio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator

1. Background and overview

Background

1.1. The RIIO-GD1 price control includes several areas of expenditure, that require information about actual efficient costs incurred, revenue received and the extent to which related outputs have been delivered before closeout. These are compared with the costs, revenues etc. that were assumed in Final Proposals to determine the value of any adjustment required for closeout.

1.2. We are proposing methodologies to closeout elements of the RIIO-GD1 price control across two broad areas:

1) The calculation of financial adjustments under the Incentives Framework[3] for GDNs' output delivery against the relevant performance target levels, which they were funded to deliver in RIIO-GD1. See Chapter 2.

2) Adjustments to RIIO-GD1 allowances that can be calculated with reference to GD1 Licence definitions and price control algebra, but where final assessment of the relevant information (e.g., actual expenditure incurred/output delivered) is required to calculate those adjustments. This includes the following cost areas:

    - Iron Mains Replacement Programme (Repex)[4]
    - Fuel Poor Network Extension Scheme (FPNES)[5]
    - Capacity Utilisation[6]
    - Interruptions[7]
    - Shrinkage and Environmental Incentives[8]

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.

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").

1.5. We will assess all information provided by the GDNs in relation to their RIIO-GD1 performance and consider whether they have delivered on their commitments and taken

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[3] These are: Special Condition 7.6 Closeout of Network Outputs ($NOCO_t$); Special Condition 7.10 Closeout of the Shrinkage Allowance Revenue Adjustment (LSHR); Special Condition 7.11 Closeout of the Environmental Emissions Incentive ($LEEI_t$); Special Condition 7.12 Closeout of the Fuel Poor Network Extension Scheme Incentive ($LFPI_t$); LEx_t; LBM_t;

[4] Special Condition 3E;

[5] Special Condition 4J

[6] Special Condition 4H

[7] Special Condition 1E

[8] Special Condition 1F

investment decisions which will provide long term benefits to customers. The onus will be upon network companies to demonstrate that they have efficiently incurred expenditure to deliver consumer benefits.

Scope of Closeout - an overview

1.6. Closeout includes: mechanisms that "true-up" and reconcile actual expenditure against services provided by the GDN; output mechanisms which enable us to recover funds from GDNs if they have not delivered the outputs they were funded to deliver; mechanisms which deal with over or underspend against fixed allowances; and mechanisms that deal with over or under-delivery against output targets.

1.7. Table 1 provides a description of the areas of the RIIO-GD1 price control that require a methodology for closeout.

Table 1: Cost areas for GD1 closeout

Area	Description	Proposed approach	Chapter
Iron mains replacement programme (Repex)	Assessment required at closeout to determine whether GDNs have delivered the primary safety output.	Closeout will assess the level of risk removed from the networks through the repex programme and compare against targets.	3
FPNES	Assessment required at closeout and mechanism to enable allowance adjustment for any under or over-delivery in RIIO-GD1 to be incorporated into the licence.	Closeout will assess delivery of fuel poor connections against targets, make provision to "true-up" any RIIO-GD1 under or over-delivery, and determine any reward or penalty.	4
Capacity utilisation	Assessment required at closeout to determine whether the GDNs have met their capacity utilisation targets.	Capacity utilisation to be closed out as part of NOMs assessment rather than assessed discretely.	5
Interruptions	Review of GDNs' RIIO-1 performance against reliability output targets required.	Closeout will assess the number of planned and unplanned interruptions occurring on the networks in RIIO-GD1 and compare against performance targets.	6
Shrinkage and Environmental incentives	Assessment is required to determine performance against shrinkage and environmental emission targets and calculate rewards/penalties.	Closeout will assess the reduction in shrinkage throughout GD1 relative to the baseline.	7
Tax clawback (WWU only)	Values to be trued-up through the legacy GD1 PCFM.	Closeout will correct the GD1 tax clawback values for WWU.	8
Disposals	Values to be trued-up through the legacy GD1 PCFM.	Closeout will true-up the value of disposals in the GD1 PCFM.	9

Exclusions from RIIO-GD1 closeout

1.8. There are a number of areas that we consider fall outside the scope of RIIO-GD1 closeout as the schemes are ongoing and performance against output targets will be assessed, and any necessary allowance adjustments made, at a later date.

Smart metering

1.9. The GDNs' were provided baseline allowances to support delivery of the smart meter rollout programme. The GDNs were not given defined targets or outputs related to smart metering. However, RIIO-GD1 Final Proposals included a re-opener that could be triggered at any time during the price control if material costs had been, or were expected to be, incurred. We also stated in RIIO-GD1 Final Proposals that should a GDN trigger a re-opener during RIIO-GD1, we would consider making adjustments to all GDNs' revenues either through provision of ex ante allowances or the establishment of a volume driver.

1.10. The smart metering re-opener was not triggered during RIIO-GD1 as no GDN had incurred costs in excess of its materiality threshold. As the licence makes no provision for allowance adjustments at RIIO-GD1 closeout in regard to immaterial costs, we do not consider it within the scope of closeout. It follows that any over or underspend in RIIO-GD1 against allowances is subject to the Totex Incentive Mechanism (TIM) sharing factor.

Gas holder demolitions

1.11. In RIIO-GD1 Final Proposals we set the GDNs a target of demolishing all redundant (and unlisted) gas holders by 31 March 2029 as part of a rolling 16-year programme in order to reduce maintenance costs for these redundant assets.

1.12. In RIIO-GD2 Final Determinations we stated that, at the time of the RIIO-GD3 price control, we would consult on establishing a final output and funding for completing the work in RIIO-GD3 with an ex-post review at RIIO-GD3 closeout (or earlier if companies complete the programme sooner) to determine delivery against the overall 16-year plan.

1.13. As such we do not consider gas holder demolitions to be within the scope of RIIO-GD1 closeout and there is no requirement to develop a closeout methodology. Any over or under-spend against RIIO-GD1 allowances will be subject to the TIM sharing factor.

Sub-deduct networks

1.14. Sub-deduct networks are gas pipe network arrangements that are beyond the GDNs' main gas meter. GDNs were funded in RIIO-GD1 to take all sub-deduct networks 'off risk' by the end of the price control.

1.15. In RIIO-GD2 Final Determinations we stated that we would assess at RIIO-GD1 closeout whether the GDNs had met their targets and consider setting clear deliverables in the RIIO-GD2 licence if the targets were not met.

1.16. We also stated that if the GDNs discovered additional sub-deducts during RIIO-GD2 they would be obliged to make them off-risk without any additional funding, as the RIIO-GD1 allowance was for identifying and covering all sub-deduct networks.

1.17. We acknowledge that Covid-19 may have impacted on the ability of the GDNs to meet their RIIO-GD1 targets and, as per the RIIO-GD2 Final Determinations decision, expect any shortfall to be delivered in RIIO-GD2 without any additional funding.

1.18. Any over or underspend against RIIO-GD1 allowances will be treated as totex and subject to the TIM sharing factor.

Enhanced physical site security

1.19. As part of the UK government's Physical Security Upgrade Programme (PSUP), networks are required to implement physical security enhancements at sites listed as Critical National Infrastructure (CNI). BEIS determines which sites require upgrades, and the design specification at each site must meet the requirements of the Centre for the Protection of National Infrastructure (CPNI).

1.20. Special Condition 3F of the RIIO-GD1 licence only makes provision for allowance adjustments following re-opener applications in 2015 and 2018 and makes no explicit provision to either (i) true-up immaterial costs or (ii) make allowance adjustments for material costs as part of RIIO-GD1 closeout.

1.21. Ofgem acknowledge that PSUP projects can take considerable time to install and that construction in 2021 may have been impacted by Covid-19 restrictions. GDNs are to identify any RIIO-GD1 projects that have not yet been completed and inform Ofgem of the expected completion date in RIIO-GD2 and submit a Tech Audit to Ofgem upon completion of the project(s).

1.22. It is BEIS, not Ofgem, that ensures PSUP work undertaken by the GDNs is done to the requisite specification, and no additional allowance will be provided in RIIO-GD2 in regard to projects due for completion in RIIO-GD1. Any over or underspend against RIIO-GD1 allowances will be subject to the TIM sharing factor.

Performance assessment submission

1.23. The GDNs have submitted their 2021 Regulatory Reporting Packs which contain performance information as well as a narrative document providing a qualitative explanation of their performance across RIIO-GD1. The GDNs also submitted a Performance Report in July 2021 as obliged by Special Condition 4H.

1.24. Ofgem expects that this information will be sufficient to enable it to undertake a robust assessment of the GDNs' RIIO-GD1 performance and determine the extent of any over or underperformance against their targets. If any additional information is required Ofgem will engage with the GDNs and request this as necessary at the closeout implementation stage.

Next Steps

1.25. We will review all responses to the consultation, requesting further evidence if necessary. Based on the information received, we will make a decision on the closeout methodologies.

1.26. We expect to publish our final determination on closeout in early 2022.

1.27. We expect to follow our final determination with a consultation on any required modifications to the RIIO-GD2 Licence. We will make any adjustments to GDNs' RIIO-GD1 allowances as part of the 2022 Annual Iteration Process.

Your response, data and confidentiality

1.28. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose.

1.29. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we will get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.30. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.31. If you wish to respond confidentially, we will keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We will not link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.32. We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

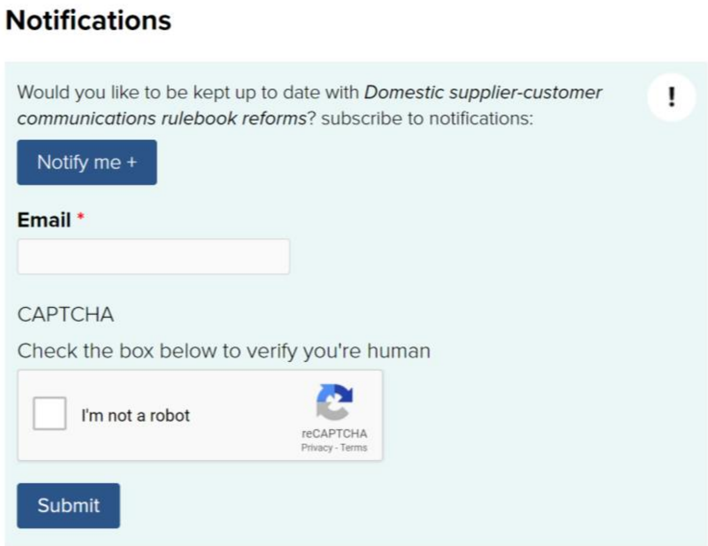
1. Do you have any comments about the overall consultation process?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?

5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).



2. Approach to financial methodologies

This section describes the process which the Authority proposes to follow in determining any revisions to the licensees' RIIO-2 RAV balances and revenue for the GD2 Price Control Period.

The section employs the following terms:

- **The RIIO-2 PCFM:** the RIIO-GD2 Price Control Financial Model
- **The Legacy PCFM:** the RIIO-GD1 Price Control Financial Model
- **Revenue RRP:** The extended GD1 Revenue Regulatory Reporting Pack
- **AIP:** Annual Iteration Process
- **GDPCR4:** Gas Distribution Price Control Review 4
- **RAV:** Regulated Asset Value

Background

2.1. To closeout GDPCR4, i.e., the price control that preceded RIIO-1, the RIIO-1 model contained "legacy" adjustments to RAV (LRAV) and revenue (LAR) in the 2013/14 regulatory year. For the GDNs, the LAR value was spread over the 8 years of RIIO-1.

2.2. In contrast, the RIIO-GD1 licence introduced mechanisms that automatically true up revenue for outturn data on an annual basis. Therefore, the RIIO-2 PCFM does not need the same catch-all legacy terms used for GDPCR4 closeout. Instead, the LAR term is the sum of the pre-existing true-up mechanisms introduced in RIIO-1 (licence terms MOD, PT, TRU, for example).

2.3. Rather than make a one-off adjustment to RAV at the start of RIIO-2, we now import the final RIIO-1 values into the RIIO-2 PCFM; this reflects the historical adjustments more transparently. Accordingly, the LRAV term has been repurposed to refer to the "outturn" (or ex-post) RAV additions in RIIO-1, rather than a one-off adjustment.

2.4. The revenue adjustment (LAR) in RIIO-2 is the sum of existing true-up mechanisms, which have been extended into RIIO-2 to cover the closeout of RIIO-1.

2.5. One component of the LAR term is "MOD", which is calculated by the RIIO-1 PCFM on an annual basis. The MOD term calculates an appropriate revenue adjustment for a future year, given a set of changes in historical years. MOD has been calculated annually as part of the AIP, and we continue to calculate it.

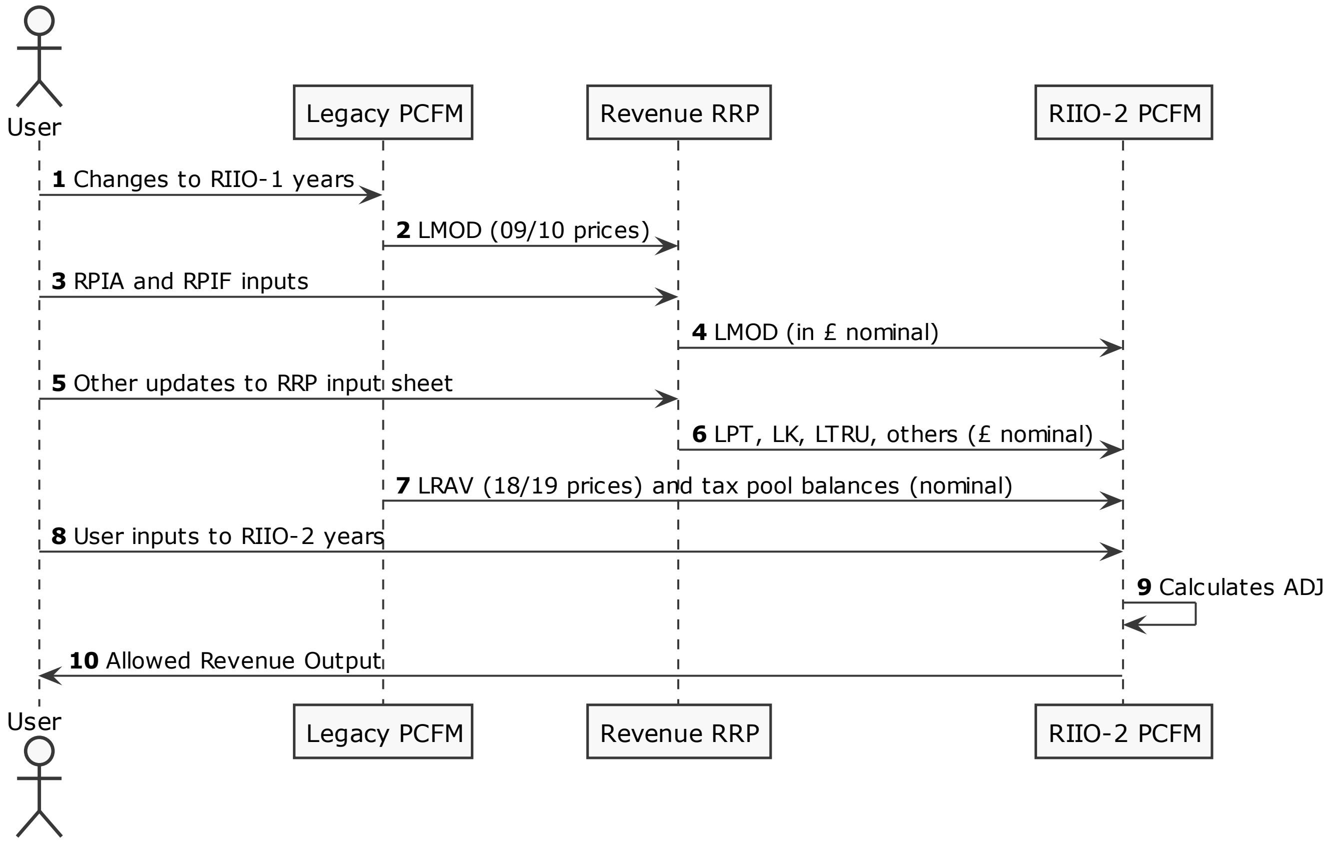
2.6. In the typical RIIO-1 process, the MOD term only reflects changes to pre-defined "variable values", and other values remain fixed through the price control. However, we propose to broaden the scope of historical changes we implement in the RIIO-1 PCFM, and thus extend the function of MOD to capture the effect of RIIO-GD1 closeout.

2.7. For illustration, Figure 1 is a sequence diagram, showing how the Legacy PCFM, Revenue RRP, and RIIO-2 PCFM interact and produce an allowed revenue value for the next regulatory year. Figure 1 should be read from top to bottom (the steps are numbered), while the arrows show where components come from and feed into.

2.8. For example, steps 2 to 4 show the LMOD value is calculated in the Legacy PCFM, converted to nominal prices in the Revenue RRP, and input into the RIIO-2 PCFM, while step 7 shows LRAV inputs come from the Legacy PCFM directly.

2.9. This process is set out in the Price Control Financial Handbook and the network licence special conditions.

Figure 1: Sequence Diagram of the RIIO-2 AIP with Legacy Adjustments



Proposed approach to closeout

2.10. The RIIO-1 AIP updated only "variable values", unless a modification was made by statutory consultation; however, in principle any ex-post change to RIIO-1 base revenue can be reflected through the MOD process and legacy net RAV additions.

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.

2.12. We propose to implement the GD1 closeout methodologies in the November 2022 AIP, though note that corrections can be made in subsequent AIPs if necessary. We have also given network operators the option to reflect a provisional closing position for RIIO-

GD1 through the 2021 November AIP, making clear that any adjustments made in 2021 will be subject to our close-out methodologies and further true-up.[9]

2.13. We note that the RIIO-GD2 Price Control Financial Handbook already posits adjusting the Legacy PCFM to accommodate closeout methodologies, however, we welcome views on what should or should not be finally incorporated into the handbook.

Phasing of the impact of closeout

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.

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

[9]. In the interim period between the beginning of RIIO-2 and the completion of the RIIO-1 close-out process, we use provisional, estimated values for the RIIO-2 PCFM that are subject to "true-up" following the final decision on our closeout methodologies. See our consultation position on close-out values in the table on page 155 of our Draft Determinations and see also out Final Determinations on close-out values in the table on page 119. This is also in line with the process as set out in the RIIO-2 Price Control Financial Handbook, paragraph 8.10, here.

3. Iron mains risk reduction programme (Repex)

This section explains our proposed methodology for closing out the RIIO-GD1 Iron Mains Risk Reduction Programme.

Background

3.1. The iron mains risk reduction programme (IMRRP), or 'repex' programme, is an HSE initiative to decommission c.72,000km of iron mains by 2032 as part of an ongoing programme to increase safety on the distribution networks.

3.2. In June 2011 the HSE revised its approach to the repex programme and agreed annual workloads with the GDNs, to be delivered over RIIO-GD1. To fund the IMRRP work in RIIO-GD1, Ofgem moved from an approach based on delivering a specific volume of work to an approach which entailed funding a level of risk reduction, based on the established mains risk prioritisation system (MRPS).

3.3. The RIIO-GD1 Final Proposals set the GDNs' allowances to achieve the Primary Output relating to safety by reducing risk on their networks from between 40-60% relative to the 2013 baseline[10], with the HSE also imposing a statutory obligation on the GDNs in relation to the delivery of iron mains replacement workloads.

3.4. RIIO-GD1 Final Proposals stated our intention to assess GDNs against the difference (or delta) between the opening safety risk score and the expected score at the end of RIIO-GD1. We also stated that any over or under delivery of risk removal as a result of mandatory workload changes from the HSE would be taken into account when performance is assessed at closeout.

3.5. We stated in RIIO-GD1 Final Proposals that we would expect to carry-over any under or over delivery of outputs into RIIO-GD2, as well as providing for a potential reward/penalty of 2.5% of the value of any over or under delivery. However, we also acknowledged that GDNs have statutory obligations in relation to the delivery of iron mains replacement through the IMRRP and that our assessment at closeout needs to ensure that we do not apply any additional penalties in relation to absolute standards over and above those set by the HSE[11].

3.6. As such, no provision for rewards or penalties was included in the GD1 Licence in relation to delivering the primary safety output. We also changed the way iron mains replacement work is funded in RIIO-GD2, with consumers funding workload delivered through a disaggregated Price Control Deliverable (PCD) rather than funding levels of risk reduction. Therefore, it is not possible under the current framework to carry RIIO-GD1 over or under performance into RIIO-GD2.

Proposed Approach

3.7. The GDNs are to provide details of their RIIO-GD1 performance against meeting their risk reduction targets through the 2021 RRP submission, as well as the

[10] RIIO-GD1 Final Proposal, overview, para 2.8
[11] RIIO-GD1 Final proposals, outputs and incentives annex, para 1.17

Performance Report obligated under Special Condition 4H of the GD1 licence.[12] We expect the GDNs to explain and justify their performance against the target level of risk reduction through the RRP commentary document submitted alongside the 2021 RRP.

3.8. We are aware from assessment of previous years' RRP submissions that all GDNs have already met/exceeded their safety primary output targets and removed the requisite level of risk from their networks.

3.9. Therefore, noting paragraphs 3.5-3.6 above, Ofgem proposes that to close out the RIIO-GD1 safety output any over or underspend against allowances is treated as totex and subject to the Totex Incentive Mechanism (TIM) sharing factor, and that no further adjustments are made to either RIIO-GD1 allowances or RIIO-GD2 performance targets in relation to the GDNs' RIIO-GD1 performance.

3.10. The HSE will undertake its own assessment of whether the GDNs have delivered their HSE-mandated repex workloads for RIIO-GD1 and determine if any action is necessary in regard to RIIO-GD1 performance. Ofgem takes no part in the HSE assessment and any enforcement action is at the discretion of the HSE and does not fall within the scope of closeout.

3.11. We will engage with HSE and the GDNs going forward to ensure that the entire Repex programme is delivered efficiently over multiple Price Controls.

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

[12] Special Condition 4H - Specification of Network Outputs

4. Fuel Poor Network Extension Scheme (FPNES)

This section explains our proposed methodology for closing out the RIIO-GD1 FPNES.

Background

4.1. The Fuel Poor Network Extension Scheme (FPNES) is a scheme delivered by the GDNs in partnership with other organisations, to help tackle fuel poverty by supporting off-grid, fuel poor households to connect to the gas network.

4.2. RIIO-GD1 Final Proposals provided baseline funding for the GDNs to collectively deliver 77,450[13] connections to fuel poor customers, constituting the GDNs primary social output. Following a review of the scheme in 2015, the GDNs' target was increased to 91,203 connections[14].

4.3. In Final Proposals we stated that we would hold GDNs to account for realising the number of fuel poor network extensions over the RIIO-1 period (as opposed to assessing performance on an annual basis), and that we would adjust the GDNs' allowances at the end of RIIO-GD1 for any failure to deliver the prescribed output, with any adjustment based on the avoided costs.[15]

4.4. New Special Condition 4J was added to the GD1 Licence following an October 2015 statutory consultation and implemented the 2015 FPNES Final Decision and set out the methodology for assessing RIIO-GD1 performance and closing out the scheme.

4.5. Special Condition 4J made provision for a reward of 2.5% of the value of the efficient costs of over-delivery as well as a penalty of 2.5% of the value of the avoided costs for unjustified under-performance. It also provided for the carry-forward of under-delivery to GD2 commitments.

4.6. In 2017 Ofgem changed the eligibility criteria for the scheme in order to ensure that it effectively targeted fuel poor households. The main revision was the removal of the eligibility criterion that the recipients must reside within the 25% most deprived areas, as measured by the government's Index of Multiple Deprivation (IMD).

4.7. In the 2017 FPNES Decision document[16] we acknowledged that removal of the IMD criterion might affect how the GDNs engage on FPNES connections. This change to qualifying criterion was in part to align with criteria the government use for related schemes (i.e., ECO), as well as not being a suitable predictor of fuel poverty[17]. However, the GDN's raised concerns that it would impact their ability to identify suitable households, as criteria moved from a geographical and age-based definition to an income-based definition.[18]

[13] Fuel Poor Network Extension Scheme final decision document, p33, para 7.5
[14] Fuel Poor Network Extension Scheme final decision document, p33, para 7.5
[15] RIIO-GD2 Final Proposals, Outputs and Incentives Annex, para 4.8
[16] Decision to change the criteria for the Fuel Poor Network Extension Scheme, p5
[17] Decision to change the criteria for the Fuel Poor Network Extension Scheme, p2
[18] RIIO-GD1 Fuel Poor Network Extension Scheme Joint GDN Closeout report, p24-25

4.8. In the 2017 FPNES Decision document[19] we stated that we would take this into account when applying the incentive mechanism, should GDNs not meet their RIIO-GD1 targets.

Proposed methodology

4.9. Special Condition 4J of the RIIO-1 gas distribution licence[20] stipulates that all GDNs are required to submit a Performance Report to Ofgem at the end of the price control setting out the extent to which each GDN has delivered the Scheme Connection Targets and provide details of its performance, including justification for any over or under-delivery.

4.10. Special condition 7.12 of the RIIO-2 gas distribution licence makes provision for the closeout of the incentive component of FPNES in the 2021/2022 regulatory year, however the condition only reflects the reward and penalty element of the 2015 FPNES Decision and does not provide for any revenue or RIIO-GD2 target adjustment in relation to RIIO-GD1 over or underperformance.

Proposed change to the closeout methodology provided for in Special Condition 4J of the GD1 Licence

4.11. The 2015 policy intention was that, providing the FPNES scheme continues into RIIO-GD2, **under-delivery** in RIIO-GD1 was to be caught up in RIIO-GD2 by making an upward adjustment to the GDNs' targets.

4.12. However, this intention was not implemented in the licence and Ofgem instead proposes that, rather than adjusting RIIO-GD2 targets, we instead make an adjustment to RIIO-GD1 allowances through the PCFM to reflect the volume of work not delivered. This will mean there is no requirement to catch up any shortfall in RIIO-GD2. We propose that the allowance adjustment is based on the average RIIO-GD1 outturn unit cost for each GDN.

4.13. We acknowledge that in effect this proposal is a revocation of this part of the 2015 FPNES Decision and replacement with an updated 2021 view of the FPNES. We propose changing the methodology for the following reasons:

a) There remains uncertainty around the future of FPNES, and RIIO-GD2 Final Determinations includes an uncertainty mechanism for ending the scheme during the price control. Therefore, if RIIO-GD1 under-delivery is carried forward, an additional mechanism would need to be developed to adjust allowances in the event the GDNs did not catch up the shortfall before the scheme ends;

b) There is uncertainty around future demand for fuel poor connections and if the RIIO-GD1 shortfall is carried forward, it may be unrealistic to expect the GDNs to deliver this in addition to their RIIO-GD2 targets;

c) If the RIIO-GD1 shortfall is not delivered before the scheme ends, or the GDNs do not meet their revised RIIO-GD2 targets (original target + shortfall), it becomes increasingly complex to determine what element of delivery was GD1 or GD2 work and make the necessary revenue adjustment at RIIO-GD2 closeout;

[19] Decision to change the criteria for the Fuel Poor Network Extension Scheme | Ofgem
[20] Gas Distribution GD1 licence, Special Condition 4J

d) RIIO-GD2 Final Determinations include a volume driver for Fuel Poor Connections[21] that allows the GDNs to deliver in excess of their targets. Therefore, if demand exists in RIIO-GD2, any RIIO-GD1 shortfall can still be delivered through this mechanism, with the net effect on output delivery and allowances being the same as carrying the under-delivery forward;

e) The proposed methodology means there is a clear break between price controls and enables us to fully draw a line under and close out FPNES in RIIO-GD1; and

f) Ofgem consider this approach to be simpler because it means the GDNs will be funded for the work that is delivered without the need to adjust GD2 targets or modify the FPNES licence conditions[22], and it mitigates against the risk of the scheme ending early or GDNs not meeting their connection targets in RIIO-GD2.

4.14. Where there has been **over-delivery** against fuel poor connection targets in RIIO-GD1, Ofgem proposes that the methodology set out in Special Condition 4J[23] is used – this is that the GDNs will be funded for the efficient costs of delivering the additional work through a legacy adjustment, as well as a reward of 2.5% of the additional efficient costs associated with over-delivery.

4.15. We propose that allowance adjustments in respect of RIIO-GD1 over-delivery are made using the same approach as adjustments for under-delivery, which is through an adjustment to the PCFM. The proposed methodological approach is set out below.

Assessment principles

4.16. Ofgem acknowledges that Covid-19 has impacted on the GDNs ability to deliver the forecast volume of work in RIIO-GD1, as government restrictions impinged upon the ability of the networks and their third-party partners to access sites and facilitate connections. We also note that changes to the eligibility criteria following the 2017 Decision have also affected the GDNs' ability to meet their RIIO-GD1 targets[24].

4.17. We also recognise that some GDNs have made additional investments supporting fuel poor households in ways not funded through the price control settlement, and we have previously stated in correspondence that these actions will be considered when assessing FPNES output performance at closeout.

4.18. Therefore, given that the assessment of previously submitted performance information indicates that any under delivery against the RIIO-GD1 targets will be minor and noting paragraphs 4.16-4.17 above, we propose to consider any under-delivery to be justified and propose not to apply any financial penalty to GDNs who have not met their RIIO-GD1 targets.

4.19. The FPNES scheme has well-defined eligibility criteria and Ofgem propose that all fuel poor connections made that have met the scheme eligibility criteria in place at the time will be considered *justified.* As per the 2015 policy intention, we propose that

[21] RIIO-2 Final Determinations – GD Sector Annex (REVISED), p18-21 and SpC 3.14
[22] SpC 7.12 and SpC 3.14
[23] Part C, Table 1
[24] Decision to change the criteria for the Fuel Poor Network Extension Scheme | Ofgem

justified over-delivery is eligible for an upward allowance adjustment and an additional reward.

4.20. Special Condition 7.12 allows for a reward or penalty of 2.5% of the *efficient* cost of over or underperforming the RIIO-GD2 targets. Ofgem proposes that the *efficient* unit cost is calculated as the RIIO-GD1 outturn average unit cost for each GDN (i.e., total costs / total connections) as this unit cost is calculated using a relatively large dataset of actual outturn data from across RIIO-GD1.

4.21. Ofgem also proposes to use this unit cost to calculate any allowance adjustment resulting from over or under delivery against RIIO-GD1 targets.

Methodology

4.22. Ofgem propose to make allowance adjustments in respect of over or under-delivery against RIIO-GD1 targets through the legacy RIIO-1 PCFM.

4.23. The GDNs are to submit FPNES performance information through the 2021 RRP submission and explain any variance against performance targets through the RRP Commentary document included as part of the submission.

4.24. Ofgem will quantify any over or under delivery against the performance targets using the assessment principles outlined in paragraphs 4.16 to 4.21 above, with the variance against the target multiplied by the unit cost.

4.25. As the GDNs were not set annual connection targets but were instead set targets to deliver by the end of the price control, we propose to smooth any allowance adjustment evenly across RIIO-1 by dividing the figure calculated in paragraph 4.24 above by 8, and then applying that figure to each year's PCFM input to the IAEFP term (Allowed uncertain costs (Fuel poor network extension scheme)).

4.26. To implement the proposed methodology, the IAEFP PCFM Variable Value will be adjusted in the Legacy PCFM so that allowances reflect RIIO-GD1 over and under-delivery. We will then re-run the Legacy PCFM to calculate revised LMOD and LRAV variable values, which will feed into the RIIO-GD2 PCFM per the process described in chapter 2 of this document.

4.27. Ofgem propose that the methodology for closing out the reward and penalty element of the FPNES is as per Special Condition 7.12 of the GD2 Licence.

Licence modification

4.28. Paragraph 8.2 of the RIIO-GD2 Price Control Financial Handbook states that legacy price control adjustments may be necessary *'to correct anomalous positions, acknowledged by Ofgem and the licensee'*[25]. Ofgem and the networks acknowledge that the RIIO-GD1 licence does not fully incorporate the policy objective at which the 2015 FPNES Decision aimed, resulting in an anomaly as described in paragraph 8.2 of the

[25] RIIO-GD2 Price Control Financial Handbook, para 8.2

Handbook. We propose to rely on paragraph 8.2 of the Handbook to implement the above methodology without any modification to either the GD1 Licence or GD2 Licence.

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

5. Capacity utilisation

This section explains our proposed methodology for closing out the capacity utilisation output.

Background

5.1. In RIIO-GD1 the GDNs were required to provide sufficient capacity on the network to ensure that they were able to meet the highest daily demand that is likely to be experienced in one winter in every twenty years (the '1 in 20' standard).

5.2. In the RIIO-1 Strategy Decision and Final Proposals we stated that we would assess the GDNs' performance by way of an *ex post* review of asset utilisation against the target utilisation index, using asset utilisation/ capacity charts. This was the secondary deliverable that we said would inform our assessment of whether the GDNs had met the primary output of delivering the '1 in 20' standard.

5.3. In Final Proposals we set out our intention to incentivise the delivery of capacity output performance in RIIO-GD1 by offsetting any over or under delivery against RIIO-GD2 targets. We also made provision to reward GDNs with 2.5% of the cost of any justified over-delivery against the primary output or penalise them to the extent of 2.5% of the avoided costs associated with under-delivering and not meeting the primary output[26]. This was formalised in Special Condition 4H of the GD1 Licence.

Proposed approach

Change to previous approach

5.4. We propose to depart from the closeout approach set out at RIIO-GD1 Final Proposals, and instead combine the closeout of the Network Outputs relating to the Network Capacity Measure with closeout of Network Outputs relating to the network asset health, criticality, and risk measures.

5.5. The principles for determining adjustments to allowed revenue for both sets of Network Outputs are set out in Part D of SpC 4H. In all material respects the principles are the same in respect of both sets of measures.

5.6. Changes to the NOMs Methodology[27] during RIIO-GD1 mean that asset utilisation is now embedded in the monetised risk values derived through application of the NOMs Methodology, and therefore separate application of these measures is now not necessary and could lead to double counting of adjustments to allowed revenue.

[26] RIIO-GD2 Final Proposals, Outputs & Incentives Annex, Figure A3.2
[27] The Methodology for Network Output Measures common to all DN Operators approved by the Authority under SpC 4G, and published on Ofgem's website on 15 December 2015: https://www.ofgem.gov.uk/publications/gas-network-output-measures-methodology-decision

5.7. For this reason, closeout of the capacity utilisation mechanism has been incorporated into our closeout of the NOMs Incentive Mechanism[28] as a whole. We are currently in the process of assessing the GDNs' initial NOMs closeout submissions, which were submitted by 31st July 2021, and expect to publish our draft decision for consultation by May 2022.

Closeout methodology

5.8. When RIIO-GD1 allowances were set, GDNs were funded to deliver portfolios of work across their networks. Both the Network Outputs relating to the Network Capacity Measure, and the Network Outputs relating to the network asset health, criticality and risk measures reflected expected outcomes form GDNs delivering their entire work portfolios. There was no explicit differentiation between the element of work within the portfolios that related to each of the two Network Output types.

5.9. During RIIO-1, the NOMs Methodology was developed to express Network Outputs in monetised risk terms. The monetised risk values derived in accordance with the NOMs Methodology included consideration of all Network Output Measures (network asset health, criticality, and risk measures, as well as the capacity utilisation measures). The subsequent rebasing process translated the GDNs' original volume-based targets in monetised risk terms. Network Capacity was therefore incorporated into monetised risk targets as revised at the time of rebasing[29].

5.10. By integrating capacity into both the monetised risk targets and monetised risk outputs, the assessment of over- or under-delivery conducted as part of the NOMs Closeout accounts for capacity utilisation. Therefore, we do not consider there to be a requirement for a specific closeout methodology for the capacity utilisation output.

Licence modification

5.11. In order to give effect to the methodology proposed above we will need to 'switch off' the provisions currently in the GD1 Licence relating to a discrete assessment for capacity utilisation and any treatment of over- or under-delivery against RIIO-GD1 capacity utilisation targets.

5.12. As such, we propose a modification of Special Condition 4H of the GD1 Licence to remove the following provisions:

- Part B (4H.6) – Network Outputs relating to the Network Capacity Measure
- Part D (Table 2) – Treatment of under or over-delivery of Network Outputs relating to the Network Capacity Measure

[28] Closeout of the NOMs Incentive Mechanism is in accordance with the Network Output Measures (NOMs) Incentive Methodology, Version 2.2 published on Ofgem's website on 18 June 2021: https://www.ofgem.gov.uk/publications/direction-changes-network-output-measures-noms-incentive-methodology
[29] The rebasing decision and revised NOMs targets for GDNs were published on Ofgem's website on 19 June 2019: https://www.ofgem.gov.uk/publications/decision-approve-and-direct-rebased-network-outputs-gas-distribution-network-operators

5.13. We propose to consult formally on this subsequent to publication of the RIIO-GD1 Closeout Decision.

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

6. Reliability (Interruptions)

This section explains our proposed methodology for closing out the RIIO-GD1 reliability primary output.

Background

6.1. Maintaining low levels of unplanned interruptions is a key output requirement for customers. At RIIO-GD1 Final Proposals we set the GDNs target levels for both the number and duration of interruptions on the networks in order to meet the reliability (loss of supply) Primary Output. The aim of this output was to drive GDNs to reduce the impact of interruptions on consumers.

6.2. In March 2018 Ofgem amended the targets for both the number and duration of planned and unplanned interruptions, having identified defects in some of the GDNs' loss of supply targets in the RIIO-GD1 mid-period review (MPR)[30].

6.3. During RIIO-GD1, Cadent raised concerns about including multiple occupancy buildings (MOBs) in unplanned interruptions targets and highlighted additional challenges in London, such as delays caused by the requirement to gain access permissions from multiple property occupants and other third parties.

6.4. Ofgem acknowledged that a higher volume of MOBs could drive more, and longer, unplanned interruptions, and updated Cadent's East of England (number and duration) and London (number) targets based on Cadent's actual 2017/18 performance data.

6.5. In RIIO-GD1 Final Proposals we stated that we would assess the GDNs' performance against the interruptions targets as part of the end of period review[31].

Proposed Methodology

6.6. As provided for in RIIO-GD1 Final Proposals, at closeout we will assess the GDNs' performance in meeting the loss of supply Primary Output.

6.7. GDNs are to provide performance data as part of their 2021 annual RRP submissions and the RIIO-GD1 Performance Reports (submitted July 2021). The reports contain data detailing both the number and duration of planned and unplanned interruptions for each year of the price control.

6.8. Where any GDN has failed to meet its RIIO-GD1 targets it is to explain the reason for any underperformance in the RRP narrative document.

[30] Decision on amendments to reliability targets for RIIO-GD1
[31] RIIO-GD1 Final Proposals, Outputs and Incentives Annex, para 7.9

6.9. The loss of supply Primary Output in RIIO-GD1 was reputational only and there is no provision in the licence for any reward or penalty, or upward/downward adjustment to the GDNs' revenues, in relation to its performance against the output.

6.10. As such, we propose that the GDNs will submit performance data and commentary in the 2021 RRP submissions and Ofgem will publish the GDNs performance in relation to the loss of supply Primary Output in the 2021 Annual Report.

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

7. Shrinkage and Environmental Emissions Incentives

This section explains our proposed methodology for closing out the shrinkage and environmental emissions incentives.

Background

7.1. Shrinkage refers to gas which is lost from the transportation network and is the dominant element of the GDNs' Business Carbon Footprint (BCF). Shrinkage is comprised of leakage from pipelines (95% of the gas loss), theft from the GDN networks (3% of the gas loss), and companies' own use (2% of gas loss). GDNs use a common leakage model to assess the leakage from each of their networks.

7.2. RIIO-GD1 included both a shrinkage allowance and an Environmental Emissions Incentive (EEI). These provided enhanced incentives to reduce gas transport losses and network emissions, based on over or underperformance against performance targets.

7.3. Both elements incorporated a rolling incentive mechanism that was designed to reward/penalise companies on the assumption that improvements in performance would be enduring. It included a two-year lag between the performance level being achieved and the value being recovered through network charges.

7.4. In RIIO-GD1 Final Proposals[32] we acknowledged that revenues under the rolling incentive would be strongly influenced by the GDNs' performance in the last year of RIIO-GD1 and that this performance could be influenced by factors outside of the GDNs' control.

7.5. In our RIIO-2 Sector Specific Methodology Decision, we stated our intention to use the values from the final year of RIIO-GD1 as the benchmark for the RIIO-GD2 incentive, on the basis that the RIIO-GD1 methodology assumed that improvements in performance would be enduring[33].

7.6. During the Covid-19 pandemic, the network companies informed us they believed shrinkage volumes would be adversely affected by a forecast reduction in repex work in the final year of RIIO-GD1, as a result of Covid restrictions, which could potentially distort the incentive in Year 8 and require a modification to the shrinkage methodology, to ensure networks or consumers were not exposed to any windfall losses or gains.

7.7. At RIIO-GD2 Draft Determinations, Ofgem acknowledged the potential Covid-related impact on shrinkage volumes and stated that *'if we decide that we need to change the way that final year performance under the RIIO-GD1 incentive is assessed, we may also need to change how the RIIO-GD2 targets are set. However, we would still expect to maintain the link between the two incentives'*.[34]

[32] RIIO-GD1: Final Proposals - Supporting Document – Outputs, incentives and innovation (ofgem.gov.uk), para 2.26
[33] RIIO-GD2: Sector Specific Methodology Decision – Gas Distribution para 3.29
[34] RIIO-2 Draft Determinations - Gas Distribution Annex (ofgem.gov.uk), para 2.114

7.8. At RIIO-GD2 Final Determinations, Ofgem decided that the appropriate way to maintain this link, while mitigating against Covid-19 adversely impacting on performance in the final year of the RIIO-GD1 incentive, was to change how we set the RIIO-GD2 performance target in the first year of the control. Instead of the baseline target being based on the RIIO-GD1 outturn year 8 position, it would be based on the 3-year average performance on network pressure and levels of gas conditioning from 2017-2020. As a consequence, to preserve the link between the RIIO-GD1 incentive and RIIO-GD2 incentives, we stated that *'we will use these averages in the closeout of the RIIO-GD1 incentive'.*[35]

RIIO-GD1 Year 8 performance

7.9. Analysis of RIIO-GD1 Year 8 performance information indicates that there was no observable impact as a result of the Covid-19 restrictions, with performance largely in line with the previous years' performance and general RIIO-GD1 trends. Some GDNs saw a slight increase in performance and others a slight decrease, however the variance was consistent with the type of year-on-year variance observed in previous years.

7.10. As such, the changes to the shrinkage and EEI methodologies decided at RIIO-GD2 Final Determinations in order to mitigate against the Covid-19 impact have turned out not to be required, as applying the RIIO-GD1 methodology to the Year 8 performance does not result in any windfall gain or loss to the GDNs as a result of Covid-19.

Proposed approach

Purpose of proposed closeout methodology

7.11. The purpose of the RIIO-GD1 Shrinkage and EEI closeout is to ensure that the progress achieved in RIIO-GD1 is not subsequently lost, to support continuity between GD1 and GD2, and to support the further reduction of network shrinkage throughout GD2.

7.12. We have identified two options that we consider meet the policy objective described in paragraph 7.8 above to maintain the link between the RIIO-GD1 and RIIO-GD2 incentives:

Option A: The RIIO-GD1 2020-21 shrinkage outturn position is adjusted so that it is based on the average pressure and gas conditioning values recorded from 2017-18 to 2019-20, rather than the outturn position from Year 8 of RIIO-GD1. The RIIO-GD2 methodology remains as per the current licence mechanism.

Option B: The RIIO-GD2 year 1 baseline value is adjusted so that it is based on the RIIO-GD1 Year 8 outturn position, rather than the average pressure and gas conditioning values recorded from 2017-18 to 2019-2020, as stated at Final Determinations, and as implemented in Special Condition 7.10. The RIIO-GD1 methodology remains as per the current licence mechanism.

[35] RIIO-GD1: Final Proposals - Supporting Document – Outputs, incentives and innovation (ofgem.gov.uk), para 2.179

Ofgem proposed methodology

Shrinkage

7.1. Noting that there was no observable Covid-19 impact on RIIO-GD1 Year 8 performance, we consider Option B to be the appropriate methodology to close out RIIO-GD1. This is the approach as was intended prior to the Covid-19 pandemic and also means that the incentive will be applied consistently across the whole of RIIO-GD1.

7.2. Under the Option B approach, as the methodology to close out the RIIO-GD1 shrinkage incentive has already been implemented in the licence[36], there is no requirement to consult further on a closeout methodology.

7.3. Ofgem therefore propose that to close out the Shrinkage incentive a mechanistic allowance adjustment is made using 2021 RRP data, applying the incentive formula detailed in Special Condition 7.10. This will then feed into the legacy adjustment term (LAR_t) detailed in Chapter 2 of this consultation.

7.4. However, to give effect to our policy intention to preserve the link between the RIIO-GD1 and RIIO-GD2 incentive, we will need to undertake a statutory consultation to modify Special Condition 7.10 in the GD2 Licence. We intend to engage with the GDNs on this separately in 2022.

Environmental Emissions Incentive

7.5. We propose to take the same approach to the EEI as we have proposed for Shrinkage and treat RIIO-GD1 performance as per the methodology set out in Special Condition 1F.

7.6. As per the Shrinkage incentive, we propose to consult later on modification of Special Condition 7.11 of the RIIO-GD2 licence in order to give effect to the Final Determinations policy position to maintain the link between the RIIO-GD1 and RIIO-GD2 incentives.

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

[36] These are: Special Condition 7.10; Special Condition 7.11;

8. Tax Clawback - WWU

This section explains our proposed methodology for closing out the RIIO-GD1 Tax Clawback mechanism for WWU.

Background

Policy and mechanism

8.1. Ofgem calculates licensees' tax allowances on a notional basis, which includes using an assumed gearing level, i.e., notional gearing.[37] 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.

8.2. The decision to implement the mechanism and the methodology for calculating the level of clawback were set out in an open letter published on 31 July 2009[38] (the '2009 Open Letter'). The methodology provided, among other things, that when calculating a licensee's actual interest for this purpose:

> *"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)"*

[37] The Price Control Financial Model (PCFM) calculates modelled or "notional" values for gearing and interest costs. These modelled values are compared against actual net debt and interest costs by the Tax Clawback mechanism.
[38] See here.

Calculation and determination of the clawback value in the pre-RIIO-GD1 and RIIO-GD1 periods

8.3. The clawback adjustment in the pre-RIIO-GD1[39] 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.

8.4. In RIIO-GD1, the clawback adjustment was done annually through the TGIEt variable value, which was updated in the RIIO-GD1 PCFM[40] at each Annual Iteration Process (AIP) and fed into the re-calculation of revenue allowances.

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.[41] We then used two tests to determine the value for TGIE: a gearing level test and a positive benefit test.

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.

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.

Tax Clawback and WWU

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*".

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 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

[39] The Gas Distribution Price Control Review (GDPCR) preceded the RIIO-GD1 price control and ran from 1 April 2007 to 31 March 2013.
[40] Now referred to as the "Legacy PCFM" as noted in chapter 2 of this document.
[41] The licensee is required to submit its price control cost reporting pack by 31 July of each year, in accordance with standard special condition A40 (Regulatory Instructions and Guidance) of the gas transporter licence.

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.

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.

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 clawback mechanism.

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**) …"*[42] (emphasis added). WWU responded to that consultation, indicating that it appeared to conflict with the advice in the 2015 Letter.[43]

8.13. In April 2019, we published our decision on the modifications, which included the clarificatory text in paragraph 8.12 above.[44] 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.

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 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.

8.16. In late 2020, WWU approached Ofgem requesting that the treatment of derivative costs set out in the 2015 Letter be applied:

(i) retrospectively to the pre-RIIO-GD1 period;

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[42] See the consultation here.
[43] See "Appendix 1 – Stakeholder representation" for WWU's response, here.
[44] Direction to introduce Regulatory Financial Performance Reporting (RFPR) | Ofgem

(ii) for all of RIIO-GD1; and,

(iii) for the RIIO-GD2 period.

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.

8.18. Because of these ongoing discussions and the imminent need to publish the draft RIIO-GD2 PCFM for consultation in December 2020 so that the final version could come into effect for the beginning of RIIO-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-RIIO-GD1 net interest. For the same reasons, we also did not at that stage correct the RIIO-GD1 TGIE values, which were based on the treatment set out in the 2015 Letter. These amounts fed into the RIIO-GD2 PCFM that was published on 3 February 2021 through the LRAV and LAR terms.

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:[45]

Consultation Position

Output parameter	Consultation Position
Close-out adjustments	To use estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls.

…

11.24 Where we have used estimates, we will then true these up and apply any further incremental adjustments to RIIO-2 RAV and revenue allowances, once the required outturn information becomes available.

and Final Determinations:[46]

Final Determination

Parameter	Final Determination	Draft Determination
Close-out adjustments	To use estimated values for close-out adjustments until we are able to close out the RIIO-1 price controls.	Same as FD

[45] RIIO-2 Draft Determinations, page 155
[46] RIIO-2 Final Determinations page 119 and paragraphs 11.24-11.27

…

Legacy RAV balance

11.24 As above, we will take the closing RAV balance, capital allowance pool balances and regulatory tax loss balance from the RIIO-1 PCFM that was used to calculate the provisional LMOD2022/23 value.

*11.25 These closing balances will reflect actual data for 2019/20 and forecast data for 2020/21 and will be used as the opening balances for RIIO-2. As we will not have actual data for 2020/21, **these balances represent our best estimate of opening RAV for RIIO-2 and remain under review until we can close out the RIIO-1 price controls**.*

Legacy adjustments to revenue (LARt)

11.26 We will use a modified RIIO-1 Revenue RRP to calculate the revenue adjustments which currently fall outside of the RIIO-1 PCFM and operate on a two-year lagged basis. These are revenues and costs such as pass-through items, the revenue correction factor and non-totex incentives and will be calculated for the 2021/22 regulatory year, for which we have actual data.

*11.27 The revenue adjustments for the 2022/23 year will contain forecast data and **will remain under review until we can close out the RIIO-1 price controls**."* (emphasis added)

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.

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.[47]

Proposed Methodology

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.

Approach to implementation - Pre-RIIO-GD1 adjustments

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.[48] 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

[47] The CMA recently dismissed WWU's appeal in respect of tax clawback during RIIO-GD2, and considered that the issue of recovering tax clawback from before RIIO-2 was out of scope of the RIIO-2 appeals process – see chapter 16 of the CMA's Final Determinations.
[48] The relevant variables to be adjusted are the RIIO-1 legacy tax term TARt, which feeds into the RIIO-1 LARt term, and the opening regulatory tax loss input value.

is appropriate 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.

Approach to implementation – RIIO-GD1 adjustment

8.24. We propose two options for the correction of the RIIO-GD1 TGIE variable values for WWU, as follows.

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

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.

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.

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 revenues to result in a £38m reduction (in nominal terms) to WWU's RIIO-GD2 allowed revenues.

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 (LRAV) values generated once the Legacy PCFM has been run, as described in chapter two of this document.

Timing of adjustments

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.

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.

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.[49]

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.[50] 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.

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.

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

[49] See paragraph 8.25 of the RIIO-GD2 Price Control Financial Handbook for further detail.
[50] See November 2021 AIP publication here: [RIIO-2 Annual Iteration Process 2021 for Transmission, Gas Distribution and the Electricity System Operator | Ofgem]

9. Disposals

This section explains our proposed methodology for closing out disposals.

Background

9.1. When a licensee sells an asset that was originally funded by consumers, we think the proceeds of that asset sale should be passed to consumers.

9.2. In RIIO-GD1, our policy was to deduct the sale proceeds of disposals directly from the licensee's RAV balance five years after the disposal took place. This five-year lag between the asset disposal and the deduction of the sales proceeds from the closing RAV balance allowed GD licensees to continue to earn depreciation and a return on the original RAV balance for an extra five years after the disposal date. This provided a cashflow incentive for GD network companies to sell assets that were no longer used or needed.

Proposed approach

Closeout methodology

9.3. We propose to apply the disposals policy that was set out in the RIIO-GD1 Price Control Financial Handbook,[51] i.e., to deduct asset disposal proceeds from the closing RAV balance for any disposals that took place within the RIIO-GD1 price control period, with a five-year lag.

9.4. The GD1 legacy PCFM contains a set of "yellow box" or fixed values that represent the assumed level of disposals for each licensee that was forecast at the start of the RIIO-GD1 price control.

9.5. During the RIIO-GD1 price control, licensees reported their actual disposals to us through their RIGs[52] reporting packs but these values were not reflected in the PCFM.

9.6. We propose to true-up the assumed disposal values within the PCFM to ensure that the appropriate values are deducted from the RAV with a five-year lag.

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

[51] See RIIO-GD1 Price Control Financial Handbook at paragraph 6.19, here.

[52] Under RIIO-1, licensees were required to submit price control cost reporting packs by 31 July of each year, in accordance with standard special condition A40 (Regulatory Instructions and Guidance) of the gas transporter licence.

Appendix 1 – Consultation questions

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

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

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

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

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

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

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.

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

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

Appendix 2 – Privacy notice on consultations

Personal data
The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer
The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data
Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data
As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data
(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be a specific as possible.)

4. For how long we will keep your personal data, or criteria used to determine the retention period.
Your personal data will be held for ***(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')***

5. Your rights
The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use "the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this".

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

9. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".