

Call for input

Tax clawback review: RIIO-2 price control financial model

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We are seeking input from stakeholders on proposals to review the regulatory guidance issued in respect of the Tax Clawback provisions of the RIIO-2 PCFM.

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Introduction

Ofgem¹, as the energy regulator, plays a key role in developing the regulatory framework to ensure that the licensees which transport electricity² and gas³ act in the interests of gas and electricity consumers.

We set price controls for these licensees, which restrict the level of revenue they are allowed to earn from their network charges as they are privately owned natural monopolies; they are usually the only service provider in a geographic location.

Through the price controls, we set a level of Allowed Revenue to cover the networks' reasonable costs and generate a fair return for their investors. One such cost is Corporation Tax. The Allowed Revenue calculation within the Price Control Financial Model (PCFM) contains a tax allowance, which is based on a notional company⁴. The tax allowance is provided to meet the tax liabilities associated with licensees regulated activities.

Ofgem expect companies to manage their own financial risks and for shareholders, not consumers, to gain or lose from their choices. We therefore recognise the importance of licensees being able to organise their group structures and tax affairs, and to finance themselves, efficiently.

The tax allowance features a tax clawback mechanism that recovers the revenue benefit the licensee obtains from the tax deductibility of interest on excess debt. As interest is tax deductible, there is a financial benefit to having greater than notional levels of debt and so the clawback ensures that where a licensee's actual gearing and interest levels are higher than the notional level, this revenue benefit is adjusted for in the tax allowance. The aim of this policy is to ensure that companies are not incentivised to gear in excess of the notional level, and that consumers do not indirectly fund an allowance for tax which the licensees do not pay.

¹ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document to refer to GEMA, the Gas and Electricity Markets Authority.

² There are fourteen electricity distribution network operators (DNOs) operating, managed by six companies and three onshore electricity transmission network operators (TOs) operating in GB.

³ National Grid Gas has recently sold its majority stake in its gas transmission and metering activity to a consortium. There are also eight Gas Distribution networks operating in GB, managed by four companies.

⁴ The notional company concept means that the model assumes the licensee entity is standalone (not part of a group), has no non-regulated assets, liabilities, incomes or costs, and has a level of gearing established by Ofgem. This allows interest and tax to be calculated in line with regulatory principles, but may not fully align with the charges shown in the licensee's statutory accounts. It also allows licensees to manage their affairs as they see fit, without impacting on their Allowed Revenue.

Context

Background

The tax clawback was first introduced in 2008 as part of TPCR4, DPCR4 and GDPCR1⁵, and further detail on the clawback was issued in an [open letter](#) in 2009.

The clawback was retained in RIIO-1⁶ through the PCFM variable value TGIE⁷, which was calculated annually in a supplementary spreadsheet to the PCFM using, among other things, input values for net debt and tax-deductible net interest⁸.

For RIIO-2, the tax clawback is calculated within the PCFM itself, using the input values for Adjusted Net Debt⁹ and Tax Deductible Net Interest¹⁰, provided by licensees via the Regulatory Financial Performance Reporting template (RFPR).

The RIIO-2 Price Control Financial Handbook (PCFH)¹¹ includes a short section describing the tax clawback. Further references to the Adjusted Net Debt and Tax Deductible Net Interest terms are found in the PCFM guidance¹² which currently instruct the reader to use the “Regulatory Net Debt including forecast new debt/refinancing” and “Regulatory Net Interest including forecast new financing/refinancing costs” from the RFPR to report these values and refer the reader to the RFPR regulatory instructions and guidance (RIGs)¹³.

The tax clawback operates by applying two tests, the gearing level test, and the positive benefit test. The gearing level test divides the licensees’ Adjusted Net Debt by its closing RAV, and uses this ratio as a proxy for actual gearing. Where this actual gearing level exceeds the notional gearing limit set in the PCFM, the test is failed. The positive benefit test compares the licensee’s Tax Deductible Net Interest, which is taken from the values input into the RFPR (which are ultimately derived from its accounts and tax computation), against the notional allowable interest calculated within the PCFM. Where the Tax Deductible Net Interest exceeds the notional interest, there is a positive benefit, and the test is failed.

⁵ [Electricity Distribution Price Control Review 4 – Final Proposals \(265/04\)](#)
[Gas Distribution Price Control Review Final Proposals Consultation Document \(285/07\)](#)
[Transmission Price Control Review: Final Proposals \(206/06\)](#)

⁶ Please see for example paras 4.46-4.70 of the [Appendix 3 GD1 Handbook - V1.3 \(ofgem.gov.uk\)](#)

⁷ Defined as Tax Gearing Interest Expense in the PCFH

⁸ Initially via the Finance tables using the 2009 letter definition, and latterly via the RFPR using the [RFPR RIGs definition](#).

⁹ Abbreviated to ANDt in the PCFM

¹⁰ Abbreviated to TDNI in the PCFM

¹¹ For example within para 6.1 of the [RIIO-ET2 Price Control Financial Handbook \(ofgem.gov.uk\)](#)

¹² First published in 2021 ([RIIO-2 PCFM Guidance | Ofgem](#)) and subsequently updated (latest [ET2 PCFM Guidance \(clean\) \(ofgem.gov.uk\)](#))

¹³ [RIIO-2 RFPR - Regulatory Instructions and Guidance version 2.0 \(clean\) \(ofgem.gov.uk\)](#)

The tax clawback is triggered if both tests are failed. If the tax clawback is triggered, the difference between the Tax Deductible Net Interest and notional interest is 'clawed back' by reducing the tax allowance¹⁴.

To date, the tax clawback has been an effective part of the regulatory framework and the majority of licensees are now within the notional gearing limits set as part of RIIIO-2, however we consider it necessary to review our guidance and the definitions it contains, to ensure it is up-to-date in respect of accounting standard and UK tax legislation changes.

Changes in accounting standards and practice

Since we published the open letter of 2009, there have been changes in accounting standards and practice, with the most significant being the requirement for companies to adopt International Financial Reporting Standards (IFRS) or "New UK GAAP" from 1 January 2015.

New UK GAAP collectively refers to the set of updated Financial Reporting Standards (FRS), which more closely align UK and international accounting standards. The following standards apply to the network licensees:

- FRS 101: IFRS with reduced disclosure, and
- FRS 102: the standard applicable to most entities.

An example of a further change would be IFRS 16 (Leases) which was introduced with effect from 1 January 2019 and recharacterised operating lease costs as depreciation and interest. This standard will be broadly mirrored for FRS 102 in 2026 following the periodic review of FRS 102 in 2024. We may therefore, for example, look at whether the definition of Tax Deductible Net Interest should be amended to exclude certain interest arising under IFRS 16.

Changes in UK tax legislation

UK tax legislation is updated regularly, with at least one Finance Act being published annually. Finance Acts will typically update the headline rate of Corporation Tax and capital allowance rates for a particular year but can also be used to make substantive changes to the application of Corporation Tax.

¹⁴ The tax clawback creates an in-year loss, which is offset against the taxable profits if available, if there are not sufficient profits, a carry-forward loss is created and offset in a future period when profits are available.

Since the issuance of the open letter in 2009 there have been updated Acts, including the Corporation Tax Act 2009 (CTA 2009) and the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). These acts were broadly re-writes of previous acts, but also contain some further provisions and have been subsequently amended by later Finance Acts.

There have been significant changes introduced through subsequent Finance Acts, including the Corporate Interest Restriction¹⁵ rules, which require to be considered. The Corporate Interest Restriction is a complex set of rules which was introduced with effect from April 2017 in the United Kingdom in response to an OECD programme¹⁶ to reduce global tax avoidance. The Corporate Interest Restriction seeks to combat attempts by multinational enterprises and other companies to obtain excessive tax relief for net interest and similar financing costs. The aim of these rules is to ensure tax relief on financing costs is commensurate with the extent to which a business's activities are subject to Corporation Tax.

We intend to review the above changes and any subsequently issued standards and interpretations as part of our review. If required, following this review we will update the definitions and ensure that there is clear guidance for licensees to correctly report their Tax Deductible Net Interest and Adjusted Net Debt values.

Scope of the review

The objective of this review of the Tax Clawback is to update the guidance for any changes to the definitions of Adjusted Net Debt and Tax Deductible Net Interest, which have arisen since the 2009 open letter was published.

The scope of the review will be to review the previously issued definitions from the 2009 open letter, along with the 2019 and subsequent RFPR RIGs guidance and the wording in the RIIO-2 PCFH and PCFM guidance in the context of the changes which have arisen in accounting standards and tax legislation since these were introduced.

The review may include a review of licensees' tax returns which have been made available as part of the 2024 RFPR RIGs submissions to ensure that the guidance accurately reflects the relevant tax-deductible items which arise in licensees tax returns.

¹⁵ Introduced into TIOPA 2010 via Finance Act (no.2) 2017.

¹⁶ OECD (2016), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/9789264268333-en>.

The further intention of the review is to consolidate the updated guidance into a single source, to provide clarity and ease of use for licensees.

It is intended to issue revised guidance as part of the RIIIO-3 draft determinations process.

Areas not within the scope of the review

We consider that the tax clawback mechanism is an effective tool in preventing over-gearing and ensuring that, where companies are geared in excess of the notional level, they do not benefit from increased tax deductions. We note that the principles applied in the gearing level and positive benefit tests are effective in supporting the policy intention of the tax clawback.

As such, we do not intend to reconsider our policy of having a tax clawback mechanism.

Questions

- 1. Are there any specific changes in accounting standards or UK tax legislation that we should ensure are captured in this review?**
- 2. Noting that we do not intend to change the policy objective of the tax clawback; are there any additional areas within the current guidance which may prevent the tax clawback from meeting its policy objective, and should therefore be reviewed?**

Next steps

We are keen to engage with a wide range of industry and interested parties during this process and draw on your experience and expertise.

To start this process and help us shape the considerations on this issue, we have set out specific questions regarding the tax clawback review in this document. We would welcome written comments by **24 January 2025**. Please email your response to RegFinance@ofgem.gov.uk. We will publish responses on our website after the response deadline. Please mark your response as confidential if you do not want it to be published.

Subject to consideration of the responses we receive, we intend to publish a follow-up letter on this issue to provide stakeholders with further detail around proposed modifications and timelines for publication.
