
Call for Input Tax Clawback response summary

Background

Ofgem published a call for input for the tax clawback review on 24 November 2024, seeking responses by 24 January 2025. A total of eight responses were received from eight respondents, some respondents issued a joint response for multiple licensees, including in separate regimes.

The breakdown of the responses is as follows:

- Three responses were from Gas Distribution licensees.
- Three responses were from businesses with both Electricity Transmission and Electricity Distribution businesses.
- One response was from the Gas Transmission licensee.
- One response was received from an Electricity Distribution licensee.

The Tax Clawback review is a relatively complex technical area of the Price Control Financial Model (PCFM) and as such responses were expected to largely be from licensees. All licensees in the Electricity Transmission and Gas Transmission sectors responded, and one Gas Distribution licensee did not respond to the consultation. Confidential responses from one licensee in the Gas Distribution sector were received, therefore all responses for the sector have been summarised on a non-attributable basis. We consider the number and range of responses to be sufficiently broad to allow Ofgem to continue with the review without soliciting further responses.

Ofgem will therefore undertake the technical review outlined within the call for input.

Responses Supportive

Responses to the Call for Input were supportive of the Tax Clawback Review being undertaken, with respondents noting that there had been significant accounting and tax changes since the clawback methodology was first introduced.

National Gas Transmission stated that they consider that the value of the tax clawback has reduced over time since its introduction, as there have been changes to tax legislation to limit interest deductibility in certain circumstances. They also queried whether an interest/EBITDA style metric would be more appropriate than the Net

Debt/Regulatory Asset Value (RAV) in calculating the clawback, as this may align more directly with the Corporate Interest Restriction (CIR) rules.

SSE stated that although they considered the review worthwhile, they considered that a wholesale tax review would be of higher importance than updating the tax clawback. They advocated that tax should move to a passthrough basis after a period of transition. They also queried why a review of licensees' tax returns is considered necessary. Ofgem consider this necessary as this will help Ofgem to understand which licensees have made specific choices within their tax filings, such as electing into the disregard regulations.

SSE also suggested that the definition of Tax Trigger Event (TTE) should be broadened to include items such as Employer's National Insurance contributions. The current review scope does not include the definition of TTE. Further, TTEs relate to Corporation Tax only, as this is the tax the notional tax allowance is intended to stand in for. Using TTEs to account for changes in above the line costs could result in these being erroneously grossed up for the tax-on-tax impact of the tax allowance. Changes in other taxes can be captured using other mechanisms such as RPE adjustments. There is also additional symmetric protection for licensees through the Totex Incentive Mechanism and sharing factor.

SPEN commented that any updates to the definitions should ensure that there are not unintended consequences as a result of the interaction between the values reported in the Regulatory Financial Performance Reporting (RFPR) packs, and the relatively simplified approach to the calculation of interest and debt within the PCFM. Ofgem agrees with this principle, and Licensees will have the ability to comment on the revised guidance as part of the RIIO-3 Draft Determinations.

ENWL noted the decision included within the RIIO-3 Sector Specific Methodology Decision (SSMD) to include cumulative accretion on inflation-linked derivatives within Adjusted Net Debt (ANDt). ENWL believe there should be a transitional arrangement to allow companies the time to adjust without incurring undue tax clawback penalties. They consider Ofgem should initially recognise the actual company position and avoid an immediate switch that could lead to higher gearing and an immediate tax clawback position, which they consider would be completely out of the control of the company. They consider that they require time to adapt to this change. Ofgem intend to implement the revised guidance for RIIO-3, therefore licensees will have time to adapt. For the Electricity Distribution sector, the revised guidance will come into effect alongside RIIO-ED3.

ENWL also commented on the Gas Distribution and Transmission RIIO-3 SSMDs which set out Ofgem's decision to implement Option 1: Nominal allowance for fixed rate debt.

To bring this change into effect, a portion of RAV, aligned to the notional fixed rate debt assumption, would be delinked from outturn inflation. This will result in a lower RAV.

ENWL wish to understand how Ofgem will reflect this new approach to debt and interest costs in the tax clawback mechanism. Ofgem do not consider that the implementation of the nominal allowance for fixed rate debt requires to be separately reflected in the tax clawback mechanism, as this will be effectively included within the agreed gearing limit.

One licensee stated that, whilst acknowledging the calculation of the tax clawback was not within the scope of the review, it considers that the clawback calculation should be revised so that if the gearing test is failed, the clawback only recovers a percentage of Tax Deductible Net Interest (TDNI) in line with the level of actual gearing.

As stated in our [SSMD](#) we do not consider the modification to pro-rata actual interest by the difference in gearing to be robust. Such a modification would not account for higher credit spread differentials caused by gearing exceeding the notional assumption.

Licensee draft proposal

One licensee proposed the following non-exhaustive lists of items it considers should be included/excluded from the definitions of Adjusted Net Debt and Tax Deductible Net Interest:

Adjusted Net Debt

- 1) Statutory audited accounts of the licensee should be used as the source basis.
- 2) All debt should be measured at par. All mark to market movements should be excluded except where accounting hedging applies.
- 3) Any operating leases capitalised to finance leases under accounting standards should be excluded.
- 4) Redeemable preference shares should be excluded because dividend thereon are not deductible for tax purposes.
- 5) Any debt instrument for which interest thereon is not tax deductible should be excluded.
- 6) Intercompany debt from wholly owned finance subsidiaries should be included.
- 7) All cash and short term financial investments should be included.
- 8) An increase in net debt caused by expenditure which is the subject to reopener claims outstanding should be excluded.

Tax Deductible Net Interest

- 1) Any interest disallowable for tax purposes should be excluded, including interest disallowable from application of the CIR legislation.
- 2) Mark-To-Market gains and losses on financial instruments other than those arising on fair value hedge accounting should be excluded.
- 3) All carry costs arising from maintenance of undrawn and standby bank facilities should be excluded, as these are not costs arising from debt.
- 4) The cost of retiring debt early should be excluded.
- 5) All financial income on cash, deposits and short term financial investments should be included.
- 6) All costs and income associated with pension assets and liabilities.
- 7) Issue costs from raising new debt should be excluded.
- 8) Preference share dividends should be excluded.
- 9) Finance lease interest should be excluded.
- 10) Interest incurred in respect of any debt used to fund reopener expenditures should be excluded.

Ofgem will consider the above list when preparing the revised guidance during the RIIO-3 Draft Determinations.

Call for input questions

The call for input asked two specific questions being:

- 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?

Responses to question 1 -specific changes in accounting standards or UK tax legislation

Three licensees highlighted the need for Ofgem to consider the changes arising from the accounting standard [IFRS 16 \(Leases\)](#). Ofgem had highlighted this change as significant within the call for input document.

One licensee proposed a working group is set up to consider specific changes to accounting standards and tax legislation.

National Grid highlighted the CIR rules, which can act to limit the amount of interest which is deductible in the company tax return. They highlighted the Public Benefit Infrastructure election, which can prevent the CIR rules from applying and advocates that Ofgem should not take the CIR rules into consideration when defining TDNIIt.

ENWL noted that the CIR rules apply on a group basis, which can complicate assessment of the level of restriction arising due solely to a licensee's debt costs. It suggested Ofgem consider how to reflect CIR rules in the clawback mechanism to ensure a fair consideration of the licensed entity's interest restrictions without giving relief to licensees due to restrictions arising due to wider group financing arrangements.

NGT state that under the CIR rules, licensees can suffer disallowances of interest in their tax returns leading to increased tax liabilities. They state that the tax clawback interest test currently provides no mechanism to include these actual disallowances of interest in the calculation. In NGT's view this could lead to a situation where a licensee is not realising a tax benefit for additional interest costs, however a tax clawback arises which reduces the tax allowance. This could unfairly leave licensees with tax liabilities that are not fully funded by the tax allowance.

Ofgem comment

Ofgem had highlighted the changes to IFRS 16 in the call for input document, and will consider this when drafting the updated guidance. Ofgem note that for tax purposes, companies are required to assess whether leased assets would have been classed as operating leases under old UKGAAP. If this is the case, depreciation of the leased asset and the implied interest charge are deductible on an accruals basis. Ofgem currently expect to draft this on the basis that the interest element of leases, which would have been classed as operating leases under old UKGAAP, should be excluded from TDNIIt.

Ofgem considers that the licensees will have sufficient opportunity through the RIIIO-3 draft determinations to comment on the proposed guidance, and therefore do not consider that a separate working group is necessary.

Ofgem note the comments from licensees regarding CIR, and will consider these when drafting the updated guidance. Ofgem note that the CIR rules operate on a group basis, and that restrictions can be allocated to group members through choice. This presents the possibility of manipulation, potentially resulting in the tax clawback being circumvented. Ofgem also note that interest restricted from deductions under the CIR rules is carried forward and is potentially available for offset in a later period, if sufficient headroom exists. This makes the position more complex for the purposes of tax clawback. Ofgem currently expect to draft the guidance on the basis that CIR restrictions should not be brought in to reduce TDNI, as such restrictions may only result in a timing difference, rather than a permanent disallowance.

Responses to question 2 -additional areas within the current guidance which may prevent the tax clawback from meeting its policy objective

One licensee stated that they consider that any additional net debt or tax deductible interest arising from any non-regulated business should be excluded. The licensee noted hydrogen trials as an example of this. They state that this would be consistent with the position in 2009, when licensees prepared regulatory accounts which covered licensed activities only.

One licensee noted that the proposed Debt Relief Support Scheme could potentially impact on tax allowances, and that this should be considered to ensure that it does not adversely impact cash flows to network companies over time.

One licensee commented that within the Gas Distribution sector Accelerated Depreciation may result in volatility, and questioned whether the tax clawback should be calculated over the price control period as a whole. The current scope of the review does not consider the basis of calculation of the clawback, which is currently applied separately for each regulatory year. One licensee also stated that credit rating agencies may change their methodology or metrics in response to policy changes, and that the tax clawback should be flexible to reflect such future changes.

Ofgem Comment

Ofgem notes that at the time the original guidance was published in 2009, regulatory accounts excluding non-regulated activities were prepared by licensees and reviewed by their auditors. This is no longer the case, and the source of the debt figures would be the audited statutory accounts. The debt and interest related to non-regulated activities is

unlikely to be separately disclosed in the statutory accounts. Allowing an apportionment between regulated and non-regulated activities could potentially be used to circumvent the tax clawback. Therefore, at present, Ofgem would not propose adjusting AND and TDNI for non-regulated debt and interest.

Ofgem will consider the potential impact of the tax clawback when implementing any Debt Relief Support Scheme, and would consider any further adjustment to definitions required at that time.

Ofgem note licensees's comments regarding potential volatility regarding accelerated depreciation and credit agency metrics, however Ofgem would expect that such issues are best addressed by ensuring that the target gearing ratios remain appropriate for the sector.

Mechanical changes

Several licensees proposed mechanical changes to the Tax Clawback calculation, whilst acknowledging that only the definition of the ANDt and TDNI_t terms are within the scope of the review.

One licensee, NGT, has suggested that changes to the reporting and updating of the variable values ANDt and TDNI_t. They note that the RFPR uses average net debt and average RAV values, but the PCFM uses closing Net Debt and closing RAV values. They also propose including a 'deadband' to cover instances of minor breach.

SPEN commented that they consider that licensees should be able to vary the TDNI_t and ANDt values within the Annual Iteration Process. They consider this reasonable as they consider that some drivers for these values such as inflation, Real Price Effect adjustments and totex reopeners will be finalised after the submission of the RFPR. They note these updates would need to be agreed by Ofgem during the Annual Iteration Process.

NGT also propose re-framing the clawback, so that it only operates to include changes to current and future periods within the model, rather than historic periods. However, this would not address the fact that historic periods are required to be included to allow actual TDNI to be finalised via the licensees submitted tax return

One licensee proposes amending the operation of the Tax Clawback calculation to restrict the clawback to the proportion of TDNI in excess of the notional interest, in line with the proportion of Adjusted Net Debt in excess of notional gearing.

Ofgem comment

Ofgem note that the intention of the review is to update the definitions of ANDt and TDNI_t, and mechanical changes to the calculation of the clawback are not within the scope of the review.

Ofgem note that there is currently a difference between the RFPR and PCFM in respect of average and closing values, and will consider whether this should be made consistent, when updating the guidance.

Ofgem consider that there is merit in allowing licensees to update the ANDt and TDNI_t values as part of the Annual Iteration Process to the extent that there are relevant drivers which change after the submission of the RFPR. This would need to be a symmetric obligation. This will be considered further in the updated guidance.

Ofgem considers that the clawback should cover all periods covered by the price control, as values in the earlier periods of the price control may change as result of refiled tax returns, regulatory amendments, or other changes.

Commencement

One licensee requested further clarity on the commencement of any proposed changes to the guidance.

Ofgem propose that the amendments to the Tax Clawback are effective from the commencement of RIIO-3 for both the ET/GT/GD sectors and the ED sector.

Whilst this does result in a mismatch between the position of the RIIO-3 licensees and the Electricity Distribution sector, which will remain in RIIO-ED2 for a further two years, this will allow the necessary licence instrument changes to be consulted on as part of the wider price control consultation program. Ofgem considers that this is in the interest of consumers as it is more efficient than undertaking a separate consultation process.

Next Steps

As outlined in the call for input, Ofgem will now complete a technical review of updated accounting standards and tax legislation.

Updated definitions of Tax Deductible Net Interest and Adjusted Net Debt will be consulted upon as part of the RIIO-3 Draft Determinations.