

# Guidance

---

## RIIO-GD3 Price Control Financial Handbook

---

First publication:

Effective date:

Version: 1.0

Team: Regulatory Finance

Telephone: 020 7901 7000

Email: [RegFinance@ofgem.gov.uk](mailto:RegFinance@ofgem.gov.uk)

---

This is the RIIO-GD3 Price Control Financial Handbook which forms part of Special Condition 8.1 (Governance of the RIIO-GD3 Price Control Financial Instruments) of the Gas Transporter licences held by gas distribution network operators.

This document consists of:

- a) requirements for how licensees must use the GD3 Price Control Financial Model to determine Allowed Revenue;
- b) an overview of the variable values used in the GD3 Price Control Financial Model; and
- c) details of how certain variable values are revised or calculated.

The procedures relating to modification of this handbook and the GD3 Price Control Financial Model are contained in Special Condition 8.1 and up to date versions of this handbook and the GD3 Price Control Financial Model can be accessed on the Ofgem website.

© Crown copyright 2025

The text of this document may be reproduced (excluding logos) under and in accordance with the terms of the [Open Government Licence](#).

Without prejudice to the generality of the terms of the Open Government Licence the material that is reproduced must be acknowledged as Crown copyright and the document title of this document must be specified in that acknowledgement.

Any enquiries related to the text of this publication should be sent to Ofgem at:  
10 South Colonnade, Canary Wharf, London, E14 4PU. Alternatively, please call Ofgem on 0207 901 7000.

This publication is available at [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Any enquiries regarding the use and re-use of this information resource should be sent to: [psi@nationalarchives.gsi.gov.uk](mailto:psi@nationalarchives.gsi.gov.uk)

## Contents

|   |           |
|---|-----------|
| <b>RIIO-GD3 Price Control Financial Handbook .....</b>          | <b>1</b>  |
| <b>1. Introduction.....</b>                                     | <b>6</b>  |
| Related documents .....   | 6         |
| Document structure .....  | 7         |
| <b>Definitions.....</b>   | <b>7</b>  |
| <b>2. The GD3 PCFM and Calculation of Allowed Revenue .....</b> | <b>9</b>  |
| The Price Control Financial Model .....                         | 9         |
| Price base .....  | 9         |
| Temporal convention .....                                       | 11        |
| Forecast variable values.....                                   | 11        |
| Time Value of Money (TVOM) .....                                | 11        |
| Changing the RIIO-GD3 PCFM .....                                | 12        |
| Error in the functionality of the RIIO-GD3 PCFM .....           | 12        |
| Calculation of Allowed Revenue .....                            | 12        |
| The RIIO-GD3 Price Control Financial Model Working Group .....  | 14        |
| Terms of reference .....  | 14        |
| <b>3. The PCFM Variable Values .....</b>                        | <b>16</b> |
| Types of PCFM Variable Values .....                             | 16        |
| List of PCFM Variable Values .....                              | 20        |
| Variant Totex Allowances .....                                  | 20        |
| Actual Totex (Capitalisation rate 1) .....                      | 22        |
| Actual Totex (Capitalisation rate 2) .....                      | 22        |
| Pass-through expenditure .....                                  | 22        |
| Incentive Revenue .....   | 23        |
| Other Revenue Allowances .....                                  | 24        |
| Legacy Adjustments .....  | 24        |
| Directly Remunerated Services .....                             | 24        |
| Finance Inputs.....   | 24        |
| Totex variant allowances allocation percentages .....           | 26        |
| RAV and assets.....   | 26        |
| <b>4. Cost of debt and cost of equity indexation .....</b>      | <b>28</b> |
| Cost of debt.....   | 28        |
| Methodology .....   | 28        |

|  |           |
|--|-----------|
| Non-availability or changes to basis of data for cost of debt .....  | 30        |
| Cost of equity – risk-free rate .....  | 30        |
| Methodology .....  | 31        |
| Vanilla WACC.....  | 32        |
| Semi-nominal WACC .....  | 33        |
| Provision and publication of the WACC Rates model.....   | 33        |
| <b>5. Real Price Effects .....</b>   | <b>35</b> |
| Formula for calculating the Real Price Effects ( $RPE_t$ ) term.....   | 35        |
| Formulae for calculating the Real Price Effects Index ( $RPEI_t$ ) and RPE totex allowance ( $RPEA_t$ )..... | 37        |
| Restatement of outturn values.....   | 37        |
| Methodology for forecast values.....   | 38        |
| Obligation to ensure alignment of the price index $PIt$ .....  | 39        |
| Provision and publication of $RPE_t$ values .....  | 39        |
| Non-availability of data .....   | 39        |
| <b>6. Tax liability allowances .....</b>   | <b>40</b> |
| Tax trigger events .....   | 44        |
| Tax review .....   | 48        |
| Capital allowances .....   | 53        |
| Definitions of Adjusted Net Debt and Tax Deductible Net Interest for the purposes of the Tax Clawback.....   | 53        |
| Adjusted Net Debt.....   | 53        |
| Tax Deductible Net Interest.....   | 54        |
| <b>7. Pensions .....</b>   | <b>56</b> |
| Financial Adjustments - Pensions.....  | 56        |
| Expected timing of pensions allowance revisions .....  | 56        |
| Section 1 – General provisions .....   | 57        |
| Price control pension principles .....   | 57        |
| Pension Scheme Established Deficit .....   | 58        |
| Established surpluses .....  | 59        |
| Pension costs outside the scope of this chapter .....  | 59        |
| Asset-backed funding arrangements.....   | 60        |
| Section 2 – Timetable and process for triennial revision of pensions allowance values .....                  | 60        |
| Reasons for updating pensions allowance values .....   | 60        |
| Process steps in a year in which a reasonableness review is being conducted .....                            | 61        |
| Reasonableness Reviews and adjustment factors .....  | 64        |

|  |           |
|--|-----------|
| Section 3 – Proposals for revised pensions allowance values .....        | 67        |
| Base Annual PSED Allowances .....  | 67        |
| Payment history allowances .....   | 70        |
| Section 4 – Calculation of the ESOPt term (applicable to NGET only)..... | 73        |
| <b>8. Legacy Adjustments.....</b>  | <b>74</b> |
| <b>Legacy inputs directed by the Authority .....</b>                     | <b>74</b> |
| General Financial Adjustment Methodology .....                           | 74        |
| GD2 Offline Tax-Trigger PCFM .....                                       | 74        |
| GD2 Legacy PCFM .....  | 75        |
| RIIO-GD2 Variable Value Methodologies.....                               | 76        |
| RIIO-GD2 Closeout Methodologies.....                                     | 76        |

## 1. Introduction

1.1. Special Condition 2.1 (Revenue restriction) determines the annual Allowed Revenue a licensee can recover in respect of Network Charges. The GD3 Price Control Financial Model (GD3 PCFM) is a Price Control Financial Instrument which provides for the calculation of Allowed Revenue. Certain inputs to the GD3 PCFM (the PCFM Variable values) are updated, resulting in updates to Allowed Revenue within the Price Control Period.

1.2. This handbook sets out how licensees must use the GD3 PCFM to determine Allowed Revenue.

1.3. This handbook provides:

- (a) a description of the GD3 PCFM;
- (b) the process the licensee must follow in calculating Allowed Revenue;
- (c) an overview of the PCFM Variable Values used in the GD3 PCFM; and
- (d) details of how certain PCFM Variable Values are revised or calculated.

## Related documents

1.4. This handbook is one of several documents relevant to the calculation of Allowed Revenue. Other key documents include:

- a) Special Conditions
- b) GD3 PCFM
- c) Associated Documents and Regulatory Instructions and Guidance (including the PCFM Guidance)
- d) Final Determinations [footnote to be added after FDs]

1.5. In any case of conflict of meaning between these documents, the following order of precedence applies:

- a) the relevant licence condition(s)
- b) this handbook
- c) the GD3 PCFM
- d) NARM handbook and Network Asset Risk Workbook

- e) Associated Documents and Regulatory Instructions and Guidance (including the PCFM Guidance)
- f) Final Determinations.<sup>1</sup>

## Document structure

1.6. The remainder of this handbook is structured as follows:

- a) Section 2 provides an overview of the GD3 PCFM;
- b) Section 3 lists the PCFM Variable Values used in the GD23 PCFM;
- c) subsequent sections provide details of how certain variable values are revised or calculated (along with further details on the GD3 PCFM).

## Definitions

1.7. This handbook uses defined terms, which are capitalised throughout this handbook, with the meaning found in the following locations:

- the table given below;
- Special Condition 1.1 (Definitions and interpretations); and
- Standard Condition 1 (Definitions for the standard conditions).

|                            |  |
|----------------------------|--|
| Base Annual PSED Allowance | means the allowance relating to pensions set out in chapter 7, section 3 of this handbook.   |
| CPI                        | means the Consumer Prices Index  |
| CPIH                       | means the Consumer Prices Index Including Owner Occupiers' Housing Costs.  |
| Defined Benefit Scheme     | means a pension scheme where the benefits that accrue to members are based on a set formula taking into account the final salary and accrual of service in the scheme. |
| GD3 PCFM                   | means the GD3 Price Control Financial Model.   |
| PCFM Guidance              | means the annex of that name to the RIGs.  |

---

<sup>1</sup> Final Determinations do not form part of the licence and have legal effect only insofar as they are specifically referenced in the other documents listed at 1.5 a-e.

|                       |  |
|-----------------------|--|
| Reasonableness Review | means the pensions review set out in para 7.30 of Chapter 7, section 2 of this handbook.   |
| RIGs                  | means the document published by the Authority in accordance with Standard Special Condition A40 (Regulatory Instructions and Guidance).  |
| Time Value of Money   | means the interest rate used to apply to year-on-year true-ups and adjustments made during the GD3 Price Control and is based on the nominal WACC set out in the "AR" sheet in the GD3 PCFM and is derived in accordance with the formula in paragraph [2.1.13 of Special Condition 2.1].            |
| Triennial Valuation   | An actuarial valuation of a pension scheme, performed on a 3-yearly cycle, which has been carried out to meet the requirements of Section 224(2)(a) of the Pensions Act 2004 and which results in a written report on scheme assets and liabilities by the scheme actuary.                           |
| Updated Valuation     | A report, prepared and signed by the scheme actuary, which updates a Triennial Valuation to a later date. This is further defined in the Energy Network Operators' Price Control Pension Costs - RIGs: triennial pension reporting pack supplement including pension deficit allocation methodology. |



## 2. The GD3 PCFM and Calculation of Allowed Revenue

### The Price Control Financial Model

2.1. For each Regulatory Year, the GD3 PCFM provides for the calculation of Allowed Revenue in accordance with Special Condition 2.1 (Revenue restriction).

2.2. The GD3 PCFM contains both fixed values and a variable values table input area for the licensee. The Allowed Revenue figure for the licensee for each Regulatory Year of the Price Control Period is calculated as per Special Condition 2.1, using the fixed values, the variable values, and the formulae and functions embedded in the GD3 PCFM.

2.3. At the beginning of the Price Control Period, Allowed Revenue is calculated by the GD3 PCFM, using the PCFM Variable Values completed by the Authority in accordance with Final Determinations. From that point, PCFM Variable Values are updated by the licensee in accordance with the document hierarchy in 1.5.

#### Price base

2.4. The GD3 PCFM works in a constant 2023/24 price base, except in respect of some calculations internal to the model that use nominal prices, eg tax, various pass-through costs and legacy calculations. The price base of each PCFM Variable Value input is labelled in the PCFM. Certain calculations relating to the indexation of the RAV also make use of a semi-nominal price index. The use of nominal prices in the GD3 PCFM tax calculations is meant to more accurately reflect the licensee's tax expenses profile in revenue allowance calculations.

2.5. The price base uses CPIH as the measure of inflation, where the price index grows by CPIH. The exact calculation is set out in Part E of Special Condition 2.1.

#### *Forecasting the price index $PI_t$*

2.6. After receipt of the final inflation update from Ofgem each November, the licensee will update outturn data for CPIH<sub>m</sub> until June of the current year (e.g. in November 2025, the outturn data values would only be entered to June 2025).

2.7. The PCFM "Main Inputs" and "Inflation" tabs contain a method for forecasting future price index values, given calendar year forecast assumptions. The calendar year forecast is labelled "CYCPIF<sub>t</sub>".

2.8. These forecasts will be the Office for Budget Responsibility’s (OBR) forecast of CPI from the “economic and fiscal outlook”. Ofgem will update the forecast assumptions from the most recent outlook available during November each year. The data will be sourced from following files based on their availability, with preference being given to them in accordance with the order they are listed below:

1. The OBR historical official forecasts database<sup>2</sup>, tab “CPI”
2. The charts and tables datafile published with the economic and fiscal outlook; and
3. The economic and fiscal outlook document

2.9. The forecast rates will be used to create a forecast of the monthly index. The OBR growth rate forecasts compare year over year index averages, so the rates are assumed to apply midpoint each year from July to June. The last outturn value of CPIH will be grown by a monthly rate in accordance with the following formula:

$$CPIH_m = CPIH_{m-1} \cdot (1 + CYCPIF_m)^{\frac{1}{12}}$$

where,

|                     |  |
|---------------------|--|
| CPIH <sub>m</sub>   | is the CPIH price index value for a given year-month “m”.  |
| CYCPIF <sub>m</sub> | means the OBR CPI forecast (annual rate) applicable to year-month m, where the OBR forecast for a calendar year is applicable from 6 months prior to the start of that calendar year, to six months after (eg the 2021 OBR forecast would be applicable from July 2020 to June 2021). If the forecast year-month falls after the range covered by OBR forecasts, the longest dated forecast year is used (eg if the November OBR forecast covered 2020-2024, then the forecast for year 2024 would be used for 2025 and 2026). |

#### *Long term inflation assumption (LTCPIH<sub>t</sub>)*

2.10. The long term inflation assumption (labelled LTCPIH<sub>t</sub>) will be fixed at 2.0% from 2026/27 onwards.

#### *Provision of updated inflation variable values*

---

<sup>2</sup> <https://obr.uk/data/>

2.11. Ofgem will perform the above updates to the PCFM Variable Values  $CPIH_m$  and  $CYCPIF_t$  and provide the updated data to the licensee by no later than 30 November. The licensee should use this data to update the PCFM.

### **Temporal convention**

2.12. The following conventions apply throughout this handbook:

- a) Relative references: The  $AR_t$  term is licensee's Allowed Revenue for each Regulatory Year  $t$  during the Price Control Period. References in this handbook to Regulatory Years are made relative to that usage. For example, in the context of  $AR_t$  for Regulatory Year 2027/28, a reference in the same context to Regulatory Year  $t-1$  would mean 2026/27 and so on.
- b) Absolute references: A reference to, for example, 'the EDE value for 2026/27' means the EDE value in the 2026/27 column of the variable values table for the licensee contained in the GD3 PCFM.

### **Forecast variable values**

2.13. In calculating Allowed Revenue for Regulatory Year  $t$ , the GD3 PCFM uses some forecast PCFM Variable Values. For example, in the case of expenditure, there is a two-year lag before outturn values can be reflected in Allowed Revenue, and so forecasts are used.

2.14. The licensee must forecast PCFM Variable Values in accordance with the requirements of this handbook and the RIGs. These updates can apply to all Regulatory Years.

2.15. For the avoidance of doubt, while a licence condition may refer to actual costs, revenue and outputs, for future periods the equivalent data should be forecast.

### **Time Value of Money (TVOM)**

2.16. The GD3 PCFM uses a 'time value of money' adjustment to incorporate the financial impact of the timing of cash flows, eg from switching revenues between Regulatory Years as a result of changes to previous years' Allowed Revenue or to correct charging error for any over or under-recovery.

2.17. The time value of money rate used in the GD3 PCFM is based on the licensee's nominal WACC, set out in the "AR" sheet in the GD3 PCFM.

### **Changing the RIIO-GD3 PCFM**

2.18. The RIIO-GD3 PCFM exists as a GD3 Price Control Financial Instrument and, therefore, as a constituent part of Special Condition 8.1. It can be changed under section 23 of the Act or certain modifications can be made in accordance with Special Condition 8.1.

### **Error in the functionality of the RIIO-GD3 PCFM**

2.19. If an error of functionality is discovered in the RIIO-GD3 PCFM, the issue will be considered at the earliest opportunity by the PCFM Working Group (see next section) and a corrective modification will be proposed by Ofgem.

## **Calculation of Allowed Revenue**

2.20. In determining the value of Allowed Revenue, the licensee must use the latest version of the GD3 PCFM published on the Authority's Website by 1 July.

2.21. The licensee must update the PCFM Variable Values table at least annually, in accordance with the PCFM Guidance.

2.22. The licensee must not make any modifications to the GD3 PCFM except for the removal of the data within those input sheets which are not relevant to the licensee, the completion or updating of the PCFM Variable Values, updating the "Cover" tab per paragraph 2.30 and updating the "UserInterface" tab of the GD3 PCFM.

2.23. Where a PCFM Variable Value is not known at the time of calculating Allowed Revenue, the licensee must determine that value in accordance with the GD3 Price Control Financial Handbook or the PCFM Guidance as applicable or otherwise provide its best estimate using the information available to it at the time. This will be deemed to be compliant with the best endeavours requirement in paragraph 2.1.3 of the Special Licence Conditions.

2.24. The licensee must seek advice and agreement from Ofgem if it is uncertain of the correct way to calculate a PCFM Variable Value

2.25. Where any PCFM Variable Value relies on a third-party publication that ceases to be published or no longer contains the value or data required for that value, the value from the most recent publication that did contain the value, or an alternate input agreed to by the Authority must be used.

2.26. No less than 14 days prior to the publication of the GD3 PCFM on the licensee's website in accordance with paragraph 2.1.7 of Special Condition 2.1 (Revenue restriction), the licensee must provide the Authority with:

- a) a copy of the GD3 PCFM which the licensee intends to publish on its website; and
- b) a commentary describing any changes since the last submission of the GD3 PCFM to the Authority.
- c) Where the Authority requires the licensee to change the GD3 PCFM following its provision to the Authority in accordance with this paragraph, the licensee shall not be required to provide a further 14-day notice period to the Authority ahead of that publication for the updated version.

2.27. Prior to publication on the licensee's website in accordance with paragraph 2.1.5 of Special Condition 2.1 (Revenue restriction), the licensee must reduce the GD3 PCFM made available under Part D of Special Condition 8.1 (Governance of the GD3 Price Control Financial Model), in accordance with instructions provided by the Authority, so that it is specific to each licensee.

2.28. The licensee must update the "publication date" label on the "Cover" tab of the GD3 PCFM with the date the model was made public on the licensee's website.

2.29. The licensee must use the following file naming convention:

GD3 PCFM Licensee 20XX-XX Allowed Revenue YYYYMMDD

where:

YYYYMMDD means the year, month, and day the GD3 PCFM was published.

20XX-XX Allowed Revenue means the Regulatory Year for which Allowed Revenue is being set

Licensee means one or more of East, London, North West, West Midlands, Northern, Scotland, Southern, Wales & West as applicable.

2.30. The GD3 PCFM will be used for the purpose of determining the value of Allowed Revenue up to and including Regulatory Year 2030/31.

## **The RIIO-GD3 Price Control Financial Model Working Group**

2.31. Ofgem will facilitate an industry expert working group to review issues arising with respect to the form or usage of the RIIO-GD3 PCFM. The terms of reference for GD3 The PCFM Working Group ('the working group') are set out below.

### **Terms of reference**

#### *Purposes of the working group*

2.32. The purposes of the working group are:

- a) to review the ongoing effectiveness of the RIIO-GD3 PCFM in producing a value for Allowed Revenue and capturing financial performance data for each Regulatory Year
- b) to provide, when requested by the Authority, its views to the Authority on the impact of any proposed modifications on the RIIO-GD3 PCFM; and
- c) to provide such views or recommendations to the Authority with regard to the RIIO-GD3 PCFM (including as to proposals to modify the RIIO-GD3 PCFM) as it sees fit.

#### *Composition*

2.33. The composition of the group will be:

- a) Chair (Ofgem)
- b) Secretary (Ofgem); and
- c) one representative per licensee

#### *Timing and duration of the group's work*

2.34. The working group's incumbency will run from 01 April 2026 to 31 March 2031.

2.35. The group will meet at least once between 01 January and 01 April during each calendar year, but may meet more frequently if required, in particular in relation to the provision of views on the impact of proposed RIIO-GD3 PCFM modifications.

2.36. In convening any meeting of the working group, Ofgem will give at least 10 working days notice of the proposed meeting date to the licensee.

2.37. Representatives may attend meetings in person or through video or telephone conferencing facilities.

#### *Resources*

2.38. Meeting facilities will be provided or coordinated by Ofgem. Ofgem will keep notes of key points of discussion and views expressed at meetings, and of any recommendations made by the working group with respect to the RIIO-GD3 PCFM. A copy of the record of each meeting will be provided to the licensee as soon as is reasonably practicable and to representatives who attended the meeting, and Ofgem will take account of any comments received in finalising the record.

### 3. The PCFM Variable Values

3.1. This section lists all the variable values (including the relevant Special Condition and Associated Documents, where relevant, for each). The variable values that can be revised are set out in List of PCFM Variable Values

Table 3.1 below.

3.2. For each variable value, the table provides a description, cross-references to the relevant Special Condition(s) (where appropriate) and details of Associated Documents (where relevant). It also identifies the variable values for which further details are provided in subsequent sections of this handbook. This includes the approaches to variable values calculated by Ofgem (eg cost of debt and Real Price Effects) and details for some variable values in addition to that provided in Special Conditions (SpC) and other Associated Documents (eg taxation and pensions).

#### Types of PCFM Variable Values

##### *List of PCFM Variable Values*

3.3. Table 3.1 presents the variable values according to the different types, which reflect the components of revenue to which they relate. This section summarises the different types of PCFM Variable Values.

##### *Totex allowance*

3.4. The following types of variable values contribute to the calculation of the totex allowance<sup>34</sup> through the Totex Incentive Mechanism:

- a) Variant Allowances (adjustments to totex allowances); and
- b) Actual totex

---

<sup>3</sup> Subject to "Capitalisation rate 1" and "Capitalisation rate 2" which relates to "Ex-ante Baseline totex + PCDs" and "Uncertainty Mechanisms only" respectively.

<sup>4</sup> Non-variant allowances also contribute to the calculation of totex but are not variable.



3.5. These types of variable values are used in the Totex Incentive Mechanism to determine the amounts that should, subject to the Totex Capitalisation Rate for the licensee, be processed as:

- a) Fast Money ( $FM_t$ ) – flowing directly into the Calculated Revenue ( $R_t$ ) figure for the Regulatory Year to which the amount relates; and
- b) Slow Money – addition to the licensee's RAV in the Regulatory Year to which the amount relates, contributing indirectly to Calculated Revenue ( $R_t$ ) through the return ( $RTN_t$ ) on RAV and depreciation ( $DPN_t$ ) over multiple Regulatory Years.

#### *Pass-through expenditure*

3.6. This type of variable value is allowed expenditure, comprising certain costs that can be passed through to consumers, and flows directly into Calculated Revenue ( $R_t$ ). It is not used in the Totex Incentive Mechanism and does not have a slow money component.

#### *Incentive Revenue*

3.7. This type of variable value penalises or rewards licensees for incentive performance and flows directly into Calculated Revenue ( $R_t$ ).

#### *Other Revenue Allowances*

3.8. This type of variable value comprises allowances that flow directly into Calculated Revenue ( $R_t$ ). These are:

- [Network Innovation Allowance;]
- [Carry-over Network Innovation Allowance;]
- [Revenue adjustments in respect of connection performance failures; ]
- [Aggregate Amount (margins on licensee's Connection Activities);]
- [Initial profile adjustment; and]
- [Time value of money profile adjustment.]

#### *Legacy Adjustments*

3.9. This type of variable value relates to adjustments for previous price controls and comprises:

- a) *Legacy Revenue adjustments ( $LAR_t$ )*: These types of adjustments flow directly into Allowed Revenue ( $AR_t$ ).
- b) *Legacy RAV Additions Adjustment ( $LRAV_t$ )*: These variable values contribute indirectly to Calculated Revenue ( $R_t$ ); and
- c) Tax balances brought forward ( $OGPt$ ,  $OSRPt$ ,  $ODRPt$ ,  $LODRPt$ ,  $OSBPt$  and  $OTLt$ ): These variable values contribute to the tax allowance ( $TAX_t$ ).

#### *Directly Remunerated Services (DRS)*

3.10. This type of variable value is used to derive the DRS adjustment term that feeds directly into Calculated Revenue ( $R_t$ ). It is not used in the Totex Incentive Mechanism and does not have a slow money component.

#### *Finance Inputs*

3.11. This category comprises:

- a) Cost of capital percentage ( $iBTA_t$  and  $RFR$ )<sup>5</sup>: This type of variable value affects the allowance provided to the licensee for financing their capital needs and contributes to Calculated Revenue ( $R_t$ ) indirectly.
- b) Allowed Revenue setting: This type of variable value is used in the calculation of Allowed Revenue and comprises the price index term, K correction factor, the Forecasting Penalty term and Calculated Revenue ( $R_t$ ).
- c) Tax allowance<sup>6</sup>: This type of variable value relates to taxation of the licensee and contributes indirectly to Calculated Revenue ( $R_t$ ) or, in the case of  $TAXA_t$ , flows directly into Calculated Revenue ( $R_t$ ).
- d) Real Price Effects ( $RPE_t$ )<sup>7</sup>: This is the annual growth rate used for the derivation of the RPE indexation values. These in turn are applied to the relevant allowed totex spend, to derive the related RPE totex allowance.

---

<sup>5</sup> See Section 4 of this handbook.

<sup>6</sup> See Section 6 of this handbook.

<sup>7</sup> See Section 5 of this handbook.

### *Forecasting Penalty inputs*

3.12. This type of variable value is used in the calculation of the Forecasting Penalty (FPt) and comprises the Base Revenue Forecasting Penalty (BRFPt), Recovered Revenue Forecasting Penalty (RRFPt), Base Revenue (BRt), Recovered Revenue (RRt), Allowed Revenue as published (AR\*t) and Base Revenue as published (BR\*t).

### *Inflation Inputs*

3.13. The GD3 PCFM contains the following PCFM Variable Values relating to the price index:

- a) CPIHm
- b) CYCPIHt
- c) LCPIHFt

3.14. These inputs provide for the model to be able to calculate PIt as well as a forecast in accordance with the methodology below.

### *Totex Variant Allowances Allocation Percentages (TVAAAt)*

3.15. These variable values comprise totex variant allowance allocation percentages, used in the GD3 PCFM to allocate variant totex allowances between the five categories of totex as listed below:

- 1. Load related capex
- 2. Non-load related capex - other
- 3. Business support (opex)
- 4. Directs opex
- 5. Repex

3.16. These allocation rates enable actual and forecast allowances to feed into Calculated Revenue ( $R_t$ ) through the Totex Incentive Mechanism (see para 3.5) and relate specifically to any re-opener or uncertainty mechanism, which have not been pre-populated in the GD3 PCFM as a “yellow box” hard-coded input.

## List of PCFM Variable Values

**Table 3.1 - PCFM Variable Values (VV)**

**Variant Totex Allowances**

| <b>VV</b>            | <b>Description</b>   | <b>SpC</b> | <b>Cross-reference / Associated Document</b>                       |
|----------------------|--|------------|--|
| NARM <sub>t</sub>    | The Baseline Network Risk Outputs                                    | SpC 3.1    | PCFM Guidance, Network Asset Risk Workbook, NARM Handbook          |
| CY <sub>t</sub>      | Cyber resilience baseline term                                       | SpC 3.2    | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| CYRE <sub>t</sub>    | Cyber resilience non-baseline term                                   | SpC 3.2    | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| CYU <sub>t</sub>     | Use it or lose it allowance  | SpC 3.2    | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| PSUP <sub>t</sub>    | Physical Security Price Control Deliverable                          | SpC 3.3    | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| PSRUPRE <sub>t</sub> | Physical Security Re-Opener  | SpC 3.3    | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| NZP <sub>t</sub>     | Net Zero Pre-construction Work and Small Net Zero Projects Re-opener | SpC 3.4    | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| RDF <sub>t</sub>     | Net Zero And Re-opener Development Fund use it or lose it allowance  | SpC 3.5    | PCFM Guidance  |
| NZ <sub>t</sub>      | Net zero Re-opener   | SpC 3.6    | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| DIGIt                | Digitalisation Re-opener   | SpC 3.7    | PCFM Guidance, Re-opener Guidance and Application Requirements     |

|                   |  |          |  |
|-------------------|--|----------|--|
| CAM <sub>t</sub>  | Coordinated adjustment mechanism Re-opener                       | SpC 3.8  | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| OTC <sub>t</sub>  | Operational transport carbon reduction Price Control Deliverable | SpC 3.9  | PCFM Guidance, PCD Reporting Requirements                          |
| T1MD <sub>t</sub> | Tier 1 Mains decommissioned Price Control Deliverable            | SpC 3.10 | PCFM Guidance  |
| T1SR <sub>t</sub> | Tier 1 Services Repex Price Control Deliverable                  | SpC 3.11 | PCFM Guidance  |
| RE <sub>t</sub>   | Tier 2A Mains and Services Replacement Volume Driver             | SpC 3.12 | PCFM Guidance  |
| REP <sub>t</sub>  | HSE policy Re-opener   | SpC 3.13 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| HPRA <sub>t</sub> | Heat policy and energy efficiency Re-opener                      | SpC 3.14 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| DIV <sub>t</sub>  | Diversions and Loss of Development Claims policy Re-opener       | SpC 3.15 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| NLLR <sub>t</sub> | New Large Load Connections Re-opener                             | SpC 3.16 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| STW <sub>t</sub>  | Specified Streetworks Costs Re-opener                            | SpC 3.17 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| PDVD <sub>t</sub> | PSR disconnections adjustment                                    | SpC 3.18 | PCFM Guidance  |
| STBD <sub>t</sub> | Tier 1 Stubs decommissioning Price Control Deliverable           | SpC 3.19 | PCFM Guidance, PCD Reporting Requirements                          |
| BIOC <sub>t</sub> | Biomethane Connections <u>use it or lose it</u> allowance        | SpC 3.20 | PCFM Guidance  |
| LMP <sub>t</sub>  | London Medium Pressure Price Control Deliverable (Cadent)        | SpC 3.21 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| FLO <sub>t</sub>  | FWACV Compliance Price Control Deliverable (Cadent)              | SpC 3.22 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |

|                  |   |          |  |
|------------------|---|----------|--|
| GMP <sub>t</sub> | Grays Medium Pressure Price Control Deliverable (Cadent)      | SpC 3.23 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| TVD <sub>t</sub> | Tinsley Viaduct Diversion Price Control Deliverable (Cadent)  | SpC 3.24 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| LST <sub>t</sub> | London Subways and Tunnel Re-opener (Cadent)                  | SpC 3.25 | PCFM Guidance, Re-opener Guidance and Application Requirements     |
| SLM <sub>t</sub> | South London Mains Price Control Deliverable (SGN)            | SpC 3.26 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |
| FSR <sub>t</sub> | Full site and system rebuilds Price Control Deliverable (SGN) | SpC 3.27 | PCFM Guidance, PCD Reporting Requirements and Methodology Document |

#### Actual Totex (Capitalisation rate 1)

| VV  | Description                    | SpC | Cross-reference / Associated Document |
|-----|--------------------------------|-----|---------------------------------------|
| ALC | Actual load related capex      |     | PCFM Guidance                         |
| AOC | Actual other capex             |     | PCFM Guidance                         |
| ACO | Actual business support (opex) |     | PCFM Guidance                         |
| ADO | Actual directs (opex)          |     | PCFM Guidance                         |
| ARE | Actual replacement expenditure |     | PCFM Guidance                         |

#### Actual Totex (Capitalisation rate 2)

| VV   | Description                    | SpC | Cross-reference / Associated Document |
|------|--------------------------------|-----|---------------------------------------|
| ALCU | Actual load related capex      |     | PCFM Guidance                         |
| AOCU | Actual other capex             |     | PCFM Guidance                         |
| ACOU | Actual business support (opex) |     | PCFM Guidance                         |
| ADOU | Actual directs (opex)          |     | PCFM Guidance                         |
| AREU | Actual replacement expenditure |     | PCFM Guidance                         |

#### Pass-through expenditure

| <b>VV</b>         | <b>Description</b>                                       | <b>SpC</b>      | <b>Cross-reference / Associated Document</b> |
|-------------------|--|-----------------|--|
| LF <sub>t</sub>   | Licence Fees   | SpC 6.1, Part A | PCFM Guidance                                |
| RB <sub>t</sub>   | Prescribed Rates   | SpC 6.1, Part B | PCFM Guidance                                |
| PD <sub>t</sub>   | Pension Deficit Charge Adjustment (NTS Pension Recharge) | SpC 6.1, Part A | PCFM Guidance                                |
| TPWI <sub>t</sub> | Third party damage and water ingress                     | SpC 6.1, Part C | PCFM Guidance                                |
| CDSP <sub>t</sub> | Gas Transporters' share of Xoserve costs                 | SpC 6.1, Part A | PCFM Guidance                                |
| MP <sub>t</sub>   | Miscellaneous pass-through                               | SpC 6.1, Part A | PCFM Guidance                                |
| TG <sub>t</sub>   | Gas theft  | SpC 6.1, Part A | PCFM Guidance                                |
| EC <sub>t</sub>   | NTS Exit costs   | SpC 6.1, Part A | PCFM Guidance                                |
| SL <sub>t</sub>   | Shrinkage costs  | SpC 6.1, Part D | PCFM Guidance                                |
| EDE <sub>t</sub>  | Established Pension Deficit Recovery Plan Payment        | SpC 6.1, Part A | PCFH section 7                               |
| SLDZ <sub>t</sub> | Other - Stranraer LDZ (SGN Scotland only)                | SpC 6.1 Part A  | PCFM Guidance                                |

### Incentive Revenue

| <b>VV</b>        | <b>Description</b>                                       | <b>SpC</b> | <b>Cross-reference / Associated Document</b> |
|------------------|--|------------|--|
| CS <sub>t</sub>  | Customer satisfaction Survey ODI                         | SpC 4.2    | PCFM Guidance                                |
| CM <sub>t</sub>  | Complaints metric ODI                                    | SpC 4.3    | PCFM Guidance                                |
| SM <sub>t</sub>  | Shrinkage management ODI                                 | SpC 4.4    | PCFM Guidance                                |
| UIP <sub>t</sub> | Unplanned interruption mean duration ODI (NGN, SGN, WWU) | SpC 4.5    | PCFM Guidance                                |

|                  |   |         |               |
|------------------|---|---------|---------------|
| UIP <sub>t</sub> | Unplanned interruption mean duration ODI (Cadent only)            | SpC 4.5 | PCFM Guidance |
| CSW <sub>t</sub> | Collaborative streetworks ODI (Cadent, EOE, SGN SO Networks only) | SpC 4.6 | PCFM Guidance |

### Other Revenue Allowances

| VV                | Description                                 | SpC     | Cross-reference / Associated Document         |
|-------------------|---|---------|---|
| NIA <sub>t</sub>  | RIIO-2 Network Innovation Allowance         | SpC 5.2 | PCFM Guidance, RIIO-2 NIA Governance Document |
| CNIA <sub>t</sub> | Carry-over Network Innovation Allowance     | SpC 5.3 | PCFM Guidance, RIIO-1 NIA Governance Document |
| VCM <sub>t</sub>  | Vulnerability and Carbon Monoxide Allowance | SpC 5.4 | PCFM Guidance, VMCA Governance Document       |

### Legacy Adjustments

| VV                | Description                                | SpC      | Cross-reference / Associated Document |
|-------------------|--|----------|---------------------------------------|
| LADJ <sub>t</sub> | Legacy Adjustment term                     | SpC 7.3  | PCFH section 8, PCFM Guidance         |
| LK <sub>t</sub>   | Legacy K Correction                        | SpC 7.4  | PCFH section 8, PCFM Guidance         |
| LRAV <sub>t</sub> | Legacy net RAV additions (after disposals) | SpC 7.14 | PCFH section 8, PCFM Guidance         |

### Directly Remunerated Services

| VV                  | Description                                     | SpC | Cross-reference / Associated Document |
|---------------------|---|-----|---------------------------------------|
| PREDRS <sub>t</sub> | Pre-vesting directly remunerated services       |     | PCFM Guidance                         |
| POSDRS <sub>t</sub> | Post-vesting directly remunerated services      |     | PCFM Guidance                         |
| OIDRS <sub>t</sub>  | Other income from directly remunerated services |     | PCFM Guidance                         |
| IDRS <sub>t</sub>   | Identified directly remunerated services costs  |     | PCFM Guidance                         |

### Finance Inputs



| <b>VV</b>                | <b>Description</b>   | <b>SpC</b>      | <b>Cross-reference / Associated Document</b> |
|--------------------------|--|-----------------|--|
| RFR                      | Risk-free rate   |                 | PCFH section 4, PCFM Guidance                |
| iBTAt                    | iBoxx trailing average   |                 | PCFH section 4, PCFM Guidance                |
| <u>KdFRD<sub>t</sub></u> | <u>The allowed return on fixed rate debt</u>                                   |                 | PCFH section 4, PCFM Guidance                |
| <u>KdILD<sub>t</sub></u> | <u>The allowed return on index-linked debt</u>                                 |                 | PCFH section 4, PCFM Guidance                |
| I <sub>t</sub>           | Sterling Overnight Index Average (SONIA)                                       | SpC 1.1, Part B | PCFH section 2, PCFM Guidance                |
| RPE <sub>t</sub>         | RPE annual growth  |                 | PCFM Guidance                                |
| AND <sub>t</sub>         | Adjusted net debt  |                 | PCFM Guidance                                |
| TDNI <sub>t</sub>        | Tax deductible net interest cost   |                 | PCFM Guidance                                |
| TAXA <sub>t</sub>        | Tax allowance adjustment   | SpC 2.2         | PCFH section 6, PCFM Guidance                |
| TTE <sub>t</sub>         | Tax liability allowance adjustments - driven by tax trigger events             |                 | PCFH section 6, PCFM Guidance                |
| OGPA <sub>t</sub>        | General pool opening balance adjustment  |                 | PCFM Guidance                                |
| OSRPA <sub>t</sub>       | Special Rate pool opening balance adjustment                                   |                 | PCFM Guidance                                |
| OGP <sub>t</sub>         | General pool capital allowance opening balance brought forward                 |                 | PCFM Guidance                                |
| OSRP <sub>t</sub>        | Special Rate capital allowance opening balance brought forward                 |                 | PCFM Guidance                                |
| OSBP <sub>t</sub>        | Structures and buildings capital allowance opening balance brought forward     |                 | PCFM Guidance                                |
| ODRP <sub>t</sub>        | Deferred revenue expenditure opening balance brought forward                   |                 | PCFM Guidance                                |
| LODRP <sub>t</sub>       | Deferred revenue pool additions (RIIO1) plus opening balance at start of RIIO1 |                 | PCFM Guidance                                |
| OTL <sub>t</sub>         | Tax loss brought forward   |                 | PCFM Guidance                                |
| ARGP <sub>t</sub>        | Totex Allocation to "General" tax pool   |                 | PCFM Guidance                                |
| ARSR <sub>t</sub>        | Totex Allocation to "Special Rate" tax pool                                    |                 | PCFM Guidance                                |
| ARSB <sub>t</sub>        | Totex Allocation to "Structures and Buildings" tax pool                        |                 | PCFM Guidance                                |
| ARDR <sub>t</sub>        | Totex Allocation to "Deferred Revenue" tax pool                                |                 | PCFM Guidance                                |
| ARR <sub>t</sub>         | Totex Allocation to "Revenue" tax pool   |                 | PCFM Guidance                                |
| ARNQ <sub>t</sub>        | Totex Allocation to "Non Qualifying" tax pool                                  |                 | PCFM Guidance                                |

|                            |   |                 |               |
|----------------------------|---|-----------------|---------------|
| CT <sub>t</sub>            | Corporation tax rate                                |                 | PCFM Guidance |
| GCA <sub>t</sub>           | General pool capital allowance rate                 |                 | PCFM Guidance |
| SRCA <sub>t</sub>          | Special Rates capital allowance rate                |                 | PCFM Guidance |
| SBCA <sub>t</sub>          | Structures and buildings capital allowance rate     |                 | PCFM Guidance |
| DRCA <sub>t</sub>          | Deferred Revenue Expenditure capital allowance rate |                 | PCFM Guidance |
| RIIO-1AR <sub>t</sub>      | RIIO-1 allowed revenue                              |                 | PCFM Guidance |
| PRP <sub>t</sub>           | Penal rate proportion                               | SpC 2.1, Part H | PCFM Guidance |
| RIIO-1 ExitAR <sub>t</sub> | RIIO-1 exit allowed revenue                         |                 | PCFM Guidance |
| RIIO-1 SAR <sub>t</sub>    | RIIO-1 supplier of last resort allowed revenue      |                 | PCFM Guidance |
| BRR <sub>t</sub>           | Recovered revenue billed basis                      |                 | PCFM Guidance |
| BD <sub>t</sub>            | Bad Debt  |                 | PCFM Guidance |
| RR <sub>i</sub>            | Recovered revenue                                   | SpC 2.1, Part B | PCFM Guidance |
| ExitRR <sub>t</sub>        | Exit recovered revenue                              |                 | PCFM Guidance |
| SRR <sub>t</sub>           | Supplier of last resort recovered revenue           |                 | PCFM Guidance |

**Totex variant allowances allocation percentages**

| <b>VV</b>         | <b>Description</b>   | <b>SpC</b> | <b>Cross-reference / Associated Document</b> |
|-------------------|--|------------|--|
| TVAA <sub>t</sub> | The range of totex variant allowance allocation percentages relating to any re-opener or uncertainty mechanism, which have not been pre-populated in the RIIO-GD2 PCFM as a “yellow box” hard-coded input. |            | PCFM Guidance                                |

**RAV and assets**

| <b>VV</b> | <b>Description</b> | <b>SpC</b> | <b>Cross-reference / Associated Document</b> |
|-----------|--------------------|------------|--|
|-----------|--------------------|------------|--|

|                   |                              |  |               |
|-------------------|------------------------------|--|---------------|
| DISP <sub>t</sub> | Disposals net sales proceeds |  | PCFM Guidance |
|-------------------|------------------------------|--|---------------|

## 4. Cost of debt and cost of equity indexation

4.1. The licensee's Calculated Revenue ( $R_t$ ) includes amounts which cover the efficient cost of raising finance for the transportation business from external sources, commonly referred to as the 'cost of capital'. These amounts are calculated as a percentage return on the licensee's RAV. The Allowed Return on Capital is Ofgem's estimate of the transportation businesses' Weighted Average Cost of Capital (WACC). This is determined using a pre-tax semi-nominal allowed return on debt percentage, a post-tax real allowed return on equity percentage and a notional gearing percentage weighting.

4.2. Under the RIIO-GD3 price control, the notional gearing percentage is fixed for the Price Control Period. However, there are annual revisions to:

4.2.1. the allowed return on debt; and

4.2.2. the allowed return on equity annually through changes to the real (CPIH based) risk-free rate (RFR).

4.3. The updates are given effect by updating the PCFM Variable Values in accordance with the methodologies which follow.

### Cost of debt

4.4. This section considers the calculation of the allowed return on fixed rate debt ( $K_{dFRD_t}$ ) and the allowed return on index-linked debt ( $K_{dILD_t}$ ).

4.5. The values of  $K_{dFRD_t}$  and  $K_{dILD_t}$  will be updated annually.

### Methodology

#### *Step 1 – obtain or forecast nominal bond yields*

4.6. For each day from 31 October 2011 to 31 October 2029, obtain a nominal annual yield as follows:

- (a) for days up to and including 31 October in the year in which the update is being conducted, obtain from the Markit data service, the nominal annual yield in % in % for the iBoxx GBP A (ISIN reference: DE000A0JY837) and iBoxx BBB (ISIN reference: DE000A0JZAH1) Non-Financials 10+ corporate indices and

- calculate a simple arithmetic average of the two indices for each corresponding trading day.
- (b) for all other days, forecast a nominal annual yield as the average of the last full calendar month of outturn data available in which the update is being conducted.

*Step 2 – calculate Daily Utilities Index (DUI<sub>t</sub>) for each trading day*

4.7. This step takes the daily nominal annual yield and incorporates additional adjustments. For each day in the period from 31 October 2011 to 31 October 2029, add to the daily yield figures obtained under Step 1:

- a) 25 basis points for additional costs of borrowing;
- b) 60 basis points calibration adjustment; and

*Step 3 – obtain (BOET<sub>t</sub>) inflation values*

4.8. Subject to paragraph 4.16, the inflation value is the 2% Bank of England CPI Target.

*Step 4 – calculate iBoxx Trailing Average (iBTA<sub>t</sub>)*

4.9. For each Regulatory Year, calculate the arithmetic average value of the DUI<sub>t</sub> using the periods shown in Table 1 from the variable values derived in steps 1 and 2.

4.10. The iBTA<sub>t</sub> derived above are rounded to two decimal places ie x.xx%.

**Table 1 – time periods for calculation of iBoxx Trailing Average (iBTA<sub>t</sub>) by Regulatory Year**

| <b><i>Regulatory Year</i></b> | <b><i>Time period for calculation</i></b> |
|-------------------------------|---|
| 2026/27                       | 31 October 2011 to 31 October 2025        |
| 2027/28                       | 31 October 2012 to 31 October 2026        |
| 2028/29                       | 31 October 2013 to 31 October 2027        |
| 2029/30                       | 31 October 2014 to 31 October 2028        |
| 2030/31                       | 31 October 2015 to 31 October 2029        |

4.11. The resulting averages, expressed as a percentage, constitute the iBTA<sub>t</sub> for each Regulatory Year.

*Step 5 - calculate the allowed return on fixed rate debt ( $KdFRD_t$ ) and the allowed return on index-linked debt ( $KdILD_t$ )*

4.12. The  $iBTA_t$  constitutes the  $KdFRD_t$  for each regulatory year.

4.13. The  $KdILD_t$  is calculated utilising the following formula for each regulatory year:

$$KdILD_t = \frac{(1 + KdFRD_t)}{(1 + BOET_t)} - 1$$

4.14. Ofgem will provide the licensee with a copy of the spreadsheet used to calculate revised  $iBTA_t$ ,  $KdFRD_t$  and  $KdILD_t$  values at the same time as giving the notice.

4.15. The data and spreadsheet used to calculate revised  $iBTA_t$  values will be published on the Ofgem Website (by 31 January in each Regulatory Year, or as soon as reasonably practicable thereafter).

### **Non-availability or changes to basis of data for cost of debt**

4.16. If, for any reason, the iBoxx, or Bank of England CPI target ceases to be published, or if Ofgem believes there is a material change in their basis, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements. To facilitate licensees using the RIIO-GD3 PCFM prior to the completion of the consultation, Ofgem may direct the use of an interim approach. Any such interim approach for a given Regulatory Year will be revised following a decision on the alternative data.

4.17. If, for reasons other than stated in paragraph 4.16, iBoxx data (paragraph 4.6) are unavailable for a period of time such that an update cannot include days up to and including 31 October in the year in which the update is being made, then a forecast will be used with the same methodology described in paragraph 4.6 (b) with outturn data available at the time. If the data concerned is subsequently published, revised variable values for the affected Regulatory Years will be calculated at the next update.

### **Cost of equity – risk-free rate**

4.18. The  $RFRT$  is calculated annually to be the 1-month (October, daily) arithmetic average of 20-year index linked gilt (ILG) yields, plus an inflation wedge. The average October index

linked gilt yields should be calculated each November. The inflation wedge is calculated once before the start of the price control period and remains constant through it. The inflation wedge should be calculated in the November prior to the start of the price control period.

## Methodology

4.19. The methodology to update the PCFM Variable Value RFRt is as follows.

*Step 1 obtain the average index linked gilt yield for the month of October each year*

4.20. The RFRt for each year of the price control is based on the 1-month arithmetic average (October) of the 20-year index linked gilt (ILG) yield.

4.21. The yields of the 20-year index linked gilts can be found from the yield curves page of the Bank of England's statistics website.<sup>8</sup>

*Step 2 derive an RPI-CPIH inflation wedge*

4.1. Index linked gilts are RPI-real instruments. To use ILGs as a proxy for the RFR we must adjust yields to CPIH-real terms by estimating the difference between future CPIH and RPI inflation. This is what is known as the inflation wedge.

4.2. Estimating the CPIH-RPI wedge is complicated by the fact that the calculation of RPI will be brought into line with the calculation of CPIH from February 2030, at which point CPIH and RPI inflation rates will be identical.

4.3. The inflation wedge is calculated assessing official forecasts of CPI and RPI out to a period up to the point of convergence of RPI and CPIH (assumed to be February 2030) and a zero wedge for the period from the point of convergence to the maturity of the ILG being measured. Note we assume CPI is a proxy for CPIH.

4.4. The calculation of the inflation wedge is based on the 20-year geometric average wedge over the 20-year tenor of the index linked gilt. To do this, we take the medium-

---

<sup>8</sup> Sourced from the yield curves page of the Bank of England's website:  
<https://www.bankofengland.co.uk/statistics/yield-curves>

term OBR forecasts for RPI and CPI for each year that are available in the November preceding the start of the price control period.<sup>9</sup>

4.5. The OBR inflation data is presented in calendar year form. The price control is based on financial years. We adjust the OBR data to reflect this. For example, for price control year 2026/2027, we take 9/12 of the OBR 2026 inflation estimates and add 3/12 of the OBR 2027 inflation estimates.

4.6. To account for the convergence of RPI and CPIH (assumed to be February 2030) for 2029/2030 we take 92% of a long run RPI assumption (we assume 2.9% based on a forward 0.80% forward looking CPI-RPI wedge) and 8% of a long run CPIH (assume 2.0%) to generate an RPI forecast of 2.83%. This assumes that for April 2028 to March 2030 (all months used in the calculation of the fiscal year average change) twenty-two out of twenty-four months are using the old RPI definition.

4.7. For 2030/2031 we take 42% of the long run RPI assumption and 58% of the of the long run CPIH assumption to obtain an RPI forecast of 2.43%. As above, this assumes ten of the twenty-four months between April 2029 and March 2031 use the old RPI definition.

4.8. For financial years 2031/2032 and beyond we assume both RPI and CPIH are equal to 2.0% and the wedge is effectively zero.

#### *Step 3 calculate the annual RFRT*

4.9. To calculate the RFRT each November add the October average of the index-linked gilt yield to the inflation wedge.

#### **Vanilla WACC**

4.10. The PCFM will use the value of RFRT to calculate the allowed return in equity in accordance with the following formula:

---

<sup>9</sup> Sourced from the data page of the OBR website: <https://obr.co.uk/download/historical-Official-forecasts-database/>



$$ARoEt = RFRT + \text{equity beta} \times (TMR - RFRT)$$

4.11. The vanilla WACC will then be derived in accordance with the following formula:

$$WACCt = iBTAt \times g \times ARoEt \times (1 - g)$$

### **Semi-nominal WACC**

4.12. The semi-nominal WACC is calculated using the real cost of equity allowance and the semi-nominal cost of debt allowance. The semi-nominal cost of debt allowance is calculated using the proportions of index linked debt and fixed rate debt for each sector. The ILD proportion for gas is 30% and for ET companies is 10%.

### **Provision and publication of the WACC Rates model**

4.13. Ofgem will provide licensees a model containing the methodology to derive (and forecast) the PCFM Variable Value RFRT and iBTAt ("the WACC Rates Model").

4.14. Ofgem will update the WACC allowances and provide a copy of the updated model containing the values to the licensee by no later than 30 November in each Regulatory Year.

4.15. Where Ofgem has not provide an updated copy of the WACC Rates model by 30 November, the licensee will perform the above updates itself.

4.16. The data and the spreadsheet used to calculate the revised RFRT and iBTAt value will be published on the Authority's website, subsequent to the publication of the PCFM in accordance with paragraph 2.1.5 of Special Condition 2.1.

| <b><i>Regulatory Year</i></b> | <b><i>Time period for calculation</i></b> |
|-------------------------------|---|
| 2022/23                       | 01 October 2021 to 31 October 2021        |
| 2023/24                       | 01 October 2022 to 31 October 2022        |
| 2024/25                       | 01 October 2023 to 31 October 2023        |

|         |                                       |
|---------|---------------------------------------|
| 2025/26 | 01 October 2024 to 31 October<br>2024 |
|---------|---------------------------------------|

## 5. Real Price Effects

5.1. The RIIO-GD3 price control includes an allowance for differences between the Price Index applied to  $AR_t$  and certain input price indices. We refer to these differences as Real Price Effects.

5.2. The Variable Value  $RPE_t$ , expressed as a percentage and identifies annual differences between the price control inflation and input price indices inflation.

5.3. The Variable Value  $RPE_t$  is used in the RIIO-3 PCFM to derive the RPE Index ( $RPEI_t$ ) applied to certain totex allowances (in 2023/24 price terms) to allow for Real Price Effects. The totex allowances to which  $RPEI_t$  applies are identified in the PCFM and the calculation of the allowance for Real Price Effects is done within the PCFM.

5.4. In updating the values of  $RPE_t$ , the licensee must follow the process set out under the heading "Methodology for forecast values" in this chapter.

### Formula for calculating the Real Price Effects ( $RPE_t$ ) term

5.5. The value of  $RPE_t$  is derived in accordance with the following formula::

$$RPE_t = \sum_{j=1}^{10} W_j \left( \left( \frac{IP_{j,t}}{IP_{j,t-1}} \right) / \left( \frac{PI_t}{PI_{t-1}} \right) - 1 \right)$$

where,

$W_j$  means the weight applied to the input price index  $j$ , which is fixed for the price control period and takes the value in Table 5.1

$IP_{j,t}$  means the arithmetic average of the input price index  $j$  between each of the monthly periods from 1 April to 31 March in Regulatory Year  $t$

$PI_t$  means the Price Index derived in accordance with Part F of Special Condition 2.1 (Revenue Restriction)

5.6. The input price indices ( $IP_j$ ), their weightings ( $W_j$ ) in the calculation of  $RPE_t$ , and the sources of out-turn values are in Table 5.1 below. The values presented in Table 5.1 are

rounded, but Ofgem will use unrounded inputs to update the RPE model in accordance with paragraph [5.19].

**Table 5.1 – Input prices indices and weightings**

| <i>j</i>  | Identifier | Index Description  | Source                 | (A)<br>Index<br>weight<br>within<br>cost<br>category | (B) Cost<br>category<br>weight | (A)x(B)<br>Index<br>weight<br>(W <sub>j</sub> ) |
|-----------|------------|--|------------------------|--|--------------------------------|---|
|           |            | <b>Labour</b>  |                        |  |                                |   |
| <b>1</b>  | K54V       | AWE: Private Sector Index: Seasonally Adjusted Total Pay Excluding Arrears | ONS                    | [XX%]  | [XX%]                          | [XX%]   |
| <b>2</b>  | K553       | AWE: Construction Index: Seasonally Adjusted Total Pay Excluding Arrears   | ONS                    | [XX%]  | [XX%]                          | [XX%]   |
| <b>3</b>  | BEAMA      | Electrical engineering labour  | BEAMA                  | [XX%]  | [XX%]                          | [XX%]   |
| <b>4</b>  | 4/CE/01    | 4/CE/01 Civil Engineering Labour   | PAFI published by BCIS | [XX%]  | [XX%]                          | [XX%]   |
| <b>5</b>  | 4/CE/EL/01 | 4/CE/EL/01 Electrical Engineering Labour                                   | PAFI published by BCIS | [XX%]  | [XX%]                          | [XX%]   |
|           |            | <b>Materials</b>   |                        |  |                                |   |
|           | 4/CE/24    | 4/CE/24 Plastic Products (including pipes)                                 | PAFI published by BCIS | [XX%]  | [XX%]                          | [XX%]   |
|           | 3/S3       | 3/S3 Structural Steelwork - Materials: Civil Engineering Work              | PAFI published by BCIS | [XX%]  | [XX%]                          | [XX%]   |
|           | 4/CE/EL/02 | 4/CE/EL/02 Electrical Engineering Materials                                | PAFI published by BCIS | [XX%]  | [XX%]                          | [XX%]   |
|           | FOCOS      | FOCOS Resource Cost Index of Infrastructure: Materials FOCOS               | BCIS                   | [XX%]  | [XX%]                          | [XX%]   |
| <b>10</b> | 3/58       | 3/58 Pipes and Accessories: Copper   |                        | [XX%]  | [XX%]                          | [XX%]   |
| <b>11</b> | 4/CE/25    | 4/CE/25 Aluminium Products   |                        | [XX%]  | [XX%]                          | [XX%]   |
| <b>12</b> | 4/CE/26    | 4/CE/26 Metal Structures   |                        | [XX%]  | [XX%]                          | [XX%]   |
| <b>13</b> | 90/12      | 90/12 Timber   |                        | [XX%]  | [XX%]                          | [XX%]   |
| <b>14</b> | NOCOS      | NOCOS Resource Cost Index of Building Non- housing: Materials NOCOS        |                        | [XX%]  | [XX%]                          | [XX%]   |

|           |         |   |  |       |       |       |
|-----------|---------|---|--|-------|-------|-------|
| <b>15</b> | COPI    | Construction Output Price Indices (COPI)                          |  | [XX%] | [XX%] | [XX%] |
|           |         | <b>Plant and Equipment</b>  |  |       |       |       |
| <b>16</b> | 70/ 2   | 70/ 2 Plant and Road Vehicles: Providing and Maintaining          |  | [XX%] | [XX%] | [XX%] |
|           |         |   |  |       |       |       |
| <b>17</b> | C28     | C28 Machinery and Equipment                                       |  | [XX%] | [XX%] | [XX%] |
| <b>18</b> | 4/CE/04 | Purchased Plant Including depreciation and maintenance (4/CE/04)  |  | [XX%] | [XX%] | [XX%] |
| <b>19</b> | 90/2    | 90/2 Plant and Road Vehicles Operatives and fuel are not included |  | [XX%] | [XX%] | [XX%] |

\*values are rounded, unrounded values are in the corresponding workbook

### Formulae for calculating the Real Price Effects Index ( $RPEI_t$ ) and RPE totex allowance ( $RPEA_t$ )

5.7. The  $RPEI_t$  values are used in the PCFM to derive the RPE indexation term  $RPEI_t$  as follows:

$$RPEI_t = \prod_{i=2025/26}^t (1 + RPE_i)$$

5.8. The total RPE totex allowance ( $RPEA_t$ ) is determined applying  $RPEI_t$  to the applicable totex allowance:

$$RPEA_t = (RPEI_t - 1) \cdot Tx_t$$

where,

$Tx_t$  means the Totex allowance for the Regulatory Year t to which RPE indexation applies. The applicable totex is identified in the PCFM.

5.9. The PCFM will allocate the RPEA values to appropriate capitalisation rate buckets based on the capitalisation rate of the totex allowance the RPE was applied to.

### Restatement of outturn values

5.10. The providers of the indices listed in Table 5.1 may, from time to time, restate or re-estimate the outturn historical values. These restated values will be used to recalculate RPE<sub>t</sub>.

### Methodology for forecast values

5.11. The values of RPE<sub>t</sub> will be updated annually.

5.12. In calculating input price indices  $IP_{j,t}$  Ofgem will update for outturn data that is available after 31 October, and provide an updated RPE model to licensees no later than 30 November, or earlier if the relevant OBR data is available before this date.. This will include updating values in Regulatory Years where a forecast was previously used. For the years where outturn values are not available then a forecast will be derived in accordance with the following sections.

- a) For labour indices, outturn data will be updated to month of June, and forecast monthly values will use a monthly growth rate calculated from the most recent average earnings forecast published by OBR<sup>10</sup> applied to the previous value:

$$IP_m = IP_{m-1} \cdot (1 + OBREF_m)^{\frac{1}{12}}$$

where,

|                    |   |
|--------------------|---|
| IP <sub>m</sub>    | is the labour input price index value for a given year-month "m".   |
| OBREF <sub>m</sub> | Means the OBR average earnings forecast (annual rate) applicable to year-month m, where the OBR forecast for a calendar year is applicable from 6 months prior to the start of that calendar year, to six months after (eg the 2026 OBR forecast would be applicable from July 2025 to June 2026). If the forecast year-month falls after the range covered by OBR forecasts, the longest dated forecast year is used (eg if the November OBR forecast covered 2025-2029, then the forecast for year 2024 would be used for 2030 and 2031). |

- b) In all other cases, forecasts will be based on applying the long-term annual average growth assumptions:

$$IP_m = IP_{m-1} \cdot (1 + LTAG_m)^{\frac{1}{12}}$$

<sup>10</sup> Sourced from the data page of the OBR website: <https://obr.uk/download/historical-Official-forecasts-database/>

where,

|          |  |
|----------|--|
| $IP_m$   | is the labour input price index value for a given year-month “m”.  |
| $LTAG_m$ | has the long term average annual growth assumption applicable to that input prices index, given in the list below: <ul style="list-style-type: none"> <li>•</li> </ul> |

### **Obligation to ensure alignment of the price index $PI_t$**

5.13. The licensee will ensure that the values of  $PI_t$  contained in the model which the licensee publishes under paragraph [2.1.5] of Special Condition 2.1 are used to derive the value of  $RPE_t$  in the same model.

### **Provision and publication of $RPE_t$ values**

5.14. Ofgem will perform the above updates to the spreadsheet used to calculate the  $RPEI_t$  values and will provide the licensee with a copy of that spreadsheet no later than 30 November. Licensees will use the values distributed by Ofgem.

5.15. Where Ofgem has not provided an updated copy of the spreadsheet used to update the  $RPEI_t$  values by 30 November, the licensee should use the previous Regulatory Year’s  $RPEI_t$  values for its tariff-setting process, unless an alternative interim approach is agreed with Ofgem.

### **Non-availability of data**

If, for any reason, the price indices used in calculating  $RPE_t$  cease to be published, or if Ofgem believes there is a material change in their basis, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements. To facilitate licensees using the GD3 PCFM prior to the completion of the consultation, Ofgem may direct the use of an interim approach. Any such interim approach for a given Regulatory Year will be revised following a decision on the alternative data.

## 6. Tax liability allowances

6.1. The PCFM calculates a licensee's tax liability allowance on a notional basis (ie as an efficient stand-alone entity) using, among other inputs, corporation tax rates and capital allowance writing down rates.

6.2. A notional basis means the model calculates, on a simplified basis<sup>11</sup>, the tax allowance of a notional company, which is a stand-alone UK tax resident limited company, and therefore does not consider the impact of group based mechanisms such as group or consortium relief. The notional company is efficient, meaning that it claims all the tax reliefs legitimately available to it within the model, and claims capital allowances in full at the highest rates available to it. The notional allowance approach helps to ensure that consumers do not bear the cost of inefficient tax behaviour.

6.3. The notional efficient company is treated as being unaffected by the corporate interest restriction, as the public benefit infrastructure exemption would be expected to apply, and as a standalone company, with fully external debt, the group ratio rule would result in no interest being disallowed.

6.4. The notional approach to tax liability allowances means that there will be differences between the tax liability allowance and the licensees' actual corporation tax liability in any given regulatory year.

6.5. Where corporation tax and capital allowance rate changes are announced, these must be reflected in the PCFM by updating the variable values for these rates ( $CT_t$ ,  $GCA_t$ ,  $SRCA_t$ ,  $SBCA_t$  and  $DRCA_t$ ) at each AIP.

6.6. The RIIO-GD3 PCFM also calculates a tax clawback adjustment. Where a licensee's gearing (calculated using the Adjusted Net Debt Variable Value ( $AND_t$ ) and the closing RAV position uplifted to year-end nominal prices in the PCFM) is greater than the notional gearing level and where its Tax deductible net interest costs ( $TDNI_t$ ) exceed the notional modelled

---

<sup>11</sup> Meaning the material drivers of the tax charge are included within the calculation, but not all adjusting items present in a licensee's corporate tax return may be captured.



interest costs, the tax benefit derived from its higher tax-deductible interest costs is clawed back and shared with consumers through the RIIO-GD3 PCFM.<sup>12</sup>

6.7. Tax liability allowances are also dependent on other variable values including:

- a) Tax trigger events (TTE) - a licensee's notional tax liability<sup>13</sup> is subject to changes in existing legislation, case law, accounting standards and HM Revenue & Customs (HMRC) policy. Changes to these can trigger a change to tax liability allowances.
- b) Tax allowance adjustment mechanism ( $TAXA_t$ ) – this mechanism enables Ofgem to direct an adjustment to the Calculated Tax Allowance subject to a tax review and having consulted with the licensee.
- c) Regulatory Capital Allowances: Opening pool balances (legacy) -opening balances of capital allowance pools can be revised by licensees with approval from Ofgem, through variable values ( $OGPt$ ,  $OSRPt$ ,  $OSBPt$ ,  $LODRPt$  and  $ODRPt$ ). These balances will be rolled forward from the closing position in the RIIO-GD2 PCFM following the close-out of the RIIO-GD2 Price Control;
- d) Capital allowances: allocation rates – the PCFM contains the rates that are used to allocate totex to each of the modelled capital allowance pools. These can be revised through variable values ( $ARGPt$ ,  $ARSRt$ ,  $ARSBt$ ,  $ARDRt$ ,  $ARRt$ ,  $ARNQt$ ); and
- e) Tax loss brought forward ( $OTL_t$ ) – this represents the opening tax loss balance, which will be rolled forward from the closing position in the RIIO-GD2 PCFM following the close-out of the RIIO-GD2 Price Control.

6.8. All of these tax related PCFM Variable Values (with the exception of the Tax Allowance adjustment term,  $TAXA_t$ ) feed into the Tax Allowance term ( $TAX_t$ ). Both the  $TAX_t$  and  $TAXA_t$  terms feed into Calculated Revenue ( $R_t$ ) as set out in Special Condition 2.1 (*Revenue restriction*).

6.9. The approach to determining or revising the variable values in paragraph 6.7 and/or the calculation in the PCFM are described, further below.

---

<sup>12</sup> The tax clawback is calculated after the impact of any changes in corporation tax is taken into account.

<sup>13</sup> The tax liability which would be modelled if the event was taken into account.

6.10. It should be noted that underlying tax liability allowances for the licensee within the PCFM may also change under the AIP as a consequence of other variable values, such as changes in allowed totex. However, these changes are distinct from the specific adjustments to tax liability allowances discussed in this chapter.

6.11. Any recalculation of the licensee's tax liability allowances necessarily includes an iterative modelling aspect: an increased allowance gives rise to an increased liability which requires an increased allowance and so on. The effect can be either positive or negative. This 'tax allowance on tax allowance' issue is dealt with by the functionality within the PCFM and is factored into Calculated Revenue ( $R_t$ ) via the AIP.

#### *Regulatory tax losses*

6.12. There have been significant changes to the capital allowances regime during the previous price control, including the permanent inclusion of full expensing and first year allowances for special rate and long-life expenditure. The effect of these changes, combined with increased capital expenditure by licensees, will significantly reduce tax liability allowances. In some instances, the approach to calculating tax liability allowances could imply that the licensee could receive a negative allowance. In some instances, the approach to calculating tax liability allowances could imply that the licensee could receive a negative allowance. In such cases, the price control treatment is to model a zero allowance and to record the tax loss arising as a 'regulatory tax loss' balance, to be deducted from the total taxable profits before the tax is calculated for any tax liability allowances that would otherwise be allocated to the Regulatory Year concerned or later Regulatory Years. The regulatory tax loss balance attributable to each Regulatory Year (together with a running total) is held within the PCFM.

6.13. As noted at 6.4 above, there are likely to be differences between the notional tax allowance, and the licensees' actual tax liability, this means that regulatory tax losses are likely to differ from any actual tax losses arising within the licensee's actual corporate tax return.

6.14. For the avoidance of doubt, regulatory tax losses are not carried back and offset against tax liability allowances for Regulatory Years earlier than the Regulatory Year to which the regulatory tax loss concerned is attributable.

6.15. Any surrender by a licensee of losses to a group company will not be reflected within the regulatory loss balance and similarly for consortium relief.<sup>14</sup> Any such surrenders of group or consortium losses will therefore result in a difference between future tax liability allowances and the actual future corporate tax liability of the licensee.

6.16. Losses are carried forward within the model, and are utilised on a carried forward basis using the statutory rules for trading losses<sup>15</sup>. At the outset of the price control these rules, as enacted, requires loss utilisation above a £5m deminimis on a group-wide basis to be limited to 50% of the profit in excess of £5m. As tax liability allowances are calculated on a notional basis, a £5m deminimis is treated as being available to each licensee. Adjustments to loss pools as a result of Tax Trigger Events will be subject to the deminimis and restriction. Adjustments to loss pools as a result of Tax Clawback shall not be subject to the restriction.

#### *Group tax arrangements*

6.17. For the purposes of the approach set out in the tax trigger event and tax review sections of this chapter, tax liabilities, allowances and trigger events are considered on a notional 'licensee business' basis. Consequently, the following are disregarded in the assessment of tax liabilities and allowances for price control purposes:

- a) the claim or surrender of group tax relief (including consortium relief);
- b) interest payments (including any coupons on debt instruments or preference share dividends) and receipts that are not tax deductible or chargeable under HMRC rules for the purposes of computing the licensee's taxable profits, including but not limited to adjustments for transfer pricing and the 'Corporate Interest Restriction Rules'; and
- c) any other adjustments required in paragraph 6.65.

6.18. For the purposes of the approach set out in the tax clawback section of this chapter, levels of debt, interest and gearing are considered at licensee level, as opposed to any other level with respect to the corporate or ownership group of which the licensee is a member.

#### *Accounting framework*

---

<sup>14</sup> <https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm80530>

<sup>15</sup> [HMRC manual - CTM05000](#)

6.19. For the purposes of the approach set out in the tax trigger event and tax review sections of this chapter, the accounting framework to be applied by the licensee for the purpose of computing tax liabilities is either:

- a) EU-IFRS, if adopted for use by the licensee;<sup>16</sup>
- b) Financial Reporting Standard 101, EU adopted IFRS with reduced disclosures; or
- c) UK GAAP under Financial Reporting Standard 102.

#### *Updating PCFM Variable values*

**6.20.** When updating its PCFM Variable Values under paragraphs 2.23 – 2.24 of this Handbook, the licensee must ensure that all tax-related values have been updated in a manner that reflects the behaviour of a notional efficient company.

6.21. Statutory capital allowance rates for general and special rate pool expenditure are significantly higher than at the start of the RIIO-2 price control period, as a result of the introduction of permanent 'full-expensing' and first year allowances, which are expected to remain in place throughout the price control period. As a result differences between forecast capital allowance allocation rates and actual eligible spend could result in increased divergence between notional and actual tax pools. Within the RIIO-3 price control licensees will be able to amend tax pool allocation variable values for both future and prior periods within the price control. This will limit divergence and the impact of such amendments will be reflected in Allowed Revenue to ensure parity.

## **Tax trigger events**

6.22. The PCFM allows for changes to a licensee's tax liability allowance, through TTE, for factors exogenous to the licensee, its owners or controllers that cause a change in its notional tax liabilities<sup>17</sup> for one or more Regulatory Years. These factors exclude changes to the corporation tax rate and writing down allowance rates, which are accounted for with the variable values ( $CT_t$ ,  $GCA_t$ ,  $SRCA_t$ ,  $SBCA_t$  and  $DRCA_t$ ), but include:

---

<sup>16</sup> Including the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) where applicable.

<sup>17</sup> The tax liability, which would be modelled if the event were taken into account.

- a) changes to applicable legislation;
- b) the setting of legal precedents through case law;
- c) changes to HMRC interpretation of legislation; and
- d) changes in accounting standards.

*Notification of tax trigger events*

6.23. The licensee must notify Ofgem on or before 30 September in each Regulatory Year t-1 of all the tax trigger events that it has become aware of by that time, except those that have been previously notified. This requirement applies equally to events that could be expected to increase or to reduce the licensee's tax liability allowances. For the purpose of complying with this requirement, the licensee must seek to ensure that it identifies and records tax trigger events.

6.24. If the licensee fails to notify Ofgem of any tax trigger events of which it becomes aware, or should be aware, then subject to the licensee demonstrating that it uses reasonable endeavours to identify all tax trigger events this may not be considered a breach of the licence conditions. We will consider each event on its merits on a case-by-case basis.

6.25. The notification, in respect of each tax trigger event should include:

- a) a description of the tax trigger event;
- b) the changes in tax liability allowances that the tax trigger event is considered to have caused and the Regulatory Years to which they relate;
- c) the calculations (including all relevant parameters and values) that the licensee used to arrive at the amounts referred to in subparagraph (b) – in performing these calculations the licensee should include a 'tax allowance on tax allowance' factor as explained in paragraph 6.11 but should ignore the tax trigger deadband;
- d) any relevant information provided by HMRC in relation to the tax trigger event;
- e) evidence of mitigating measures that the licensee has taken to minimise any additional liabilities arising from the event; and
- f) comments from the licensee on:
  - i. the relevance of the tax trigger event to its tax position,
  - ii. whether grounds exist to contest the applicability of the tax trigger event to the licensee, and

- iii. the reporting treatment the licensee expects to apply in its tax submissions to HMRC and in its Regulatory Accounts or statutory accounts where Regulatory Accounts are not prepared.

6.26. The licensee's notification should also state whether it considers that the materiality threshold (see paragraph 6.35) has been exceeded for the Regulatory Year(s) concerned, taking into account the total net amount of tax liability changes (upward and downward) included in the current notification and any previous notifications.

6.27. Ofgem will review any notifications given to it by the licensee under paragraph 6.23 and may ask the licensee:

- a) for additional information in respect of one or more of the notified events; and/or
- b) to submit the results of agreed upon audit procedures specified by Ofgem and carried out by the licensee's Appropriate Auditor, to assist in confirming the appropriateness and accuracy of the licensee's calculations.

6.28. Ofgem will by 05 December in the same Regulatory Year t-1 inform the licensee whether, in respect of each tax trigger event, it has:

- a) agreed (on a provisional or confirmed basis) the change in tax liabilities figure calculated by the licensee;
- b) determined (on a provisional or confirmed basis) a different change in tax liabilities figure from that calculated by the licensee; or
- c) decided that consideration of any change in tax liabilities should be deferred until further/better information is available.

6.29. In deciding which of the actions set out in paragraph 6.28 should be taken, Ofgem will, consider whether the licensee has conclusively agreed its tax liabilities for the Regulatory Year concerned with HMRC. Where there has been a provisional agreement/determination or a deferral of consideration, the TTE values concerned will be subject to further revision in a later Regulatory Year.

6.30. Where Ofgem decides to use a different change in the tax liabilities figure from that calculated by the licensee or decides that consideration of any change in tax liabilities should be deferred, it will set out its reasons and/or calculations. The licensee has the right to reply setting out its objections, which Ofgem will consider.

6.31. Ofgem will also notify the licensee by 05 December in each Regulatory Year t-1 of any tax trigger events that it proposes to take into account that have not been included in a notification sent to Ofgem by the licensee. The licensee has the right to reply setting out its objections, which Ofgem will consider.

6.32. If Ofgem has not finished considering any matters raised by the licensee under paragraph 6.30 or paragraph 6.31 before notifying the licensee of tax trigger events that it proposed to take into account, the Authority will through business correspondence, apprise the licensee of any provisionality it has applied in determining the revised TTE values that it proposes to apply, that might entail a further revision to those values for use in the next Regulatory Year.

6.33. Where a tax trigger event changes the allocation of allowable expenditure into different statutory capital allowance pools, the applicable allocation and allowance rates will be adjusted to take into account the new expected allocation basis from the effective date of the new requirement. Ofgem will work with licensees to agree the financial effect of revised tax pool allocation requirements where these are not straightforward.

6.34. Some tax trigger events will impact all licensees in the sector, particularly changes to the capital allowances regime which, for example, create new types of capital allowance pools<sup>18</sup>. In these circumstances Ofgem will, taking into account the views of licensees, decide whether it is more appropriate to use the tax trigger event described in paragraphs 6.20 to 6.31 above, or to update the price control financial model to accommodate the required calculations in line with the processes described in Chapter 2 of this document

#### *Materiality threshold and 'deadband'*

6.35. A materiality threshold is applied to tax trigger events during the Price Control Period and a £m threshold amount for each Regulatory Year is included among the tax trigger deadband values on the 'Finance & tax' worksheet (Tax trigger calculations section) for the licensee in the PCFM.

---

<sup>18</sup> An example of this would be the introduction of Structures and Building Allowances in [Finance Act 2019](#)

6.36. A change to the licensee's notional tax liability allowance for a particular Regulatory Year is only applied where one or more trigger events would result in a tax liability allowance change for that Regulatory Year whose absolute value is greater than the threshold amount. Furthermore, any change to the tax liability allowance (upward or downward) is limited to the amount that is in excess of the threshold amount for the Regulatory Year concerned. Additionally, tax trigger events will only be taken into account for the purposes of increasing the licensee's tax liability allowances where the licensee has demonstrably used its reasonable endeavours to minimise any increase in its tax liabilities.

6.37. Where the change to the licensee's tax liability allowance for a particular Regulatory Year is below the threshold, subsequent tax trigger events, relating back to that Regulatory Year, could cause the threshold amount to be exceeded. In that case, a change to the licensee's tax liability allowance for the Regulatory Year concerned (a revised TTE value) would be determined once the threshold had been exceeded.

6.38. For the avoidance of doubt, a regulatory tax loss figure attributable to a particular Regulatory Year is not taken into account for the purposes of deciding whether the threshold amount has been exceeded for that Regulatory Year.

#### *Logging of trigger events*

6.39. Ofgem will keep a log of tax trigger events that have been subject to notifications by it or by the licensee showing for each tax trigger event:

- a) a description of the event;
- b) the name of the party who notified the event (Ofgem or licensee);
- c) the date of notification;
- d) the amount of any change in the licensee's tax liabilities that has been determined;  
and
- e) details of any tax trigger events for which a determination is in abeyance and a description of the outstanding actions to be taken.

## **Tax review**

6.40. Special Condition 2.2 (Tax allowance adjustment) sets out that the Authority will direct any value of  $TAXA_t$  that it considers should be made after a tax review.



6.41. At the outset of the Price Control Period on 01 April 2026, the value of  $TAXA_t$  is set at zero for the duration of the Price Control Period. Under Special Condition 2.2, Part A the licensee's Calculated Tax Allowance can be updated for any periods on or after 1 April 2026 following a tax review. The Authority may consider initiating a tax review if one or more of the events described below occurs.

*Potential tax review trigger events*

6.42. The Authority may consider triggering a tax review for the relevant licensee(s) in the following scenarios:

- a) if there are material, unexplained differences between the Calculated Tax Allowance and Actual Corporation Tax Liability, which have not been adequately explained in the supporting commentary to the reconciliation<sup>19</sup>;
- b) A material unexplained variance as per section a) would have arisen, but has been prevented from arising due to the licensee inputting Tax Related Variable Values, which Ofgem consider may not represent the values which would be used by a notional efficient company;
- c) if Ofgem is notified in writing by a licensee or stakeholder of any event that the licensee or stakeholder considers will have a material, unexplained impact on the differences between the licensee's Calculated Tax Allowance and its Actual Corporation Tax Liability; or
- d) if a licensee undergoes a material change in circumstances e.g. a change in ownership that is likely to result in a material, unexplained impact on the differences between the licensee's Calculated Tax Allowance and its Actual Corporation Tax Liability.

*Materiality*

6.43. Under paragraph 6.42, an unexplained difference between the Calculated Tax Allowance and Actual Corporation Tax Liability will be subject to the same materiality threshold that is applied to tax trigger events during the Price Control Period as described in

---

<sup>19</sup> The reconciliation referred to is the Tax Reconciliation template reconciling the notional tax allowance per the RIIO-GD2 PCFM and actual tax liability per their latest CT600 forms. This template forms part of the licensee's annual RIIO-GD2 PCFM submissions.

paragraph 6.26 of this handbook. For the avoidance of doubt, an unexplained difference is considered material if it exceeds the threshold described.

6.44. Where there are numerous unexplained differences in the submitted Tax Reconciliation, which are individually immaterial but when taken in aggregate are greater than the materiality threshold amount, the licensee is required to provide supporting explanation(s) in the commentary to the Tax Reconciliation as per the RIIO-2 Regulatory Financial Performance Reporting Regulatory Instructions and Guidance.

#### *Notifying the Authority*

6.45. Any notification by the licensee under paragraph 6.42b must be made in writing to the Authority on or before 30 September in respect of the Regulatory Year two years prior and include statements setting out:

- a) the reason for the notification including a description of the specific event(s) that the licensee considers will have an impact on its Actual Corporation Tax Liability;
- b) the impact of the specific event(s) on differences between the licensee's Calculated Tax Allowance and its Actual Corporation Tax Liability and whether it is considered material;
- c) the Regulatory Year(s) that the licensee considers will be affected by the tax review trigger event;
- d) a calculation and the basis of the calculation for any proposed adjustments to the value of the TAXA<sub>t</sub> term; and
- e) supporting evidence including any relevant information or correspondence received from HMRC and any other information that the licensee considers is relevant.

6.46. Any notification by other stakeholders under paragraph 6.33(b) must be made in writing to the Authority on or before 30 September in respect of the Regulatory Year two years prior and must include as much information as is available to the stakeholder in line with the criteria set out in paragraph 6.36. Where there are gaps in the information provided by the relevant stakeholder, Ofgem will engage with the applicable licensee to ascertain whether the licensee itself should submit a notification under paragraph 6.33b).

6.47. Where Ofgem receives a notification from any stakeholder after 31 July in any Regulatory Year and an adjustment is made following the process outlined in paragraphs 6.39 to 6.47, that adjustment will be made in the subsequent Regulatory Year following the

direction of the  $TAXA_t$  term. In such a case, the functionality of the PCFM means that a Time Value of Money Adjustment will be applied.

6.48. If an adjustment is made to the  $TAXA_t$  term for a period prior to the Regulatory Year in which the tax review is triggered, any resultant changes to Allowed Revenue will, subject to a Time Value of Money Adjustment, be brought forward. For the avoidance of doubt such an adjustment will not have any retrospective effect on a previously published value of Allowed Revenue.

#### *Preliminary assessment*

6.49. Where one or more of the tax review trigger events under paragraph 6.42 occur, Ofgem will perform a preliminary assessment before deciding whether to undertake a formal tax review, or direct a  $TAXA_t$  adjustment based on the preliminary assessment.

6.50. This preliminary assessment may involve the Authority requesting further information from the affected licensee(s) and from the stakeholder who submitted the notification under 6.33(b) and explaining it is considering undertaking a tax review.

6.51. In certain circumstances it may become clear, during the preliminary assessment that an adjustment to the value of the  $TAXA_t$  term is required based on the evidence provided to Ofgem.

6.52. In such circumstances it should not be necessary to appoint an Appropriately Qualified Independent Expert to undertake a formal tax review, as this would result in extra cost and increase the time taken to arrive at the appropriate  $TAXA_t$  adjustment. Ofgem will notify the licensee that it considers an adjustment to be required and explain why it is not necessary to appoint an AQIE, and shall request representations from the licensee. Ofgem will confirm the value of this adjustment to the licensee.

6.53. Where 6.51 applies, the Authority will direct that an adjustment be made to correct for the effect of the confirmed material, unexplained difference. The Authority will make a direction adjusting the tax allowance through the variable value  $TAXA_t$  in accordance with Part B of Special Condition 2.2 (Tax allowance adjustment).

6.54. Before making a direction, the Authority will consult on the proposed adjustment to the  $TAXA_t$  for no less than 28 days. The licensee shall, during this period, also be able to request

that Ofgem undertake a formal tax review and appoint an Appropriately Qualified Independent Examiner.

#### *Tax review process*

6.55. If the preliminary information requested does not suitably address the concerns raised, and if Ofgem considers that it is unclear whether a TAXAt adjustment is required, or the value of the adjustment cannot be readily ascertained, Ofgem may undertake a formal tax review, for which it will procure a review by an Appropriately Qualified Independent Examiner.

6.56. Ofgem will notify the licensee or licensees affected in accordance with Part A of Special Condition 2.2 (Tax allowance adjustment) that it intends to commence the tax review.

6.57. Throughout the course of the tax review, the licensee will have opportunities to comment on the Appropriately Qualified Independent Examiner's findings and engage with both the examiner and Ofgem before the final report is submitted by the examiner to Ofgem. Ofgem shall communicate the examiner's findings to the licensee within 10 working days of receipt of the examiner's report.

#### *After the review*

6.58. Following the tax review, the Authority will consider the findings of the Appropriately Qualified Independent Examiner's report. Where the examiner's report confirms that a material, unexplained difference exists between the licensee's Calculated Tax Allowance and its Actual Corporation Tax Liability, the Authority will direct that an adjustment be made to correct for the effect of the confirmed material, unexplained difference. The authority will make a direction adjusting the tax allowance through the Variable Value TAXAt in accordance with Part B of Special Condition 2.2 (Tax allowance adjustment).

6.59. Before making a direction, the Authority will consult on the proposed adjustment to the TAXAt for no less than 28 days.

6.60. Where the Appropriately Qualified Independent Examiner's report contains information that is considered confidential or market sensitive, the licensee may request that this information be redacted from any publication. Information agreed in writing as being confidential by the Authority will be excluded from any publications.

6.61. The adjusted value will be reflected in the RIIO-GD3 PCFM and will be published on the Ofgem Website by 31 January in each Regulatory Year.

6.62. For the avoidance of doubt, there will be no duplication or double-counting of adjustments between the  $TAXA_t$  term and the other tax mechanisms that feed into the  $TAX_t$  term.

6.63. The costs of the Appropriately Qualified Independent Examiner shall be borne by Ofgem in the first instance and treated as normal operating costs. Where the conclusion of a tax review results in a  $TAXA_t$  adjustment, the cost of the tax review (being the fees of the Appropriately Qualified Independent Examiner, and any associated costs) shall be borne by the licensee. This shall be achieved by including the costs within the  $TAXA_t$  adjustment.

## Capital allowances

### *Opening pool balances (legacy)*

6.64. Tax liability allowance calculations under the AIP make use of regulatory tax pool balance figures held within the PCFM. The opening balances for these pools will be the closing balances from the RIIO GD2 PCFM. RIIO-GD2 dealt with First Year Allowances and Full-expensing using the Tax Trigger Event methodology. Adjustments to pool balances may be required in the opening period of RIIO-GD3 as a result. The opening balances (as at 01 April 2026) for these tax pools may be subject to legacy price control adjustments through revisions to ( $OGP_t$ ,  $OSRP_t$ ,  $OSBP_t$ ,  $LODRP_t$  and  $ODRP_t$ ) variable values.

## Definitions of Adjusted Net Debt and Tax Deductible Net Interest for the purposes of the Tax Clawback

6.65. Definitions of Adjusted Net Debt and Tax Deductible Net Interest have been revised to reflect changes in accounting standards and tax legislation since the clawback was first introduced. Revised definitions are detailed below:

### **Adjusted Net Debt**

*Adjusted Net Debt includes:*

- Cash at bank;

- Bank overdrafts;
- Short term investments;
- External borrowings (adjusted to reflect the ultimate liability in sterling resulting from any cross currency swaps relating to that debt instrument and excluding the impact of fair value adjustments and accrued interest);
- Cumulative accretion, net of paydown, associated with index linked derivatives.
- Equity accounted hybrid bonds;
- Inter-company borrowings;
- Short term loans to related parties (except where they have demonstrated the characteristics of being long term in nature, for example by repeated renewal); and
- Long term loans to related parties only where they can be justified as for the benefit of the regulated business and are not in the nature of a distribution.

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

*Adjusted Net Debt excludes:*

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

**Tax Deductible Net Interest**

Net Interest includes actual Net Interest (payable less receivable) for the price controlled business extracted from statutory accounts, used on an accruals basis and total interest on index-linked debt based on the charge to the income statement in statutory accounts.

*Tax Deductible Net Interest includes:*

- Actual Net Interest (payable less receivable) for the price controlled business extracted from statutory accounts, used on an accruals basis; and
- Interest on index-linked debt based on the charge to the income statement in statutory accounts (i.e. on an accruals basis).
- Coupon payments on equity accounted hybrid bonds.
- Dividends on preference shares where a deductible debit arises under the loan relationship rules.
- FV movements on financing derivatives where such movements are taxable / deductible in line with their accounting treatment
- Debits arising within the licensee entity as a result of a change in accounting standards.

*Tax Deductible Net Interest excludes:*

- Any interest that would otherwise be included, but which does not qualify for corporation tax relief, and cannot be carried forward for potential relief in future periods;
- Movements relating to pension fund liabilities reported in the statutory accounts within Net Interest;
- Interest on operating lease / right of use assets under IFRS16 / FRS102.
- Interest arising from inter-company guarantees classed as insurance contracts under IFRS17
- Fair value adjustments (e.g. losses on derivatives), where such movements are disregarded for corporation tax;
- Dividends on preference shares (where a deductible debit does not arise);
- 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); and
- The cost of maintaining committed undrawn liquidity backup lines (i.e. commitment fees).
- Interest relating to the financing of TNUoS assets/liabilities

## 7. Pensions

### Financial Adjustments - Pensions

7.1. The PCFM contains a Variable Value (EDE) allowance<sup>20</sup> for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period. Opening values for EDE are based on the outcome of a pension reasonableness review concluded in November 2023. EDE (or the pensions allowance value) will be updated during the Price Control Period, through the AIP, according to the provisions of this chapter.

#### Expected timing of pensions allowance revisions

7.2. The intention is that pensions allowance values will only be revised periodically in light of triennial actuarial valuations of the relevant pension schemes. During the RIIO-GD3 Price Control Period, two pension scheme valuations, or reasonableness reviews thereof, will be in process, as set out in Table 7.1, with both of these expected to result in publication of revised allowances within the period.

**Table 7.1 – Expected timetable for pensions scheme valuations**

| <b>Pension scheme valuation date</b> | <b>Completion of Reasonableness Review</b> | <b>Publication of revised pension allowance value</b> |
|--------------------------------------|--|---|
| 31 March 2025                        | 31 October 2026<br>(rr = 2026/27)          | 30 November 2026                                      |
| 31 March 2028                        | 31 October 2029<br>(rr = 2029/30)          | 30 November 2029                                      |

(where rr is the effective date for revised allocations at each triennial actuarial valuation that take effect in the year rr)

<sup>20</sup> In the context of PSED repair expenditure we refer to 'allowances' rather than 'allowed expenditure' because EDE is included in full in Calculated Revenue ( $R_t$ ) in the RIIO-GD3 PCFM, ie it is not subject to the TIM.



7.3. Although the intention is to revise pensions allowance values according to the timetable in Table 7.1, it may be necessary to revise them at different times if, for example, the outcome following any detailed review of an established surplus (see 7.12), or a scheme valuation or completion of a Reasonableness Review (see from paragraph 7.30) is delayed. In those circumstances, pensions allowance values would still be determined in a way that is consistent with the procedures set out in this chapter. The revision of Pensions Allowance values at a different time because of the delayed completion of a Reasonableness Review will not affect the timetable for subsequent reviews of Pensions Allowance referred to in Table 7.1.

7.4. Licensees whose scheme triennial valuation dates differ to those shown in the first column of Table 7.1 will be required to provide either a full valuation or an updated valuation on these dates. The approach that should be used by the licensee to produce an updated valuation is set out in the Authority's Pension Deficit Allocation Methodology<sup>21</sup>, published in the Triennial Pension Reporting Pack as part of the Regulatory Instructions Guidance.

7.5. The remainder of this chapter sets out:

- Section 1: general provisions
- Section 2: the timetable and process for revising pension allowance values, including details of the Reasonableness Review
- Section 3: the calculation of revised pensions allowance values
- Section 4: the calculation of the ESOP<sub>t</sub> term (applicable to NGET only)

## Section 1 – General provisions

### Price control pension principles

7.6. The Authority's price control pension principles are set out in Ofgem's guidance note on price control pension principles under RIIO issued as Appendix 3 to the decision letter,

---

<sup>21</sup>

[https://www.ofgem.gov.uk/sites/default/files/docs/2020/04/pension\\_regulatory\\_instruction\\_and\\_guidance\\_version\\_2.1\\_clean\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2020/04/pension_regulatory_instruction_and_guidance_version_2.1_clean_0.pdf)

'Decision on the Authority's policy for funding Pension Scheme Established Deficits' dated 7 April 2017.<sup>22</sup>

### **Pension Scheme Established Deficit**

7.7. For the purposes of this chapter:

- a) the term cut-off date refers to the date of 31 March 2013
- b) the term Pension Scheme Established Deficit (PSED), or "established deficit", means an amount derived as the value of the liabilities within a defined benefit pension scheme (or schemes) sponsored (or co-sponsored, eg if part of a group scheme) by the licensee expressed as a positive number, less the corresponding assets, where those assets and liabilities are:
  - i. attributable to the licensee's transportation business, and
  - ii. attributable to pensionable service up to and including the cut-off date.<sup>23</sup>

7.8. The licensee's PSED will be calculated using:

- a) the triennial actuarial valuation of the pension scheme or schemes that contain the PSED described in paragraph 7.7 b)
- b) the allocation of assets and liabilities in the scheme(s) referred to in subparagraph a) to the PSED using the Pension Deficit Allocation Methodology;
- c) the effective date for revised allocations at each triennial actuarial valuation that take effect in the year rr (see Table 7.1); and
- d) the Reasonableness Review with respect to the price control pension principles which could, exceptionally, result in adjustments to the PSED figure on account of errors in methodology or data.

7.9. While the Price Control Period ends on 31 March 2031, Pensions Allowance values will be determined having regard to further PSED repair periods determined under the

---

<sup>22</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/04/decision\\_on\\_policy\\_for\\_funding\\_psed.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_psed.pdf)

<sup>23</sup> This definition applies even if the value derived is a negative amount (a surplus position) and may be described as an "established surplus".

methodology set out in this chapter (and the associated Price Control Financial Instrument licence condition).

### **Established surpluses**

7.10. The existence of an established surplus indicates that consumers have funded the relevant pension scheme more than it would now appear was necessary. One of the objectives behind our policy is to protect the consumer interest by encouraging strategies that ensure any over-funding can be returned to consumers, where appropriate, and that minimise the risk of a surplus being unrecoverable for consumers or being used, for example to de-risk the scheme, in a way that would not otherwise be in the consumer interest. Strategies may include careful management of deficit funding, the use of asset backed funding arrangements as described from paragraph 7.14, and the use of pension contribution holidays, especially when a scheme still has a significant number of active members. The existence of a surplus does not necessarily mean consumers have overpaid, for example, an efficiently incurred surplus can be effectively used to de-risk scheme funding in a way that reduces the likelihood of consumers needing to fund future deficits.

7.11. In the event that an established surplus arises, it may be appropriate for a licensee and the pension scheme trustees to agree a programme of pension contributions below the level that would otherwise be necessary to fund the accruals of benefits for active members and any deficit relating to post cut-off service. These reduced contributions can be called a contribution holiday. It is important that a pension contribution holiday, to the extent that it is attributable to an established surplus, is returned to consumers.

7.12. As part of the Reasonableness Review (see paragraph 7.30) we will conduct an initial review of any established surplus to identify whether a more detailed review is required. This more detailed review would occur as part of the close out of RIIO-3, using the latest information available at that time. The review would take into account the mitigating actions a company has put in place to manage an unnecessary surplus, prevailing and forecast market conditions, the impact of any pension payment holidays (including the timing of those holidays) and the materiality of the surplus. If the review concludes an adjustment is required, it would be applied as part of RIIO-3 close-out.

### **Pension costs outside the scope of this chapter**

7.13. The following costs are dealt with as totex in the relevant price control and therefore fall outside the scope of this chapter:

- a) pension costs associated with employee service after the cut-off date
- b) accrued liability costs associated with employee service after the cut-off date (Pension Scheme Incremental Deficit costs), and
- c) pension scheme administration costs and Pension Protection Fund levy costs.

### **Asset-backed funding arrangements**

7.14. The licensee may choose to enter into asset-backed funding arrangements with pension scheme trustees, either directly or indirectly through related parties. Such arrangements might include a range of alternative funding arrangements, for example, mechanisms involving contingent assets or loan notes benefitting relevant pension schemes.

7.15. Any asset-backed funding arrangements must be fully compliant with all conditions, for example relating to the ring fence, in the licensee's licence (except where appropriate consent has been granted under the terms of a condition).

7.16. Notwithstanding that an arrangement may be fully compliant with licence conditions, the licensee is encouraged to provide information on any such mechanism or prospective mechanism to the Authority at the earliest opportunity. In general, the Authority would encourage asset-backed funding arrangements that would facilitate the return of funds to consumers in the event that a pension scheme deficit turns out to be smaller than anticipated.

7.17. Asset-backed funding arrangements would in general be disregarded in the determination of revised Pensions Allowance values because allowances are provided for PSED repair and not for ancillary arrangements (such as asset-backed funding) per se. However, such arrangements would be relevant in any proposal by the licensee for Pensions Allowance values under the methodology set out in this chapter.

## **Section 2 – Timetable and process for triennial revision of pensions allowance values**

### **Reasons for updating pensions allowance values**

7.18. The licensee's pensions allowance values may be revised during the Price Control Period to reflect:

- a) information contained in pension scheme actuarial valuation reports provided by the licensee to the Authority
- b) the licensee's updated PSED
- c) information on the history of actual amounts received by the relevant pension scheme(s) in respect of PSED repair payments, attributable to the licensee, submitted to the Authority
- d) proposals made by the licensee for Base Annual PSED Allowances and payment history allowances
- e) asset-backed funding arrangements associated with proposals referred to in subparagraph d)
- f) the outcomes of Reasonableness Reviews (see from paragraph 7.30), and
- g) any pension contribution holiday attributable in whole or in part to the existence of an established surplus.

**Process steps in a year in which a reasonableness review is being conducted<sup>24</sup>**

Step 1: by 31 July

7.19. The Authority will be in receipt of price control review information from the licensee for Regulatory Years up to and including the last complete Regulatory Year.

7.20. The Authority will obtain the licensee's Scheme Valuation Data Set for the relevant valuation of the licensee's defined-benefit pension schemes by 31 July and commence a Reasonableness Review.

7.21. The Scheme Valuation Data Set should comprise:

- a) the actuarial valuation of each defined-benefit scheme in respect of which the licensee is a sponsoring employer, being either a full valuation or an update of the last preceding full triennial valuation, with the asset and liability values projected forward

---

<sup>24</sup> Although the intention is to conduct the steps of the reasonableness review according to the dates specified in this section, it may be necessary to change these dates (eg as occurred with the review in 2020, when dates were changed as a consequence of the impacts Covid-19) whilst following the same steps.

to the full valuation date on the basis set out in the Pension Deficit Allocation Methodology<sup>25</sup>

- b) each scheme's statement of funding principles
- c) each scheme's statement of investment principles; and
- d) any other information reasonably required.

Step 2: by 31 August

7.22. The licensee will submit:

- a) Explanations and supporting evidence where appropriate for how it has interpreted the interests of consumers to inform its participation in the governance of pension schemes, including setting investment and risk strategies
- b) Explanation of how it has responded to any recommendations set out by the Authority in preceding Reasonableness Reviews.

7.23. The licensee will also submit Pension Deficit Allocation Methodology information and its PSED figure as at the relevant valuation date indicated in Table 7.1 showing the movements from the previous valuation date.

Step 3: by 14 September

7.24. The licensee will submit:

- a) its proposals with supporting explanation for
  - i. Base Annual PSED Allowances (PBAPA<sub>y</sub>), under paragraph 7.45
  - ii. payment history allowances (PPH<sub>y</sub>), under paragraph 7.51
  - iii. any proposed prospective discounting basis for payment history variances, reflected in PhDR<sub>y</sub>, under paragraph 7.51.
- b) explanation of how it has engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED.

---

<sup>25</sup> <https://ofgem.gov.uk/publications-and-updates/notice-modify-regulatory-instructions-and-guidance-held-network-operators>

7.25. In its explanations under paragraphs 7.24 b), the licensee should set out why it considers its proposals appropriately protect the interests of consumers. The licensee's explanations should, in each case where appropriate, refer to the prevailing level of Base Annual PSSED Allowances, the profile of repair payments that can be agreed with the scheme trustees, how it has sought to maintain confidence of scheme trustees in the covenant with the licensee in support of such agreement, how it has sought to minimise the risk of stranded surplus, how it has sought to balance the interests of existing and future consumers, how it has sought to manage the volatility of revenues and financial ratios and any asset-backed arrangements that are intended to protect the consumer interest. The licensee's explanations should, where appropriate, refer to or be consistent with information it submitted in accordance with paragraph 7.22.

Step 4: by 30 September

7.26. The Authority will provisionally decide whether:

- a) any change should be made to the licensee's proposals for Base Annual PSSED Allowances and payment history allowances for reasons anticipated in paragraph 7.31 a) and b), and 7.32
- b) to apply an existing adjustment factor, introduce a new adjustment factor or extend the scope or effect of an existing adjustment factor for reasons anticipated in paragraph 7.33. Adjustment factor can be either upwards or downwards
- c) to set out any recommendation to the licensee to adopt good practice before the next reasonableness review under paragraph 7.37.

7.27. The Authority will give notice of any such provisional decisions to the licensee, allowing 14 days for representations to be made.

Step 5: by 31 October

7.28. The Authority will complete its Reasonableness Review:

- a) determine the values  $BAP_{A_y}$ , representing the Base Annual PSSED Allowances, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.45
- b) determine the values  $PH_y$ , representing the payment history allowances, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.51

- c) determine the values  $AF_y$ , representing any adjustment factors, for each of the three years following the Reasonableness Review
- d) calculate the Pensions Allowance values for each of the three years following the Reasonableness Review, such that:

$$EDE_y = BAPA_y + PH_y + AF_y$$

- e) set out any recommendation to the licensee to adopt good practice before the next Reasonableness Review
- f) determine the discount rates for payment history allowances,  $hDR_y$ , or an unambiguous basis for determining them, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.51
- g) confirm whether a more detailed review of any established surplus is required (see paragraph 7.12).

Step 6: by 30 November

7.29. The Authority will direct revised Pensions Allowance values and will publish a report on the Reasonableness Review.

**Reasonableness Reviews and adjustment factors**

7.30. After receiving the whole (or substantially the whole) of the licensee's Scheme Valuation Data Set (see paragraph 7.21) and its proposals for Base Annual PSED Allowances and Payment History Allowances (see paragraph 7.24) in respect of each defined benefit pension scheme, the Authority will review the way in which the licensee has:

- a) formulated and justified its proposals for Base Annual PSED Allowances and Payment History Allowances
- b) engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED, recognising the responsibilities of trustees and the regulatory framework they are subject to, recognising the uncertainties that exist in the PSED valuation and recognising the strength of the employer's covenant
- c) responded to any recommendations set out by the Authority in preceding Reasonableness Reviews
- d) otherwise followed good practice, informed by practice in the regulated and broader private sectors, taking into account statutory and regulatory factors affecting the relevant pension schemes and the specific circumstances of each scheme, in promoting consumer interests with respect to the PSED.



7.31. The review referred to in paragraph 7.30 is termed the Reasonableness Review for the purposes of this methodology. Having completed the Reasonableness Review, the Authority will consider whether there is any case for:

- a) making corrections to the licensee's calculations in respect of its proposals for Base Annual PSED Allowances and Payment History Allowances due to data or methodological errors
- b) determining Base Annual PSED Allowances and Payment History Allowances with different profiles (while maintaining the same overall prospective values) compared with those proposed by the licensee under paragraphs 7.45 and 7.51
- c) continuing to apply, modifying the scope or modifying the effect of any existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review
- d) applying any new adjustment factor under paragraph 7.33, and
- e) conducting a more detailed review of any established surplus (see paragraph 7.12).

7.32. The Authority will only make a determination in respect of paragraph 7.31 b) if it considers the licensee's proposals under paragraphs 7.45 and 7.51 do not appropriately protect the interests of consumers, taking into account statutory and regulatory factors affecting the relevant pension schemes, which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED.

7.33. Consistent with its price control pensions Principle 3,<sup>26</sup> the Authority will only apply adjustment factors referred to in paragraph 7.31 c) and 7.31 d) to the extent necessary to disallow any excess costs arising from a material failure in the licensee's responsibility for taking good care of entrusted pension scheme resources on behalf of consumers. New adjustment factors will only arise in the following limited circumstances:

- a) where the Authority has established the licensee's recklessness, negligence, fraud or breach of fiduciary duty towards consumers, such as failures in its participation in the governance of a pension scheme to correct for poor governance or management of the scheme's resources, including any undue risk of a stranded surplus

---

<sup>26</sup> See Appendix 3, of [https://www.ofgem.gov.uk/system/files/docs/2017/04/decision\\_on\\_policy\\_for\\_funding\\_psed.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_psed.pdf)

- b) inequitable charges for consumers arising from using the time value of money in paragraphs 2.16 and **Error! Reference source not found.** in ascertaining the cumulative payment history variance under paragraph 7.48 for any materially accelerated PSED payments that would otherwise have been determined with reference to the discount rate specified in the licensee's Scheme Valuation Data Set
- c) the licensee's failure to respond adequately to any recommendations set out by the Authority in preceding Reasonableness Reviews.

7.34. Any modification to the effect of existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review will be made after taking equitable account of the time value of money involved, in general with reference to hDR<sub>y</sub>.

7.35. Before deciding to make determinations referred to in paragraphs 7.31 b), 7.31 c) and 7.31 d), the Authority will consult with the licensee (see paragraph 7.27), giving its reasons with reference to paragraphs 7.32 and 7.33 and to the Pensions Principles referred to in paragraph 7.6.

7.36. After, considering any representations made by the licensee, the Authority will:

- a) notify the licensee of its decision
- b) set out the matters, referred to in paragraphs 7.32 and 7.33, that have led to its decision, and
- c) Set out the basis on which it considers any adjustment factors referred to in 7.31 c) or 7.31 d) might be discontinued at the next Reasonableness Review.

7.37. Where, after consulting with the licensee (paragraph 7.27) and giving due weight to the licensee's representations, the Authority considers the licensee is not following good practice which would have the effect of promoting consumer interests with respect to the PSED, the Authority will set out recommendations to the licensee for it to adopt before the next reasonableness review where:

- a) the Authority considers that adopting the recommendations would not conflict with statutory and regulatory factors affecting the relevant pension schemes
- b) the Authority has taken into account the relative duties of the licensee and the pension scheme trustees and the extent to which the licensee is only able to influence trustee decisions

- c) the Authority considers that adopting the recommendations would be in the interests of consumers and would not disproportionately impact the licensee
- d) the Authority considers it is practical for the licensee to adopt the recommendations.

## Section 3 – Proposals for revised pensions allowance values

7.38. This section describes what the licensee must take into account in making its proposals for:

- a) Base Annual PSED Allowances
- b) payment history allowances.

### Base Annual PSED Allowances

7.39. Base Annual PSED Allowances represent how consumers will fund the established deficit as evaluated at the last triennial review. The licensee must set out its proposal for Base Annual PSED Allowances after taking account of the following paragraphs.

7.40. The licensee must set out its calculations of:

- a) the indicative further PSED repair period, see from paragraph 7.41
- b) the indicative base annual PSED allowance, see from paragraph 7.43 and
- c) its proposal for Base Annual PSED Allowances, see from paragraph 7.45.

### *Indicative further PSED repair period*

7.41. The indicative further PSED repair period represents a number of years (not necessarily a whole number) from the valuation date specified in Table 7.1 and is ascertained by taking the number of years that is the lower of:

- a) the value  $irp$ , where  $irp$  is calculated using the following formula:

$$irp = \frac{-LN \left( 1 - LN(1 + DR) \times \frac{PSED}{EBAPA} \right)}{LN(1 + DR)}$$

where:

PSED is defined in paragraph 7.7 b), expressed in 2023/24 price terms

LN returns the natural logarithm of the value to which it is applied

DR is an annual real (inflation-adjusted) discount rate specified in or justified with reference to the licensee's Scheme Valuation Data Set (established in accordance with Principle 4 - see paragraph 7.6), and

EBAPA is an average of the Base Annual PSED Allowance expressed in 2023/24 price terms for years rr-1 and rr, where the year rr is the Regulatory Year specified in Table 7.1 for the relevant Reasonableness Review.

and

b) 15.

In the event that the PSED is negative, irp is set to zero.

7.42. For example, if the discount rate was 2%, the PSED was £1m and the EBAPA value was £100k, then the Indicative further PSED repair period would be 11.14 years, being the lower of:

a) 11.14, calculated under the formula at paragraph 7.41 a), and

b) 15.

#### *Indicative Base Annual PSED Allowance*

7.43. The indicative amount for the Base Annual PSED Allowance, IBAPA, is zero if PSED is negative but is otherwise ascertained using the following formula:

$$IBAPA = PSED \frac{LN(1 + DR)}{1 - (1 + DR)^{-irp}}$$

where:

irp is the indicative further PSED repair period ascertained under paragraph 7.41.

7.44. For example, if the PSED was £1m in 2023/24 prices, the Indicative further PSED repair period was 11.14 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be £100k. IBAPA will equal EBAPA unless irp is limited to 15.

#### *Proposal for Base Annual PSED Allowances*

7.45. Subject to its consideration of the factors set out in subparagraphs (a) to (d) below, the licensee may propose allowances in line with the Indicative Base Annual PSED Allowance calculated under paragraph 7.43. The licensee may propose, with its supporting rationale, an

alternative profile of Base Annual PSED Allowances over a repair period that may be shorter or longer than the period determined by paragraph 7.41 if it considers that the indicative Base Annual PSED Allowance calculated by paragraph 7.43 above either:

- a) does not fairly represent a profile of repair payments that can be agreed with the scheme trustees,
- b) following consultation with the Authority, does not appropriately protect the interests of consumers,
- c) derives from an indicative further PSED repair period ascertained under paragraph 7.41 which is less than 5 years, or
- d) is otherwise inappropriate or inequitable.

7.46. The alternative proposal under paragraph 7.45 must represent a profile of Base Annual PSED Allowances,  $PBAPA_y$  for each year  $y$  subsequent to the valuation date specified in Table 7.1, such that

$$\sum_{y \geq rr-1} \frac{PBAPA_y(1 + f \times DR)}{(1 + DR)^{y+2-rr}} \leq PSED + LO - ABV$$

where:

$$f = \frac{1}{LN(1 + DR)} - \frac{1}{DR}$$

**LO** means the value of any assets included in the PSED valuation that represent an obligation from the licensee for future payments (or other consideration) to the relevant scheme(s) under an arrangement agreed between the licensee and the scheme(s)

**ABV** means the value of assets as at the PSED valuation date held under asset-backed arrangements that is fairly attributable to funding by the licensee out of negative cumulative payment history variances (see paragraph 7.48) up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 7.51) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the

interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 7.51.

PBAPA<sub>y</sub> for years rr-1 and rr are the Base Annual PSED Allowances determined by the Authority for those years, and

### Payment history allowances

7.47. The determination of revisions to Pensions Allowance values for the licensee will include payment history allowances, which may be positive or negative, relating to the cumulative variance between the licensee's PSED repair payments and its historical allowances for PSED repair prior to the PSED valuation date. The payment history prior to a triennial valuation will affect that valuation, and thus the Base Annual PSED Allowances needed to fund it as described in paragraph 7.39. Payment history allowances ensure that customers are properly compensated if the licensee has, prior to the triennial valuation, paid less in funding the PSED than it has received from consumers, and that companies do not lose out if they have paid more.

7.48. The cumulative pre-valuation payment history variance value at the end of the Reasonableness Review year,  $V_{rr}$ , is ascertained using a method permitted by paragraph 7.50 or using the following formula:

$$V_{rr} = LTU + \sum_{y=pc01}^{rr-2} \left( \frac{(D_y - E_y)(1 - CT_y)}{(1 + g_y \times hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right) - \sum_{y=rr-1}^{rr} \left( \frac{PH_y(1 - CT_y)}{(1 + g_y \times hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right)$$

where:

- LTU is the legacy true-up value specified in paragraph 7.49, where relevant
- pc01 means the first Regulatory Year subsequent to the cut-off date
- rr is the Regulatory Year specified in Table 7.1 for the relevant Reasonableness Review
- D<sub>y</sub> means the net sum of the following, which may be positive or negative, expressed in 2023/24 price terms:

- amounts received by the relevant pension scheme(s) in respect of PSED repair during the course of year  $y$ , including amounts received in respect of an obligation accounted for in the LO term in paragraph 7.46
- less any amounts directly or indirectly returned to the licensee or a related undertaking by the relevant pension scheme(s) during the course of year  $y$  under an arrangement agreed between the licensee and the scheme(s),
- less the amount by which ongoing pension contributions (for active members) have been reduced on account of an established surplus as described in paragraph 7.11.
- plus any amounts determined by the Authority as advisory fees or other costs relating to the development or implementation of a pensions initiative, eg a contingent asset arrangement, following a review of evidence submitted by the licensee.

$PH_y$  is the payment history allowance determined by the Authority at a preceding Reasonableness Review or price control review, in accordance with paragraph 7.28 or otherwise, and included in the licensee's revenue allowances for year  $y$

$E_y$  means the licensee's Base Annual PSED Allowances plus payment history allowances,  $PH_y$  (which may be positive or negative), included in revenue allowances for the year  $y$  expressed in 2023/24 prices in accordance with paragraph 7.47.  $E_y$  excludes any adjustment factor value  $AF$  but includes any prior period history allowances included in revenue allowances in the period since  $pco1$  relating to any true-up value in LTU and any other relevant allowances, including contingent asset allowances. With the written agreement of the Authority, the licensee may adjust prior period history allowances to exclude those attributable to legacy true-up values excluded from the LTU term in accordance with paragraph 7.49.

$CT_y$  means the actual or, in the case of  $CT_{rr+1}$ , prospective rate of Corporation Tax applicable to the licensee in year  $y$

$\prod$  means the product of the series in the brackets for the specified range;

for example:

$$\prod_{t=rr-2}^{rr} (1 + hDR_t) = (1 + hDR_{rr-2})(1 + hDR_{rr-1})(1 + hDR_{rr})$$

$hDR_y$  means the discount rate values under any alternative discounting basis determined by the Authority in the relevant reasonableness review for year  $y$  (see 7.28 e)) or, where no alternative discounting basis has been specified, the time value of money as described in paragraphs 2.16 and **Error! Reference source not found..**

$$g_y = \frac{1}{2 + hDR_y}$$

7.49. Where relevant,

- a) Subject to subparagraph b), the legacy true-up value, LTU, represents the present value as at the end of the Reasonableness Review year of any arrangement or arrangements previously agreed or determined by the Authority for the post cut-off true-up of the licensee's pension deficit payment history or true-up of other pension-related costs prior to the cut-off date.
- b) With the Authority's written agreement, the licensee may attribute payment history allowances to legacy true-up values identified in subparagraph a) on a present value neutral basis and exclude both attributable payment history allowances from the calculation of  $E_y$  in paragraph 7.48 and the attributable LTU value from the LTU term applied in paragraph 7.48.

7.50. The licensee may choose to present a truncated calculation of the term  $V_{rr}$  specified in paragraph 7.48, on a basis that is demonstrably consistent with the formula specified in paragraph 7.48. Such a truncated calculation would include cumulative pre-valuation payment history variance values calculated for a previous reasonableness review and rolled forward for payment history variances arising since the valuation date relevant to that earlier review, discount rates and, where relevant, changes in corporation tax rates.

7.51. The licensee should propose payment history allowances for future years  $y$ ,  $PPH_y$ , such that:

$$\sum_{y \geq rr+1} \left( PPH_y (1 + h_y \times PhDR_y) \prod_{t=rr+1}^y \left( \frac{1}{1 + PhDR_t} \right) \right) \leq V_{rr} + ABC$$

$PhDR_y$  means the discount rate for payment history allowances for year  $y$  proposed by the licensee, or the rate forecast for year  $y$  according to the licensee's proposed



basis of determining discount rates, in either case framed in accordance with paragraph 7.25. Such a proposal may relate  $PhDR_y$  to the value of  $DR$ , the time value of money or rates of return on asset-backed arrangements. In the absence of any proposal,  $PhDR_y$  is the time value of money in period  $rr+1$  calculated in accordance with paragraphs 2.16 and **Error! Reference source not found..**

ABC means the deemed present value as at the end of the Reasonableness Review year of the cumulative funding of asset-backed arrangements through negative cumulative payment history variances up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV (see paragraph 7.46) and ABC agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, ABC should be set at the present value of ABV specified in paragraph 7.46 as at the end of the reasonableness review year, after applying appropriate discount rates (generally  $hDR_y$ ).

$$h_y = \frac{1}{2 + PhDR_y}$$

## Section 4 – Calculation of the ESOPt term (applicable to NGET only)

7.52. This licensee must adhere to the formula and principles laid out in Special Condition 6.1.6 and Ofgem's 'Decision on the pension scheme arrangements for National Grid employees transferring to the future System Operator'.<sup>27</sup>

---

<sup>27</sup> <https://www.ofgem.gov.uk/decision/decision-pension-scheme-arrangements-national-grid-employees-transferring-future-system-operator>

## 8. Legacy Adjustments

8.1. Adjustments relating to GD2 Variable Value methodologies and GD2 closeout methodologies, which are implemented in the GD2 Legacy PCFM will be directed by the Authority.

8.2. The Authority will direct the values of LK, LADJ, LRAV, and tax pools (OGP, OSRP, OSBP, LOSBP, ODRP, LODRP and OTL) to be carried over into the GD3 PCFM in accordance with the procedure set out in Special Conditions 7.2 (Legacy AIP Adjustment term), 7.3 (Legacy K correction), and [7.X] (Legacy net RAV additions and tax balances) and in accordance with the General Financial Adjustment Methodology set out in this chapter.

### Legacy inputs directed by the Authority

#### General Financial Adjustment Methodology

8.3. The Authority will determine adjustments following the end of the GD2 Price Control Period in accordance with this chapter, and a direction will specify the adjustments the licensee must make in the GD2 Legacy PCFM inputs. The direction will specify a GD2 Variable Value named in the version of the licence as in force on 31 March 2026, or otherwise specify row and column references in the GD2 Legacy PCFM.

8.4. After the Authority has directed values in accordance with paragraph [8.2], and the licensee has provided RIIIO-GD2 Variable Value updates from paragraphs [8.6 to 8.8], the Authority will take the steps outlined in this General Financial Adjustment methodology.

8.5. Prior to the Authority directing the values in accordance with paragraph [8.2], the licensee will take the following steps when submitting the legacy GD2 PCFM:

#### GD2 Offline Tax-Trigger PCFM

- a) Ensure the GD2 Offline Tax-Trigger PCFM is adjusted in accordance with the methodologies set out in this chapter, and where these methodologies are not available the licensee must use their best estimates;
- b) Ensure the year selected on the 'UserInterface' worksheet is 2026
- c) Update all variable values (other than TTET, OGPA<sub>t</sub> and OSRPA<sub>t</sub>) in the relevant licensee input sheet, in line with those in the GD2 legacy PCFM.

- d) Update the % values in rows 13 and 14 of the 'Super\_Tax' worksheet to reflect the percentage of additions qualifying for super-deductions and first year allowances.
- e) Run the macro in the "UserInterface" sheet for the relevant company
- f) The values in cells AR55:AT55, AR56:AT56 and AP58:AT58 of the 'Super\_Tax' worksheet are the values to be input into the relevant row within the licensee worksheet of the GD2 legacy PCFM.

### GD2 Legacy PCFM

- g) Ensure the GD2 Legacy PCFM is adjusted in accordance with the methodologies set out in this chapter, and where these methodologies are not available their best estimates;
- h) Ensure values for TTET, OGPA and OSRPA are copied into the GD2 Legacy PCFM from the GD2 Offline Tax-Trigger PCFM per the guidance described above
- i) Ensure "31 Mar 2027" is selected on the "UserInterface tab" of the GD2 Legacy PCFM;
- j) Update variable values in the relevant licensee input sheet of the GD2 Legacy PCFM; and
- k) Values in the Legacy Summary worksheet which are listed in Table 8.2 can then be used to update the relevant terms in the GD3 PCFM

8.6. Except where paragraph [8.7] applies, the licensee must then populate the GD3 PCFM with the inputs directed by the Authority and listed in Table Error! No text of specified style in document..2.

8.7. The Authority will not direct the final values for the inputs listed in Table Error! No text of specified style in document..2 until each of the closeout methodologies set out in Table 8.3 have been determined. Until that time, the licensee must use its best estimates.

### **Table Error! No text of specified style in document..2: GD2 PCFM Inputs for legacy inputs directed by the Authority**

#### **Legacy ADJ**

| Licence Terms | Special Condition |
|---------------|-------------------|
| LADJ          | [SpC 7.2 Part A]  |

#### **Legacy K**

| Licence Terms | Special Condition |
|---------------|-------------------|
| LK            | [SpC 7.3 Part A]  |

### Legacy RAV

| Licence Terms | Special Condition |
|---------------|-------------------|
| LRAV          | [SpC 7.4 Part A]  |

### Legacy Tax Pools

| Licence Terms | Special Condition |
|---------------|-------------------|
| OGP           | SpC 7.4 Part B    |
| OSRP          | SpC 7.4 Part B    |
| OSBP          | SpC 7.4 Part B    |
| ODRP          | SpC 7.4 Part B    |
| LOSBP         | SpC 7.4 Part B    |
| LODRP         | SpC 7.4 Part B    |
| OTL           | SpC 7.4 Part B    |

### RIIO-GD2 Variable Value Methodologies

#### Revision of GD2 Variable Values

8.8. The licensee must use the version of the licence as in force on 31 March 2026 to determine the GD2 Variable Values.

8.9. The licensee must populate the relevant fields in the GD2 Legacy PCFM.

8.10. The GD2 Variable Values may be further adjusted by the closeout methodologies below.

#### RIIO-GD2 Closeout Methodologies

8.11. The following sections set out how adjustments to the GD2 Legacy PCFM will be determined. The licensee must then adjust the GD2 Legacy PCFM input as directed in accordance with Table Error! No text of specified style in document..3 below.

8.12. Table Error! No text of specified style in document..3 lists the adjustments to the GD2 Legacy PCFM that the licensee must make for closeout methodologies, following the General Financial Adjustment Methodology in this chapter.

8.13. Where a Special Condition (SpC) is cited in a methodology, it refers to the provisions of the licence as in force on 31 March 2026. These conditions may also refer to definitions within the GD2 Price Control Financial Handbook as in force on 31 March 2026.

Table Error! No text of specified style in document..3: Closeout adjustments in the GD2 Legacy PCFM

| <b>Closeout methodology</b>  | <b>Relevant<br/>GD2 licence<br/>reference</b> | <b>GD2 Legacy<br/>PCFM input<br/>adjusted</b> | <b>Basis for<br/>profiling<br/>adjustments</b> | <b>Directi<br/>on<br/>Timing</b> |
|--|---|---|--|----------------------------------|
| [Rows of this table to be added once closeout methodologies are known] |   |   |  |                                  |

Except where otherwise stated, all calculations under this section of the GD3 Price Control Financial Handbook are to be made with reference to 2018/19 prices using the GD2 Price Control Period price base.

**[Additional headings to be added with detail on closeout methodologies once available]**





## Appendix 1 – Totex Incentive Mechanism

A2.1 The Totex Incentive Mechanism (TIM) enables licensees to retain a specified portion of underspending against totex allowances (with network users benefiting from the reciprocal portion) or to bear a specified portion of overspending (with network users funding the reciprocal portion).

A2.2 The TIM adjusts totex allowances for (forecast or outturn) over or underspend against those allowances. The adjustment depends on the amount of under or overspend and the Totex Incentive Strength (TIS) for the licensee. The TIS is the post-tax percentage the licensee bears of an overspend, or retains of an underspend, against allowances. The adjustment that is made to the totex figures is the Funding Adjustment Rate (often called the 'sharing factor') which is calculated as  $(1 - \text{TIS})$  and is a fixed input value for the licensee in the PCFM. Applying the Funding Adjustment Rate to the over (or under) spend gives the amount that is added to (or subtracted from) the totex allowances, giving a post-TIM totex.

A2.3 The PCFM apportions post-TIM totex using the Totex Capitalisation Rate for the licensee as either fast money or slow money (see paragraph 3.5). The Totex Capitalisation Rate for the licensee for the relevant Regulatory Year is a fixed input value for the licensee in the PCFM. Under the AIP, the effects of this modelling treatment (including any ancillary effects such as the impact on tax allowances) are reflected in the value of the term  $R_t$ .

A2.4 A schematic of the TIM, with illustrative numbers showing an overspend, is provided in the chart below.



**Figure A2.1: Illustration of the Totex Incentive Mechanism**

