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## GT3 Price Control Financial Handbook

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This is the GT3 Price Control Financial Handbook which forms part of Special Condition 8.1 (Governance of the GT3 Price Control Financial Instruments) of the Gas Transporter licence held by National Gas Transmission plc in respect of the national gas transportation system.

This document consists of:

- a) requirements for how licensees must use the GT3 Price Control Financial Model to determine Allowed Revenue;
- b) an overview of the variable values used in the GT3 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 GT3 Price Control Financial Model are contained in Special Condition 8.1 and up to date versions of this handbook and the GT3 Price Control Financial Model can be accessed on the Ofgem website.

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## 1. Introduction

1.1. Special Conditions 2.1 (Transportation owner revenue restriction) and 2.3 (System operator revenue restriction) determine the annual Allowed Revenue and SO Allowed Revenue the licensee can recover in respect of NTS Transportation Owner Charges and NTS System Operation Charges respectively. The GT3 Price Control Financial Model (GT3 PCFM) is a Price Control Financial Instrument which provides for the calculation of Allowed Revenue and SO Allowed Revenue. Certain inputs to the GT3 PCFM (the PCFM Variable values) are updated, resulting in updates to Allowed Revenue and SO Allowed Revenue within the Price Control Period.

1.2. This handbook sets out how licensees must use the GT3 PCFM to determine Allowed Revenue and SO Allowed Revenue.

1.3. This handbook provides:

- (a) a description of the GT3 PCFM;
- (b) the process the licensee must follow in calculating Allowed Revenue and SO Allowed Revenue;
- (c) an overview of the PCFM Variable Values used in the GT3 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) GT3 PCFM
- c) Associated Documents (including NARM handbook and Network Asset Risk Workbook) 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 GT3 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 GT3 PCFM;
- b) Section 3 lists the variable values used in the GT3 PCFM;
- c) subsequent sections provide details of how certain variable values are revised or calculated (along with further details on the GT3 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);
- Standard Condition 1 (Definitions for the standard conditions);and
- The Uniform Network Code (UNC)

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.

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<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.

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.
GT2 Price Control Period	means the period of five Regulatory Years commencing on 1 April 2021.
GT2 Variable Value	means the values in the table of that name in the GT2 Price Control Financial Handbook.
GT3 PCFM	means the GT3 Price Control Financial Model.
PCFM Guidance	means the annex of that name to the RIGs.
Reasonableness Review	means the pensions review set out in paragraph 7.31 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 (RIGs)).
RPI	means the Retail Prices Index.
Time Value of Money	means the interest rate used to apply to year-on-year true-ups and adjustments made during the GT3 Price Control and is based on the nominal WACC set out in the "AR" sheet in the GT3 PCFM.
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 GT3 PCFM and Calculation of Allowed Revenue

### The Price Control Financial Model

2.1. For each Regulatory Year, the GT3 PCFM provides for the calculation of Allowed Revenue and SO Allowed Revenue in accordance with Special Condition 2.1 (Transportation owner revenue restriction) and Special Condition 2.3 (System operator owner revenue restriction).

2.2. The GT3 PCFM contains both fixed values and a variable values table input area for the licensee. The Allowed Revenue and SO Allowed Revenue figures for the licensee for each Regulatory Year of the Price Control Period are calculated as per Special Conditions 2.1 and 2.3, using the fixed values, the variable values, and the formulae and functions embedded in the GT3 PCFM.

2.3. At the beginning of the Price Control Period, Allowed Revenue and SO Allowed Revenue is calculated by the GT3 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 GT3 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. Calculations relating to the indexation of the RAV also make use of a semi-nominal price index. The use of nominal prices in the GT3 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 CPIHm until September of the current year (e.g.

in November 2025, the outturn data values would only be entered to September 2025).

2.7. The GT3 PCFM “Main Inputs” and “Inflation” tabs contain a method for forecasting future price index values, given financial year forecast assumptions. The financial year forecast is labelled “FYCPIHF<sub>t</sub>”.

2.8. These forecasts will be the Office for Budget Responsibility’s (OBR) forecast of CPIH from the “economic and fiscal outlook”. The Authority will update and provide the forecast assumptions to the licensee from the most recent outlook available during November each year. The data will be sourced from the 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 “CPIH”
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 October to September. The last outturn value of CPIH will be grown by a monthly rate in accordance with the following formula:

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

where,

CPIH<sub>m</sub> is the CPIH price index value for a given year-month “m”.

FYCPIHF<sub>m</sub> means the OBR CPIH forecast (annual rate) applicable to year-month m, where the OBR forecast for a financial year is applicable from 6 months prior to the start of that financial year, to six months after (eg the 2026 OBR forecast would be applicable from October 2025 to September 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

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

covered 2024/25-2028/29, then the forecast for year 2028/29 would be used for 2029/30 and 2030/31).

#### *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*

2.11. Ofgem will perform the above updates to the GT3 PCFM Variable Values CPIH<sub>m</sub> and FYCPIHF<sub>t</sub> and provide the updated data to the licensee by no later than 30 November or as soon as reasonably practicable. The licensee should use this data to update the GT3 PCFM.

### **Temporal convention**

2.12. The following conventions apply throughout this handbook:

- a) *Relative references*: The AR term is the licensee's TO 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 <sub>$t$</sub>  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 GT3 PCFM.

### **Forecast variable values**

2.13. In calculating Allowed Revenue for Regulatory Year  $t$ , the GT3 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 GT3 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 and SO Allowed Revenue or to correct charging errors for any over or under-recovery.

2.17. The time value of money rate used in the GT3 PCFM is based on the licensee's nominal WACC, set out in the "AR" and "SOAR" sheets in the GT3 PCFM.

### **Changing the GT3 PCFM**

2.18. The GT3 PCFM exists as a GT3 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 under Special Condition 8.1 in accordance with that condition.

### **Error in the functionality of the GT3 PCFM**

2.19. If an error of functionality is discovered in the GT3 PCFM, the issue will be considered at the earliest opportunity by the GT3 Price Control Financial Model Working Group (see definition at paragraph 2.30) 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 GT3 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 GT3 PCFM except for the completion or updating of the PCFM Variable Values, updating the inflation input

values provided by Ofgem within the "Inflation" sheet of the GT3 PCFM with outturn data to 30 September, updating the "Cover" tab in accordance with paragraph 2.27 and updating the "UserInterface" tab of the GT3 PCFM.

2.23. Where a PCFM Variable Value is not known at the time of calculating Allowed Revenue or SO Allowed Revenue, the licensee must determine that value in accordance with the GT3 Price Control Financial Handbook or in accordance with 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 Special Licence Condition 2.1.

2.24. The licensee must seek advice from the Authority 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 GT3 PCFM on the licensee's website in accordance with paragraph 2.1.7 of Special Condition 2.1 (Transportation owner revenue restriction) and paragraph 2.3.7 of Special Condition 2.3 (System operator revenue restriction), the licensee must provide the Authority with:

- a) a copy of the GT3 PCFM which the licensee intends to publish on its website; and
- b) a commentary describing any changes since the last submission of the GT3 PCFM to the Authority.

Where the Authority requires the licensee to change the GT3 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. The licensee must update the "publication date" label on the "Cover" tab of the GT3 PCFM with the date the model was made public on the licensee's website.

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

GT3 PCFM Licensee 20XX-XX Allowed Revenue YYYYMMDD

where:

YYYYMMDD means the year, month, and day the GT3 PCFM was published.

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

Licensee means NGT

2.29. The GT3 PCFM will be used for the purpose of determining the value of Allowed Revenue and SO Allowed Revenue up to and including Regulatory Year 2030/31.

## **The GT3 Price Control Financial Model Working Group**

2.30. Ofgem will facilitate an industry expert working group to review issues arising with respect to the form or usage of the GT3 PCFM (the "GT3 Price Control Financial Model Working Group"). The terms of reference for The GT3 PCFM Working Group are set out below.

### **Terms of reference**

#### *Purposes of the working group*

2.31. The purposes of the working group are:

- a) to review the ongoing effectiveness of the GT3 PCFM in producing a value for Allowed Revenue and SO Allowed Revenue and capturing financial performance data for each Regulatory Year; and
- b) to provide, when requested by the Authority, its views to the Authority on the impact of any proposed modifications on the GT3 PCFM; and
- c) to provide such views or recommendations to the Authority on the GT3 PCFM (including proposals to modify the GT3 PCFM) as it sees fit.

### *Composition*

2.32. The composition of the group will be:

- a) Chair (Ofgem)
- b) Secretary (Ofgem); and
- c) representatives of the licensee.

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

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

2.34. The group will meet at least once between 01 January and 01 April during each calendar year, but may meet more frequently if required.

2.35. 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.

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

### *Resources*

2.37. Meeting or virtual 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 GT3 PCFM. A draft of the meeting note will be circulated to the licensee for comment and approval as soon as is reasonably practicable following the meeting. 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).
- 3.2. The variable values that can be revised are set out in List of PCFM Variable Values
- 3.3. Table 3.1 and Table 3.2 below in respect of the licensee's TO and SO activities respectively.
- 3.4. For each variable value, the tables provide a description, cross-references to the relevant Special Condition(s) (where appropriate), and details of Associated Documents (where relevant). They also identify 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).
- 3.5. Types of PCFM Variable Values List of PCFM Variable Values
- 3.6. Table 3.1 and Table 3.2 present 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 allowances*

- 3.7. The following types of variable values contribute to the calculation of the totex allowance<sup>3</sup>, through the Totex Incentive Mechanism:
- a) Variant Allowances (adjustments to totex allowances)
  - b) Actual totex

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<sup>3</sup> Non-variant allowances also contribute to the calculation of totex but are not variable.



3.8. 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 ( $FM_t$  and  $SOFM_t$ ) – flowing directly into the Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) figures 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 ( $R_t$  and  $SOR_t$ ) through the return ( $RTN_t$  and  $SORTN_t$ ) on RAV and depreciation ( $DPN_t$  and  $SODPN_t$ ) over multiple Regulatory Years.

#### *Pass-through expenditure*

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

#### *Incentive Revenue*

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

#### *Other Revenue Allowances*

This type of variable value comprises allowances that flow directly into Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ).

#### *Legacy Adjustments*

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

- a) *Legacy Revenue adjustments* ( $LAR_t$  and  $SOLAR_t$ ): These adjustments flow directly into Allowed Revenue and SO Allowed Revenue ( $AR_t$  and  $SOAR_t$ ).

- b) *Legacy RAV Additions Adjustment* ( $LRAV_t$  and  $SOLRAV_t$ ): These variable values contribute indirectly to Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ); and
- c) Tax balances brought forward ( $OGPt$ ,  $OSRPt$ ,  $OSBPt$ ,  $ODRPt$ ,  $LODRPt$ ,  $OTLt$ ,  $SOOGPt$ ,  $SOOSRPt$ ,  $SOOSBPt$ ,  $SOLODRPt$ ,  $SOLODRPt$  and  $SOLOTLt$ ): These variable values contribute to the tax allowance ( $TAX_t$  and  $SOTAX_t$ )

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

3.12. This type of variable value is used to derive the DRS adjustment 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*

3.13. This category comprises:

- a) Cost of capital percentage ( $iBTA_t$ ,  $RFR$ )<sup>4</sup>: This type of variable value affects the allowance provided to the licensee for financing their capital needs and contributes to Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) indirectly.
- b) Allowed Revenue setting: This type of variable value is used in the calculation of Allowed Revenue and SO Allowed Revenue and comprises price index term, K correction factor ( $K_t$  and  $SOK_t$ ), the Forecasting Penalty term ( $FP_t$  and  $SOFP_t$ ) and Calculated Revenue and SO Calculated Revenue.
- c) Tax allowance<sup>5</sup>: This type of variable value relates to taxation of the licensee and contributes indirectly to Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) or, in the case of  $TAXA_t$  and  $SOTAXA_t$ , flows directly into Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ).
- d) Real Price Effects ( $RPE_t$  and  $SORPE_t$ )<sup>6</sup>: This is the annual growth rate used for the derivation of the RPE and SORPE indexation values. These in turn are applied to the relevant allowed totex spend, to derive the related RPE totex allowance.

#### *Forecasting Penalty inputs*

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

<sup>5</sup> See Section 6 of this handbook.

<sup>6</sup> See Section 5 of this handbook

3.14. This type of variable value is used in the calculation of the forecasting penalty ( $FP_t$  and  $SOFP_t$ ) and comprises the base revenue forecasting penalty ( $BRFP_t$  and  $SOBRFP_t$ ), Recovered Revenue forecasting penalty ( $RRFP_t$  and  $SORRFP_t$ ), base revenue ( $BR_t$  and  $SOBR_t$ ) and Target Revenue and SO Target Revenue as published ( $TR^*_t$  and  $SOTR^*_t$ ).

#### *Inflation Inputs*

3.15. The GT3 PCFM contains the following PCFM Variable Values relating to the price index:

- a)  $CPIH_m$
- b)  $FYCPIH_t$
- c)  $LTCPIH_t$

3.16. These inputs enable the model to be able to calculate  $PI_t$  as well as calculate a forecast in accordance with the methodology above.

#### *Totex Variant Allowances Allocation Percentages (TVAA<sub>t</sub>)*

3.17. These variable values comprise totex variant allowance allocation percentages, used in the GT3 PCFM to allocate variant totex allowances between the six categories of totex as listed below:

1. Load related capex
2. Asset replacement capex
3. Other capex
4. Non-load (opex)
5. Indirects (opex)
6. Non-operational capex

3.18. These allocation rates enable actual and forecast allowances to feed into Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) through the Totex Incentive Mechanism (see paragraph 3.6) and relate specifically to any re-opener or uncertainty mechanism, which have not been pre-populated in the GT3 PCFM as a “yellow box” hard-coded input.

## List of PCFM Variable Values

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

### Variant Totex Allowances

VV	Description	SpC	Cross-reference / Associated Document
NARM <sub>t</sub>	Baseline Network Risk Output	SpC 3.1	PCFM Guidance, Network Asset Risk Workbook, NARM Handbook
NARMAH <sub>t</sub>	NARM Asset Health Re-opener	SpC 3.1	PCFM Guidance, Re-opener Guidance and Application Requirements
CY <sub>t</sub>	Cyber resilience term Price Control Deliverable	SpC 3.2	PCFM Guidance, PCD Reporting Requirements and Methodology Document
CYRE <sub>t</sub>	Cyber resilience Re-Opener	SpC 3.2	PCFM Guidance, Re-opener Guidance and Application Requirements
CYU <sub>t</sub>	Cyber Use it or lose it allowance	SpC 3.2	PCFM Guidance, Re-opener Guidance and Application Requirements
RESTRE <sub>t</sub>	Resilience Activity Re-opener	SpC 3.3	PCFM Guidance, PCD Reporting Requirements and Methodology Document
PSUP <sub>t</sub>	Physical Security Price Control Deliverable	SpC 3.3	PCFM Guidance, PCD Reporting Requirements and Methodology Document
PSUPRE <sub>t</sub>	Physical Security Price Control Deliverable - Re-Opener Element	SpC 3.3	PCFM Guidance, Re-opener Guidance and Application Requirements
SPD <sub>t</sub>	Small Decarbonisation Projects Re-opener	SpC 3.4	PCFM Guidance, Net Zero Pre-construction Work and Small Net Zero projects Re-opener Governance Document
DPD <sub>t</sub>	Decarbonisation Project Development Fund UIOLI	SpC 3.5	PCFM Guidance
DEP <sub>t</sub>	Decarbonisation and Environmental Policy Re-Opener	SpC 3.6	PCFM Guidance, Re-opener Guidance and Application Requirements
DIGI <sub>t</sub>	Digitalisation Re-opener	SpC 3.7	PCFM Guidance, Re-opener Guidance and Application Requirements

VV	Description	SpC	Cross-reference / Associated Document
CAM <sub>t</sub>	Coordinated Adjustment Mechanism Re-opener	SpC 3.8	PCFM Guidance, Re-opener Guidance and Application Requirements
BTR <sub>t</sub>	Bacton terminal site redevelopment Price Control Deliverable	SpC 3.9	PCFM Guidance, PCD Reporting Requirements and Methodology Document
CEP <sub>t</sub>	Compressor Emissions Price Control Deliverable	SpC 3.10	PCFM Guidance, PCD Reporting Requirements and Methodology Document
FIOC <sub>t</sub>	Funded Incremental Obligated Capacity Price Control Deliverable	SpC 3.11	PCFM Guidance, Guidance on the Incremental Obligated Capacity Re-opener
FIOCRE <sub>t</sub>	Funded Incremental Obligated Capacity Price Control Deliverable - Re-Opener Element	SpC 3.11	PCFM Guidance, Re-opener Guidance and Application Requirements, Guidance on the Incremental Obligated Capacity Re-opener
AH <sub>t</sub>	Asset health Re-Opener	SpC 3.12	PCFM Guidance, Re-opener Guidance and Application Requirements
RA <sub>t</sub>	Redundant assets Price Control Deliverable	SpC 3.13	PCFM Guidance, PCD Reporting Requirements and Methodology Document
QL <sub>t</sub> and PD <sub>t</sub>	Uncertain Costs Re-opener	SpC 3.14	PCFM Guidance, Re-opener Guidance and Application Requirements
BIOCT	Biomethane Connections use it or lose it allowance	SpC 3.15	PCFM Guidance
CBD <sub>t</sub>	Compressor Breakdown Use it or lose it allowance	SpC 3.16	PCFM Guidance
RNS <sub>t</sub> and GNS <sub>t</sub>	Nitrogen Sleeves Price Control Deliverable	SpC 3.17	PCFM Guidance, PCD Reporting Requirements and Methodology Document
WIRP <sub>t</sub>	West Import Resilience Project Price Control Deliverable	SpC 3.18	PCFM Guidance, PCD Reporting Requirements and Methodology Document
WIRPO <sub>t</sub>	West Import Resilience Project Re-opener	SpC 3.18	PCFM Guidance, Re-opener Guidance and Application Requirements
GSPR <sub>t</sub>	Gas strategic planning re-opener	SpC 3.19	PCFM Guidance, Re-opener Guidance and Application Requirements
GNCCRE <sub>t</sub>	Office and Gas National Control Centre and Emergency Control Room Relocation Re-opener	SpC 3.20	PCFM Guidance, Re-opener Guidance and Application Requirements

VV	Description	SpC	Cross-reference / Associated Document
NC <sub>t</sub>	Network capability re-opener	SpC 3.21	PCFM Guidance, Re-opener Guidance and Application Requirements
BEF <sub>t</sub>	Bacton Enhanced Filtration re-opener	SpC 3.22	PCFM Guidance, Re-opener Guidance and Application Requirements
NDCRE <sub>t</sub>	Network decarbonisation and emissions compliance Re-opener	SpC 3.23	PCFM Guidance, Re-opener Guidance and Application Requirements
CAB <sub>t</sub>	Compressor acoustic building replacement Price Control Deliverable	SpC 3.24	PCFM Guidance, PCD Reporting Requirements and Methodology Document
ER <sub>t</sub>	Easement Reinstatement Price Control Deliverable	SpC 3.25	PCFM Guidance, PCD Reporting Requirements and Methodology Document
RVPS <sub>t</sub>	Removal of valve and pipe stabbings Price Control Deliverable	SpC 3.26	PCFM Guidance, PCD Reporting Requirements and Methodology Document
ARE <sub>t</sub>	Actuator replacement Price Control Deliverable	SpC 3.27	PCFM Guidance, PCD Reporting Requirements and Methodology Document
GT2ACA <sub>t</sub>	GT2/GT3 Crossover Adjustment	SpC 3.28	PCFM Guidance

### Actual Totex (Capitalisation Rate 1)

VV	Description	SpC	Cross-reference / Associated Document
ALC	Actual load related capex expenditure		PCFM Guidance
ARC	Actual asset replacement capex expenditure		PCFM Guidance
AOC	Actual other capex expenditure		PCFM Guidance
ACO	Actual non-load (opex)		PCFM Guidance
AIO	Actual indirects (opex)		PCFM Guidance
ANC	Actual non-operational capex		PCFM Guidance

### Actual Totex (Capitalisation Rate 2)

VV	Description	SpC	Cross-reference / Associated Document
ALCU	Actual load related capex expenditure		PCFM Guidance
ARCU	Actual asset replacement capex expenditure		PCFM Guidance
AOCU	Actual other capex expenditure		PCFM Guidance
ACOU	Actual non-load (opex)		PCFM Guidance
AIOU	Actual indirects (opex)		PCFM Guidance
ANCU	Actual non-operational capex		PCFM Guidance

### Pass-through expenditure

VV	Description	SpC	Cross-reference / Associated Document
RB <sub>t</sub>	Prescribed Rates	SpC 6.1, Part B	PCFM Guidance
LF <sub>t</sub>	Licence Fees	SpC 6.1, Part A	PCFM Guidance
EDE <sub>t</sub>	Pension deficit charge	SpC 6.1, Part A	PCFM Guidance
OPTC <sub>t</sub>	Secretary of State in respect of Policing Costs	SpC 6.1, Part A	PCFM Guidance
IS <sub>t</sub>	Gas conveyed to Independent Systems (SIU)	SpC 6.2	PCFM Guidance
PTV <sub>t</sub>	PARCA Termination Value	SpC 6.1, Part D	PCFM Guidance
Hy <sub>t</sub>	Hy-Net	SpC 6.1, Part E	PCFM Guidance
NZPSt	Distribution Networks' Net Zero Pre-construction Work and Small Net Zero Projects Re-opener	SpC 6.1, Part F	PCFM Guidance

### Incentive Revenue

VV	Description	SpC	Cross-reference / Associated Document
CSI <sub>t</sub>	Customer satisfaction incentive	SpC 4.2	PCFM Guidance

### Other Revenue Allowances

VV	Description	SpC	Cross-reference / Associated Document
NIA <sub>t</sub>	RIIO-3 Network Innovation Allowance	SpC 5.2	PCFM Guidance, RIIO-3 NIA Governance Document

CNIA <sub>t</sub>	Carry-over RIIO-2 Network Innovation Allowance	SpC 5.3	PCFM Guidance, RIIO-2 NIA Governance Document
SIFF <sub>t</sub>	The Strategic Innovation Fund	SpC 5.7	SIF Governance Document, PCFM Guidance
PRPN <sub>t</sub>	Pre-RIIO pension true up	SpC 5.1	PCFM Guidance

### Legacy Adjustments

VV	Description	SpC	Cross-reference / Associated Document
LADJ <sub>t</sub>	Legacy Adjustment term	SpC 7.2	PCFH section 8, PCFM Guidance
LK <sub>t</sub>	Legacy K Correction	SpC 7.3	PCFH section 8, PCFM Guidance
LRAV <sub>t</sub>	RIIO-2 net RAV additions (after disposals)	SpC 7.4	PCFH section 8, PCFM Guidance
OGP <sub>t</sub>	General pool capital allowance opening balance brought forward	SpC 7.4	PCFH section 8, PCFM Guidance
OSRP <sub>t</sub>	Special Rate capital allowance opening balance brought forward	SpC 7.4	PCFH section 8, PCFM Guidance
OSBP <sub>t</sub>	Structures and buildings capital allowance opening balance brought forward	SpC 7.4	PCFH section 8, PCFM Guidance
ODRP <sub>t</sub>	Deferred revenue expenditure opening balance brought forward	SpC 7.4	PCFH section 8, PCFM Guidance
LODRP <sub>t</sub>	Deferred revenue pool additions (RIIO2) plus opening balance at start of RIIO2	SpC 7.4	PCFH section 8, PCFM Guidance
OTL <sub>t</sub>	Tax loss brought forward	SpC 7.4	PCFH section 8, PCFM Guidance

### Directly Remunerated Services

VV	Description	SpC	Cross-reference / Associated Document
DRSR <sub>t</sub>	Directly remunerated services revenue	SpC 9.7	PCFM Guidance
DRSC <sub>t</sub>	Directly remunerated services cost	SpC 9.7	PCFM Guidance

### Finance Inputs

VV	Description	SpC	Cross-reference / Associated Document
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RFR	Risk-free rate		PCFH section 4, PCFM Guidance
iBTA <sub>t</sub>	iBoxx trailing average		PCFH section 4, 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
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
FEGP <sub>t</sub>	General pool additions qualifying for full expensing allowance		PCFM Guidance

FESR <sub>t</sub>	Special rate pool additions qualifying for full expensing allowance		PCFM Guidance
BRFPA <sub>t</sub>	Base revenue forecasting penalty adjustment	SpC 2.1 Part G	PCFM Guidance
RRFPA <sub>t</sub>	Recovered revenue forecasting penalty adjustment	SpC 2.1, Part G	PCFM Guidance
BRR <sub>t</sub>	Recovered revenue billed basis		PCFM Guidance
BD <sub>t</sub>	Bad debt		PCFM Guidance
RR <sub>t</sub>	Recovered revenue	SpC 2.1, Part B	PCFM Guidance
RPA <sub>t</sub>	Revenue profiling adjustment	SpC 2.1, Part D	

**Table 3.2 - PCFM Variable Values (VV) for SO**

#### Variant Totex Allowances

VV	Description	SpC	Cross-reference / Associated Document
CY <sub>t</sub>	Cyber resilience termPrice Control Deliverable	SpC 3.2	PCFM Guidance, PCD Reporting Requirements and Methodology Document
CYRE <sub>t</sub>	Cyber resilience Re-Opener	SpC 3.2	PCFM Guidance, Re-opener Guidance and Application Requirements
CYU <sub>t</sub>	Cyber Use it or lose it allowance	SpC 3.2	PCFM Guidance, Re-opener Guidance and Application Requirements
DEP <sub>t</sub>	Decarbonisation and Environmental Policy Re-opener	SpC 3.6	PCFM Guidance, Re-opener Guidance and Application Requirements
FIOC <sub>t</sub>	Funded Incremental Obligated Capacity Price Control Deliverable	SpC 3.11	PCFM Guidance, Guidance on the Incremental Obligated Capacity Re-opener
FIOCRE <sub>t</sub>	Funded Incremental Obligated Capacity Price Control Deliverable - Re-Opener Element	SpC 3.11	PCFM Guidance, Re-opener Guidance and Application Requirements, Guidance on the

VV	Description	SpC	Cross-reference / Associated Document
			Incremental Obligated Capacity Re-opener

### Actual Totex

VV	Description	SpC	Cross-reference / Associated Document
SOANC	Actual non-operational capex		PCFM Guidance
SOACO	Actual controllable opex		PCFM Guidance

### Pass-through expenditure

VV	Description	SpC	Cross-reference / Associated Document
SOEDE <sub>t</sub>	Pension Scheme Established Deficit	SpC 6.3	PCFM Guidance, PCFH Section 7
CDSP <sub>t</sub>	CDSP Costs, excluding costs incurred in relation to UK Link Gemini	SpC 6.3, Part A	PCFM Guidance
ARGSP <sub>t</sub>	ISOP's gas revenue provision	SpC 6.4	PCFM Guidance

### Other Revenue

VV	Description	SpC	Cross-reference / Associated Document
CMIR <sub>t</sub>	Constraint management incentive revenue	SpC 5.5, Part B	PCFM Guidance
SOPRPN <sub>t</sub>	Pre-RIIO pension true up and	SpC 5.4, Part A	PCFM Guidance
RAREnCA <sub>t</sub>	Revenue from accelerated release of incr. obl. entry capacity	SpC 5.5, Part A	PCFM Guidance
ExBBCNLRA <sub>t</sub>	Exit capacity buyback cost which users are liable to reimburse	SpC 5.5, Part A	PCFM Guidance
RBC <sub>t</sub>	Revenue for net residual balancing costs	SpC 5.6, Part A	PCFM Guidance

OMC <sub>t</sub>	Total costs for procurement of operating margin services	SpC 5.6, Part A	PCFM Guidance
SC <sub>t</sub>	System costs	SpC 5.6, Part A	PCFM Guidance
RBIR <sub>t</sub>	Residual balancing incentive	SpC 5.6, Part B	PCFM Guidance
QDAIR <sub>t</sub>	Quality of demand forecasting incentive revenue	SpC 5.6, Part C	PCFM Guidance
GHGCC <sub>t</sub>	Green house gas compressor emissions incentive	SpC 5.8, Part B	PCFM Guidance
GHGP <sub>t</sub>	Green house gas emissions incentive	SpC 5.8, Part D	PCFM Guidance
SHR <sub>t</sub>	Shrinkage Procurement incentive	SpC 5.8, Part G	PCFM Guidance
MIR <sub>t</sub>	Maintenance incentive	SpC 5.6, Part D	PCFM Guidance

## Legacy Adjustments

VV	Description	SpC	Cross-reference / Associated Document
SOLADJ <sub>t</sub>	System Operator legacy adjustment term	SpC 7.6	PCFH section 8, PCFM Guidance
SOLK <sub>t</sub>	System Operator legacy K correction	SpC 7.7	PCFH section 8, PCFM Guidance
SOLRAV <sub>t</sub>	RIIO-2 net RAV additions (after disposals)	SpC 7.8	PCFH section 8, PCFM Guidance
SOOGP <sub>t</sub>	General pool capital allowance opening balance brought forward	SpC 7.8	PCFH section 8, PCFM Guidance
SOOSRP <sub>t</sub>	Special Rate capital allowance opening balance brought forward	SpC 7.8	PCFH section 8, PCFM Guidance
SOOSBP <sub>t</sub>	Structures and buildings capital allowance opening balance brought forward	SpC 7.8	PCFH section 8, PCFM Guidance
SOODRP <sub>t</sub>	Deferred revenue expenditure opening balance brought forward	SpC 7.8	PCFH section 8, PCFM Guidance
SOLODRP <sub>t</sub>	Deferred revenue pool additions (RIIO2) plus opening balance at start of RIIO2	SpC 7.8	PCFH section 8, PCFM Guidance
SOOTL <sub>t</sub>	Tax loss brought forward	SpC 7.8	PCFH section 8, PCFM Guidance

## Finance Inputs

VV	Description	SpC	Cross-reference / Associated Document
RFR <sub>t</sub>	Risk-free rate		PCFH section 4, PCFM Guidance
iBTA <sub>t</sub>	iBoxx trailing average		PCFH section 4, PCFM Guidance
RPE <sub>t</sub>	RPE indexation		PCFM Guidance
AND <sub>t</sub>	Adjusted net debt		PCFH section 6, PCFM Guidance
TDNI <sub>t</sub>	Tax deductible net interest cost		PCFH section 6, PCFM Guidance
SOTAXA <sub>t</sub>	Tax allowance adjustment	SpC 2.4	PCFH section 6, PCFM Guidance
SOTTE <sub>t</sub>	Tax liability allowance adjustments - driven by tax trigger events		PCFH section 6, PCFM Guidance
SOOGPA <sub>t</sub>	General pool opening balance adjustment		PCFM Guidance
SOOSRPA <sub>t</sub>	Special Rate pool opening balance adjustment		PCFM Guidance
SOARGP <sub>t</sub>	Allocation to "General" tax pool		PCFM Guidance
SOARSR <sub>t</sub>	Allocation to "Special Rate" tax pool		PCFM Guidance
SOARR <sub>t</sub>	Totex allocation to "Revenue" tax pool		
SOARSB <sub>t</sub>	Allocation to "Structures and Buildings" tax pool		PCFM Guidance
SOARDR <sub>t</sub>	Totex allocation to "Deferred revenue" tax pool		PCFM Guidance
SOARNQ <sub>t</sub>	Allocation to "Non Qualifying" tax pool		PCFM Guidance
SOCT <sub>t</sub>	Corporation tax rate		PCFM Guidance
SOGCA <sub>t</sub>	General pool allowance rate		PCFM Guidance
SOSRCA <sub>t</sub>	Special Rate allowance rate		PCFM Guidance
SOSBCA <sub>t</sub>	Structures and buildings allowance rate		PCFM Guidance
SODRCA <sub>t</sub>	Deferred revenue expenditure allowance rate		PCFM Guidance

SOFEGPt	General pool additions qualifying for full expensing allowance		PCFM Guidance
SOFESRt	Special rate pool additions qualifying for full expensing allowance		PCFM Guidance
SOBRFPAt	Base revenue forecasting penalty adjustment	SpC 2.3 Part G	PCFM Guidance
SORRFPAt	Recovered revenue forecasting penalty adjustment	SpC 2.3, Part G	PCFM Guidance
BSORR <sub>t</sub>	Recovered revenue billed basis		PCFM Guidance
SOBD <sub>t</sub>	System Operator Bad Debt		PCFM Guidance
SORR <sub>t</sub>	Recovered revenue	SpC 2.3, Part D	PCFM Guidance

### Totex variant allowances allocation percentages

VV	Description	SpC	Cross-reference / Associated Document
TVAAt	The range of totex variant allowance allocation percentages relating to any re-opener or uncertainty mechanism, which have not been pre-populated in the GT3 PCFM as a “yellow box” hard-coded input.		PCFM Guidance

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

4.1. The licensee's Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) 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 semi-nominal WACC, please see the end of the chapter for the calculation.

4.2. Under the GT3 price control, the notional gearing is fixed for the Price Control Period. However, there are annual revisions to: the allowed return on debt; and 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 ( $KdFRDt$ ) and the allowed return on index-linked debt ( $KdILDt$ ).

4.5. The values of  $KdFRDt$  and  $KdILDt$  will be updated annually.

### Methodology

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

4.6. For each day from 1 April 2012 to 31 March 2030, obtain a nominal 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 % 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 the year 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 01 April 2012 to 31 March 2030, add to the daily yield figures obtained under Step 1:

- a) 32 basis points for additional costs of borrowing;
- b) 72 basis points calibration adjustment.

*Step 3 – obtain ( $\pi_t$ ) inflation values*

4.8. For each day from 01 April 2012 to 31 March 2030, obtain an inflation value from the OBR's Historical official forecasts database, as follows:

- a) For days prior to 01 April 2012, the inflation forecasts used will be 2% for CPIH.
- b) For days on or after 01 April 2012 and up to and including 31 March 2025, the inflation value is the latest Office for Budget Responsibility (OBR) year 5 forecast of CPI that was available on that given day, subject to the assumption that the OBR forecast is available from the first day of the month following the month of publication; and
- c) For all other days, the inflation value is the latest OBR year 5 forecast of CPIH available on 31 October in the year in which the update is being conducted, in each case using the year 4 forecast for the year if the year 5 forecast is not available.

*Step 4 – calculate iBoxx Trailing Average (iBTAt)*

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 iBTAt derived above are rounded to two decimal places ie x.xx%.

**Table 1 – time periods for calculation of iBoxx Trailing Average (iBTAt) by Regulatory Year**

<i>Regulatory Year</i>	<i>Time period for calculation</i>
2026/27	1 April 2012 to 31 March 2026
2027/28	1 April 2013 to 31 March 2027
2028/29	1 April 2014 to 31 March 2028
2029/30	1 April 2015 to 31 March 2029



2030/31	1 April 2016 to 31 March 2030
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4.11. The resulting averages, expressed as a percentage, constitute the  $iBTA_t$  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:

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

4.14. Ofgem will provide the licensee with a copy of the data and spreadsheet used to calculate revised  $iBTA_t$ ,  $KdFRD_t$  and  $KdILD_t$  values.

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

**Close out adjustment mechanism for costs arising from the expected adjustment of the RPI methodology in 2030.**

4.16. The purpose of this section is to enable the Authority to review and amend the calculation of additional costs of borrowing. This contributes to the calculation of the terms  $KdFRD$  and  $KdILD$ .

4.17. The amendment may adjust the term for efficient costs incurred by Licensees in connection with either or both of the following:

- a) The finalisation of compensatory arrangements with debt investors arising from the transition from RPI to CPIH;
- b) Litigation between companies and debt investors in relation to the transition.

4.18. The Authority may initiate, by notice to the Licensee, an assessment of relevant costs incurred during the RIIO-3 regulatory period under this section from 1 April 2030.

4.19. The Authority shall conduct such assessment no later than one (1) year following the conclusion of the RIIO-3 price control, unless it reasonably determines that a later assessment is necessary due to ongoing litigation or unresolved compensatory processes.

4.20. In determining the relevant size of the adjustment, if any, the Authority shall consider what costs would reasonably be incurred by an efficient licensee adopting the notional capital structure. This assessment shall include an evaluation of:

- a) Submitted evidence of costs incurred by licensees
- b) Whether the processes followed by licensees reflect prudent and diligent management.
- c) Consistency of underlying lending documentation and compensatory provisions with broader corporate practices.

4.21. The Licensee shall provide to the Authority, upon request:

- a) Comprehensive documentation evidencing the costs incurred;
- b) Relevant legal or expert opinions;
- c) Justification of alignment with corporate practice and the notional capital structure;
- d) Any other information the Authority may reasonably require.

4.22. The Licensee shall maintain appropriate records to support the evaluation.

4.23. Following its assessment, the Authority may direct an adjustment to the additional costs of borrowing.

4.24. Before making a direction under paragraphs [x] the Authority will publish on the Authority's Website:

- a) the text of the proposed direction;

- b) the reasons for the proposed direction; and
- c) a period during which representations may be made on the proposed direction, which will not be less than 28 days.

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

4.25. If, for any reason, the IBoxx, or OBR CPHI forecast 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 GT3 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.

4.26. If, for reasons other than stated in paragraph 4.25, iBoxx data (paragraph **Error! Reference source not found.**(a)) 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 applied using the nominal annual yield as the average of the last full calendar month of outturn data available in which the update is being conducted with the same methodology described in paragraph 4.6(b). 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**

4.27. The RFR<sub>t</sub> 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

4.28. 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*

4.29. 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.

4.30. 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>7</sup>

*Step 2 derive an RPI-CPIH inflation wedge*

4.31. 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.

4.32. 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.

4.33. The inflation wedge is calculated assessing official forecasts of CPIH 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.

4.34. 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-term OBR forecasts for RPI and CPIH for each year that are available in the November preceding the start of the Price Control Period.<sup>8</sup> The OBR inflation data is presented in financial year form.

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<sup>7</sup> Sourced from the yield curves page of the Bank of England's website:  
<https://www.bankofengland.co.uk/statistics/yield-curves>

<sup>8</sup> Sourced from the supporting document tables in the OBR website titled "economic and fiscal outlook":  
[Economic and fiscal outlook – March 2025 - Office for Budget Responsibility](#)

4.35. 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 2.8% the year 5 forecast from the OBR) and 8% of a long run CPIH (we assume 2.1% the year 5 forecast from the OBR) to generate an RPI forecast of 2.74%. 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.

4.36. 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 2.39%. As above, this assumes ten of the twenty-four months between April 2029 and March 2031 use the old RPI definition.

4.37. For financial years 2031/2032 and beyond we assume both RPI and CPIH are equal to 2.1% and the wedge is effectively zero.

*Step 3 calculate the annual RFRT*

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

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

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

**Semi-nominal WACC**

4.40. 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%.

$$SnomWACCt = (KdFRDt \times \text{fixed rate portion}) + (KdILDt \times \text{ILD portion}) + ((ARoEt \times (1-g)))$$

## **Nominal WACC**

4.41. The nominal WACC is calculated using the nominal cost of equity allowance and the nominal cost of debt allowance. The nominal cost of debt allowance is calculated using the proportion of debt for each sector. The nominal cost of equity is the real cost of equity inflated by an inflation assumption

$$\text{NomWACC}_t = (\text{KdFRD}_t \times \text{fixed rate debt portion}) + (\text{KdILD}_t \text{ inflated by OBR forecast inflation} \times \text{ILD debt portion}) + ((\text{ARoE}_t \text{ inflated by OBR forecast inflation}) \times (1-g))$$

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

4.42. Ofgem will provide licensees a model containing the methodology to derive (and forecast) the PCFM Variable Value RFR<sub>t</sub> and iBT<sub>t</sub> ("the WACC Rates Model").

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

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

4.45. The data and the spreadsheet used to calculate the revised RFR<sub>t</sub> and iBT<sub>t</sub> 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.

## 5. Real Price Effects and Uncertain Event

### Real Price Effects

5.1. The GT3 price control includes an allowance for differences between the Price Index applied to Allowed Revenue and SO Allowed Revenue ( $AR_t$  and  $SOAR_t$ ) and certain input price indices. We refer to these differences as Real Price Effects.

5.2. The variable values  $RPE_t$  and  $SORPE_t$ , expressed as a percentage, identify annual differences between the price control inflation and input price indices inflation.

5.3. The variable values  $RPE_t$  and  $SORPE_t$  (for the licensee's TO and SO activities respectively), are used in the GT3 PCFM to derive the RPE Index ( $RPEI_t$  and  $SORPEI_t$ ) applied to certain totex allowances (in 2023/24 price terms) to allow for Real Price Effects. The totex allowances to which the variable values  $RPE_t$  and  $SORPE_t$  apply are identified in the GT3 PCFM and the calculation of the allowance for Real Price Effects is done within the GT3 PCFM.

5.4. In updating the values of  $RPE_t$  and  $SORPE_t$ , the process set out under the heading "Methodology for forecast values" in this chapter will be followed.

### Formula for calculating the Real Price Effect ( $RPE_t$ ) and $SORPE_t$ terms

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

$$RPE_t \text{ and } SORPE_t = \sum_{j=1}^N W_{j,t} \left( \left( \frac{IP_{j,t}}{IP_{j,t-1}} \right) / \left( \frac{PI_t}{PI_{t-1}} \right) - 1 \right)$$

where,

$W_{j,t}$  means the weight applied to the input price index  $j$  at time  $t$ , during the Price Control Period and takes the values 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 E of Special Condition 2.1 (Transmission owner revenue restriction)

$N$  where  $N = 5$  for TO, and  $N = 3$  for SO.

5.6. The input price indices ( $IP_j$ ), their weightings ( $W_{j,t}$ ) in the calculation of  $RPE_t$  or  $SORPE_t$  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 for  $RPE_t$  and  $SORPE_t$**

Index	Identifier	Index Description & Source	Year	NGT (TO) Index Weights for RPE (W <sub>j,t</sub> )	NGT (SO) Index Weights for SORPE (W <sub>j,t</sub> )
Labour					
1	K54V	AWE: Private Sector Index: Seasonally Adjusted Total Pay Excluding Arrears [Source: ONS]	2026-2027	10.0%	13.9%
			2027-2028	9.9%	14.0%
			2028-2029	9.6%	14.6%
			2029-2030	9.9%	14.5%
			2030-2031	10.0%	15.0%
2	K553	AWE: Construction Index: Seasonally Adjusted Total Pay Excluding Arrears [Source: ONS]	2026-2027	10.0%	13.9%
			2027-2028	9.9%	14.0%
			2028-2029	9.6%	14.6%
			2029-2030	9.9%	14.5%
			2030-2031	10.0%	15.0%
3	4/CE/01	4/CE/01 Civil Engineering Labour [Source: BCIS]	2026-2027	10.0%	13.9%
			2027-2028	9.9%	14.0%
			2028-2029	9.6%	14.6%
			2029-2030	9.9%	14.5%
			2030-2031	10.0%	15.0%
Materials					
4	FOCOS	FOCOS Resource Cost Index of Infrastructure: Materials FOCOS [Source: BCIS]	2026-2027	9.1%	N/A
			2027-2028	9.3%	N/A
			2028-2029	10.5%	N/A
			2029-2030	10.4%	N/A
			2030-2031	10.5%	N/A
5	3/S3	3/S3 Structural Steelwork - Materials: Civil Engineering Work [Source: BCIS]	2026-2027	9.1%	N/A
			2027-2028	9.3%	N/A
			2028-2029	10.5%	N/A
			2029-2030	10.4%	N/A
			2030-2031	10.5%	N/A

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



**Formulae for calculating the Real Price Effects Index (RPEI<sub>t</sub> and SORPEI<sub>t</sub>) and RPE totex allowance (RPEA<sub>t</sub> and SORPEA<sub>t</sub>)**

5.7. The RPE<sub>t</sub> and SORPE<sub>t</sub> values are used in the GT3 PCFM to derive the RPE indexation term RPEI<sub>t</sub> and SORPEI<sub>t</sub> as follows:

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

and

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

5.8. The RPE totex allowance (RPEA<sub>t</sub> and SORPEA<sub>t</sub>) is determined applying RPEI<sub>t</sub> and SORPEI<sub>t</sub> to the applicable totex allowance:

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

and

$$SORPEA_t = (SORPEI_t - 1) \cdot Tx_t$$

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 GT3 PCFM will allocate the RPEA and SORPEA values to appropriate capitalisation rate buckets based on the capitalisation rate of the totex allowance the RPE and SORPE 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 RPET and SORPET.

### Methodology for forecast values

5.11. The values of RPET and SORPET 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 a forecast will be derived in accordance with the following sections.

- a) For labour indices, outturn data will be updated to the month of September, and forecast monthly values will use a monthly growth rate calculated from the most recent average earnings forecast published by OBR<sup>9</sup> applied to the previous value:

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

where,

$IP_m$  is the labour input price index value for a given year-month "m".

$OBREF_m$  Means the OBR average earnings forecast (annual rate) applicable to year-month m, where the OBR forecast for a financial year is applicable from 6 months prior to the start of that financial 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 2024/25-2028/29, then the forecast for year 2028/29 would be used for 2029/30 and 2030/31).

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

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

where,

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<sup>9</sup> Sourced from the data page of the OBR website titled "Historical official forecast database – [Month] [Year]": <https://obr.uk/data/>

$IP_m$	is the 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 Table 5.1 above.

### **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 2.1.7 of Special Condition 2.1 are used to derive the value of  $RPE_t$  and  $SORPE_t$  in the same model.

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

5.14. Ofgem will perform the above updates to the spreadsheet used to calculate the  $RPE_t$  and  $SORPE_t$  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  $RPE_t$  and  $SORPE_t$  values by 30 November, the licensee should use the previous Regulatory Year’s  $RPE_t$  and  $SORPE_t$  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  $RPE_t$  and  $SORPE_t$  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 GT3 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.**

**Uncertain Event**

## **affecting Special Condition 5.5, Special Condition 5.6 and Special Condition 5.8**

5.16. The GT3 PCFM contains variable values:

- a)  $CM_t$  relating to Special Condition 5.5 (Entry Capacity and Exit Capacity Constraint Management);
- b)  $SOIRC_t$  relating to Special Condition 5.6 (System operator external incentives, revenues and costs); and
- c)  $SOEIt$  relating to Special Condition 5.8 (System operator environmental incentives)

5.17. The Authority will review the provisions of Special Condition 5.5 (Entry Capacity and Exit Capacity Constraint Management), Special Condition 5.6 (NTS System Operator external incentives, revenues and costs) or Special Condition 5.8 (System operator environmental incentives) as the result of an Uncertain Event.

5.18. An Uncertain Event may arise from any one or more of the following:

- a) Any change in applicable legislation or regulations which affects or may be expected to affect the functions of the licensee as set out in Special Condition 5.5 (Entry Capacity and Exit Capacity Constraint Management), Special Condition 5.6 (NTS System Operator external incentives, revenues and costs) or Special Condition 5.8 (System operator environmental incentives);
- b) an event or circumstance constituting Force Majeure;
- c) an event or circumstance resulting in the declaration of a Network Gas Supply Emergency; or
- d) in relation to the Residual Gas Balancing Incentive set out in Part B of Special Condition 5.6 (NTS System Operator external incentives, revenues and costs) where:
  - i. There is material evidence that there is an increase in within-day volatility of gas demand has resulted from changes in CCGT operation as a consequence of increased levels of wind generation; and
  - ii. The increased levels of within-day volatility of gas demand have had a material impact on the licensee's performance as calculated by the  $LPM_t$  or  $PPM_t$ .

5.19. The licensee or any interested party may notify the Authority of an event or circumstance which, in their opinion, constitutes or may be likely to constitute an Uncertain Event.

5.20. Where the Authority has received a notification under paragraph 5.19, it will, within three months from the date of the receipt of that notification, decide whether an Uncertain Event has occurred or is likely to occur and give reasons for its decision.

5.21. Where the Authority decides that an Uncertain Event has occurred or is likely to occur in respect of one or more relevant incentives set out in Special Condition 5.5 (Entry Capacity and Exit Capacity Constraint Management), Special Condition 5.6 (NTS System Operator external incentives, revenues and costs) or Special Condition 5.8 (System operator environmental incentives), the Authority will consider modifying the relevant incentive(s) under Section 23 of the Act in order to ensure that the incentives affected by the Uncertain Event continue to have an appropriate incentive effect on the licensee.

5.22. In relation to the Residual Gas Balancing Incentive set out in Part B of Special Condition 5.6 (NTS System Operator external incentives, revenues and costs) only, any licence condition modified in accordance with Section 23 of the Act as a result of the operation for an Uncertain Event set out under paragraph 5.18 (d) will not take effect prior to 1 April 2030.

## 6. Tax liability allowances

6.1. The GT3 PCFM calculates a licensee's tax liability allowance on a notional basis (i.e. 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>10</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 GT3 PCFM by updating the variable values for these rates ( $CT_t$ ,  $GCA_t$ ,  $SRCA_t$ ,  $SBCA_t$  and  $DRCA_t$ ) at each annual update of the PCFM.

6.6. The GT3 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 GT3 PCFM) is greater than the notional gearing level and where its Tax deductible net interest costs ( $TDNI_t$ ) exceed the notional modelled interest costs, the tax benefit derived from its higher tax-deductible interest costs is clawed back and shared with consumers through the GT3 PCFM.

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<sup>10</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.

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

- a) Tax trigger events TTE and SOTTE - a licensee's notional tax liability<sup>11</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 review adjustment mechanism  $TAXA_t$  and  $SOTAXA_t$  – 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 in accordance with paragraph 8.7 until directed by Ofgem, through variable values ( $TO:OGP_t$ ,  $OSRP_t$ ,  $OSBP_t$ ,  $LODRP_t$  and  $ODRP_t$ ;  $SO: SOLOGP_t$ ,  $SOLOSRP_t$ ,  $SOLOSBP_t$ ,  $SOLODRP_t$ ,  $SOLLODRP_t$  and  $SOLOTL_t$ ). These balances will be rolled forward from the closing position in the RIIO-GT2 PCFM following the close-out of the RIIO-GT2 Price Control
- d) Capital allowances: allocation rates – the GT3 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 ( $ARGP_t$ ,  $ARSR_t$ ,  $ARSB_t$ ,  $ARDR_t$ ,  $ARR_t$ ,  $ARNQ_t$ ).
- 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-GT2 PCFM following the close-out of the RIIO-GT2 Price Control.

6.8. All of these tax related PCFM Variable Values (with the exception of the Tax Allowance adjustment term and System Operator Tax Allowance Adjustment Term,  $TAXA_t$  and  $SOTAXA_t$ ) feed into the Tax Allowance term ( $TAX_t$ ) and System Operator Tax Allowance Term ( $SOTAX_t$ ). Both the  $TAX_t$  and  $TAXA_t$  terms (and SO equivalent terms) feed into Calculated Revenue and System Operator Calculated Revenue ( $R_t$  and  $SOR_t$ ) as set out in Special Condition 2.1 (Revenue restriction) and Special Condition 2.3 respectively.

6.9. The approach to determining or revising the variable values in paragraph 6.7 and/or the calculation in the GT3 PCFM are described, further below.

6.10. It should be noted that underlying tax liability allowances for the licensee within the GT3 PCFM may also change under the AIP as a consequence of other variable values, such

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<sup>11</sup> The tax liability which would be modelled if the event was taken into account.

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 GT3 PCFM and is factored into Calculated Revenue and SO Calculated Revenue ( $R_t$  and  $SOR_t$ ) via the AIP.

#### *Regulatory tax losses*

6.12. There have been significant changes to the capital allowances regime, 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 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 GT3 PCFM.

6.13. As noted at 6.4 above, there will be differences between the notional tax allowance, and the licensees' Actual Corporate Tax Liability, this means that regulatory tax losses are likely to differ from any actual corporate 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>12</sup> Any such surrenders

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<sup>12</sup> <https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm80530>



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>13</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*

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<sup>13</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>14</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 chapter 3 and chapter 4 of this Handbook, the licensee must ensure that all tax-related values<sup>15</sup> 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 ET2 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 RIIIO-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 or SO Allowed Revenue to ensure parity.

## **Tax trigger events**

6.22. The GT3 PCFM allows for changes to a licensee's tax liability allowance, through variable values TTE and SOTTE, for factors exogenous to the licensee, its owners or controllers that cause a change in its notional tax liabilities<sup>16</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 TO and SO variable values ( $CT_t$ ,  $GCA_t$ ,  $SRCA_t$ ,  $SBCA_t$  and  $DRCA_t$ ), but include:

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<sup>14</sup> Including the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) where applicable.

<sup>15</sup> Meaning variable values for Corporation Tax and capital allowance rates, and tax pool allocations.

<sup>16</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 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 used 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 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 and / or SOTTE 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 under paragraph 6.31 before notifying the licensee of tax trigger events that it proposed to take into account, Ofgem will through business correspondence, apprise the licensee of any provisionality it has applied in determining the revised TTE and / or SOTTE 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, particularly changes to the capital allowances regime which, for example, create new types of capital allowance pools<sup>17</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 6.22 to 6.33 above, or to update the GT3 PCFM 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' and 'System Operator' worksheets (Tax trigger calculations section) for the licensee in the GT3 PCFM. The materiality threshold is a fixed value for each Regulatory Year of the Price Control Period. The threshold was determined for each Regulatory Year as the greater of:

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<sup>17</sup> An example of this would be the introduction of structures and building allowances in [Finance Act 2019](#)

- 0.33 percent of the Opening Base Revenue Allowance for the licensee for the Regulatory Year concerned; and
- the effect that a one per cent change in the rate of corporation tax would (all other things being equal) have had on the calculation of the Opening Base Revenue Allowance for the licensee for the Regulatory Year concerned.

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 and / or SOTTE 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**

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6.40. Special Condition 2.2 (Transportation owner 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 and Special Condition 2.4 (System Operator tax allowance adjustment) sets out that the Authority will direct the value of  $SOTAXA_t$  that it considers should be made after a tax review. In this section, reference to  $TAXA_t$  includes  $SOTAXA_t$ .

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 and Special Condition 2.4 Part A, the licensee's Calculated Tax Allowance and SO Calculated Tax Allowance can be updated for any periods from 31 March 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 the Actual Corporation Tax Liability, which have not been adequately explained in the supporting commentary to the reconciliation<sup>18</sup>;
- b) If 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<sup>19</sup>, 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 its Actual Corporation Tax Liability.

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<sup>18</sup> The reconciliation referred to is the Tax Reconciliation template reconciling the notional tax allowance per the GT3 PCFM and actual tax liability per their latest CT600 forms. This template forms part of the licensee's annual RIGs submissions.

<sup>19</sup> Meaning variable values for Corporation Tax and capital allowance rates, and tax pool allocations.

### *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 paragraph 6.35 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 in accordance with the RIIO-3 Regulatory Financial Performance Reporting Regulatory Instructions and Guidance.

### *Notifying the Authority*

6.45. Any notification by the licensee under paragraph 6.42 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 the licensee's 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  $TAXA_t$  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 6.42(c) 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 6.45. 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 6.42(c).



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 6.46, 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 GT3 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 and / or SO 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 or SO 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 6.42(c) 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 (AQIE) 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) and/or Part B of Special Condition 2.4 (System operator tax allowance adjustment).

6.54. Before making a direction, the Authority will consult on the proposed adjustment to the TAXA<sub>t</sub> 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 AQIE.

#### *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 TAXA<sub>t</sub> 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 AQIE<sup>20</sup>.

6.56. Ofgem will notify the licensee or licensees affected in accordance with Part A of Special Condition 2.2 (Transportation owner 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 AQIE's written findings and engage with both the AQIE and Ofgem before the final report is submitted by the Examiner to Ofgem. Ofgem shall communicate the examiner's written findings to the licensee within 10 working days of receipt of the AQIE's report.

#### *After the review*

6.58. Following the tax review, the Authority will consider the findings of the AQIE's report. Where the AQIE'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 TAXA<sub>t</sub> in accordance with Part B of Special Condition 2.2 (Transportation owner tax allowance adjustment) and/or Part B of Special Condition 2.4 (System operator tax allowance adjustment).

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<sup>20</sup> The examiner would be a qualified tax accountant from a reputable firm regulated by a relevant professional body. If appropriate, the examiner used may be the licensee's Appropriate auditors as defined in Standard Condition B1 of the Electricity Transmission licence.

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 AQIE'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 GT3 PCFM and will be published in accordance with Chapter 2 of this document.

6.62. For the avoidance of doubt, there will be no duplication or double-counting of adjustments between the TAXAt term and the other tax mechanisms that feed into the TAXt or SOTAXt terms.

6.63. The costs of the AQIE 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 TAXAt adjustment, the cost of the tax review (being the fees of the AQIE, and any associated costs) shall be borne by the licensee. This shall be achieved by including the costs within the TAXAt 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 GT3 PCFM. The opening balances for these pools will be the closing balances from the RIIO GT2 PCFM. RIIO-GT2 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 GT3 as a result. The opening balances (as at 01 April 2021) for these tax pools may be subject to legacy price control adjustments through revisions to TO (OGPt, OSRPt, OSBPt, LODRPt and ODRPt) and SO (OGPt, OSRPt, OSBPt, LODRPt and ODRPt) variable values.

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

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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. Any item which could be included (or excluded) under more than one of the below descriptions, shall not be double-counted.

#### *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.
- Interest which has been excluded from deduction by the Corporate Interest Restriction rules.

#### *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 GT3 PCFM contains variable value allowances<sup>21</sup> (EDE and SOEDE) for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period. Opening values for EDE and SOEDE are based on the outcome of a pension Reasonableness Review concluded in November 2023. EDE and SOEDE (or the pensions allowance values) will be updated during the Price Control Period. In this chapter, reference to EDE includes SOEDE.

#### 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 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**

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

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 paragraph 7.13), or a scheme valuation or completion of a Reasonableness Review (see

<sup>21</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 ( $R_t$  and  $SOR_t$ ) in the GT3 PCFM, ie it is not subject to the TIM.

from paragraph 7.31) 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>22</sup>, published in the Triennial Pension Reporting Pack as part of the Regulatory Instructions and 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 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, 'Decision on the Authority's policy for funding Pension Scheme Established Deficits' dated 7 April 2017.<sup>23</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

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<sup>22</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)

<sup>23</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/04/decision\\_on\\_policy\\_for\\_funding\\_pseds.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_pseds.pdf)



- 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>24</sup>

7.8. Where relevant PSED is further sub-divided for GT Transmission Operator and System Operator, in accordance with the Authority’s pension deficit allocation methodology.

7.9. 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.

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

## **Established surpluses**

7.11. 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

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<sup>24</sup> This definition applies even if the value derived is a negative amount (a surplus position) and may be described as an “established surplus”.

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 7.15, 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.

7.12. 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.

7.13. As part of the Reasonableness Review (see paragraph 7.31) 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**

7.14. 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**

7.15. 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.

7.16. 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).

7.17. 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.

7.18. 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**

7.19. 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 PSSED 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 7.31), 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>25</sup>**

Step 1: by 31 July

7.20. 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.

7.21. The Authority will obtain the licensee's Scheme Valuation Data Set, separately for its TO and SO activities, for the relevant valuation of the licensee's defined-benefit pension schemes by 31 July and commence a Reasonableness Review.

7.22. 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 to the full valuation date on the basis set out in the Pension Deficit Allocation Methodology<sup>26</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

7.23. The licensee will submit:

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<sup>25</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.

<sup>26</sup> <https://ofgem.gov.uk/publications-and-updates/notice-modify-regulatory-instructions-and-guidance-held-network-operators>

- a) Explanations and supporting evidence where appropriate for how it has interpreted the interest 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.

7.24. The licensee will also submit, separately for its Transmission Operator and System Operator activities, 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

7.25. The licensee will submit:

- a) its proposals with supporting explanation for
  - i. Base Annual PSED Allowances (PBAPA<sub>y</sub>), under paragraph 7.46
  - ii. payment history allowances (PPH<sub>y</sub>), under paragraph 7.52
  - iii. any proposed prospective discounting basis for payment history variances, reflected in PhDR<sub>y</sub>, under paragraph 7.52.
- 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.

7.26. In its explanations under paragraphs 7.25 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 PSED 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 7.23.

Step 4: by 30 September

7.27. The Authority will provisionally decide, separately for the licensee's TO and SO activities, whether:

- a) any change should be made to the licensee's proposals for Base Annual PSED Allowances and payment history allowances for reasons anticipated in paragraph 7.32 a) and b), and 7.33
- 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 7.34. 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 7.38.

7.28. 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

7.29. The Authority will complete its Reasonableness Review, separately for the licensee's TO and SO activities:

- a) determine the values  $BAP_{Ay}$ , representing the Base Annual PSED Allowances, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.46
- 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 7.52
- 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:
$$EDE_y \text{ or } SOEDE_y = BAP_{Ay} + PH_y + AF_y$$
- 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 7.52

- g) confirm whether a more detailed review of any established surplus is required (see paragraph 7.13).

Step 6: by 30 November

7.30. The Authority will direct revised pensions allowance values and will publish a report on the Reasonableness Review.

**Reasonableness Reviews and adjustment factors**

7.31. After receiving the whole (or substantially the whole) of the licensee's Scheme Valuation Data Set (see paragraph 7.22) and its proposals for Base Annual PSED Allowances and Payment History Allowances (see paragraph 7.25) 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.

7.32. The review referred to in paragraph 7.31 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 7.46 and 7.52
- 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 7.34, and
- e) conducting a more detailed review of any established surplus (see paragraph 7.13).

7.33. The Authority will only make a determination in respect of paragraph 7.32 b) if it considers the licensee's proposals under paragraphs 7.46 and 7.52 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.

7.34. Consistent with its price control pensions Principle 3,<sup>27</sup> the Authority will only apply adjustment factors referred to in paragraph 7.32 c) and 7.32 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
- b) inequitable charges for consumers arising from using the time value of money in paragraphs 2.16 and 2.17 in ascertaining the cumulative payment history variance under paragraph 7.49 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

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<sup>27</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)



- c) the licensee's failure to respond adequately to any recommendations set out by the Authority in preceding Reasonableness Reviews.

7.35. 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>.

7.36. Before deciding to make determinations referred to in paragraphs 7.32 b), 7.32 c) and 7.32 d), the Authority will consult with the licensee (see paragraph 7.28), giving its reasons with reference to paragraphs 7.33 and 7.34 and to the Pensions Principles referred to in paragraph 7.6.

7.37. 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 7.33 and 7.34, that have led to its decision, and
- c) Set out the basis on which it considers any adjustment factors referred to in 7.3232 c) or 7.3232 d) might be discontinued at the next Reasonableness Review.

7.38. Where, after consulting with the licensee (paragraph 7.28) 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 interest of consumers and would not disproportionately impact the licensee
- d) the Authority considers it is practical for the licensee to adopt the recommendations.

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## Section 3 – Proposals for revised pensions allowance values

7.39. 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**

7.40. 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.

7.41. The licensee must set out its calculations of:

- a) the indicative further PSED repair period, see from paragraph 7.42
- b) the indicative base annual PSED allowance, see from paragraph 7.44 and
- c) its proposal for Base Annual PSED Allowances, see from paragraph 7.46.

#### *Indicative further PSED repair period*

7.42. 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.

7.43. 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 7.42 a), and

b) 15.

#### *Indicative Base Annual PSED Allowance*

7.44. 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 7.42.

7.45. 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*

7.46. 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 7.4444. 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 7.42 if it

considers that the indicative Base Annual PSED Allowance calculated by paragraph 7.44 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 7.4242 which is less than 5 years, or
- d) is otherwise inappropriate or inequitable.

7.47. The alternative proposal under paragraph 7.46 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 7.49) 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 7.5252) 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 7.52.

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

## Payment history allowances

7.48. 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 7.4040. 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.

7.49. 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 7.5151 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 7.50, 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 7.47
- 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 7.12.
- 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 7.29 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 7.4848.  $E_y$  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 7.50.

$CT_y$  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 7.29 e)) or, where no alternative discounting basis has been specified, the time value of money as described in paragraphs 2.16 and 2.17.

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

7.50. 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 7.49 and the attributable LTU value from the LTU term applied in paragraph 7.49.

7.51. The licensee may choose to present a truncated calculation of the term  $V_{rr}$  specified in paragraph 7.49, on a basis that is demonstrably consistent with the formula specified in paragraph 7.49. 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.

7.52. 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 7.26. 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 2.17.

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 7.4747) 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 7.4747 as at the end of the Reasonableness Review year, after applying appropriate discount rates (generally  $hDR_y$ ).

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



## 8. Legacy Adjustments

8.1. Adjustments relating to GT2 Variable Value methodologies and GT2 closeout methodologies, which are implemented in the GT2 Legacy PCFM will be directed by the Authority.

8.2. The Authority will direct the values of LK, LADJ, LRAV, SOLK, SOLADJ, SOLRAV, and tax pools (OGP, OSRP, OSBP, LOSBP, ODRP, LODRP, OTL, SOOGP, SOOSRP, SOOSBP, SOLOSBP, SOODRP, SOLODRP, SOOTL) to be carried over into the GT3 PCFM in accordance with the procedure set out in Special Conditions 7.2 (Legacy AIP Adjustment term), 7.3 (Legacy K correction), 7.4 (Legacy net RAV additions and tax balances), Special Conditions 7.6 (System Operator Legacy AIP Adjustment term), 7.7 (System Operator Legacy K correction), 7.8 (System Operator 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 GT2 Price Control Period in accordance with this chapter, and a direction will specify the adjustments the licensee must make in the GT2 Legacy Price Control Financial Model (GT2 Legacy PCFM) inputs. The direction will specify a GT2 Variable Value named in the version of this licence as in force on 31 March 2026, or otherwise specify row and column references in the GT2 Legacy PCFM.

8.4. After the Authority has directed values in accordance with paragraph 8.2, and the licensee has provided GT2 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 GT3 PCFM:

#### GT2 Offline Tax-Trigger PCFM

- a) Ensure the GT2 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, OGPAT and OSRPAT, SOTTET, SOOGPAT and SOOSRPAT) in the relevant licensee input sheet, in line with those in the GT2 legacy PCFM.
- d) Update the % values in rows 13 and 14 of the 'Super\_Tax - TO' and 'Super\_Tax - SO' worksheets 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 -TO' and 'Super\_Tax - SO' worksheets are the values to be input into the relevant row within the licensee worksheet of the GT2 legacy PCFM.

### **GT2 Legacy PCFM**

- g) Ensure the GT2 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, OGPAT, OSRPAT, SOTTET, SOOGPAT, SOOSRPAT are copied into the GT2 Legacy PCFM from the GT2 Offline Tax-Trigger PCFM per the guidance described above
- i) Ensure "31 Mar 2027" is selected on the "UserInterface tab" of the GT2 Legacy PCFM;
- j) Update variable values in the relevant licensee input sheet in the GT2 Legacy PCFM.
- k) Values in the Legacy Summary worksheet which are listed in Table 8.1 can then be used to update the relevant terms in the GT3 PCFM

8.6. Except where paragraph 8.7 applies, the licensee must then populate the GT3 PCFM with the inputs directed by the Authority and listed in Table 8.1.

8.7. The Authority will not direct the final values for the inputs listed in Table 8.1 until each of the closeout methodologies set out in Table 8.2 have been determined. Until that time, the licensee must use its best estimates.

**Table Error! No text of specified style in document..1: GT2 PCFM Inputs for legacy inputs directed by the Authority**

**Legacy ADJ**

Licence Terms  
LADJ

Special Condition  
SpC 7.2 Part A

**Legacy K**

Licence Terms  
LK

Special Condition  
SpC 7.3 Part A

**Legacy RAV**

Licence Terms  
LRAV

Special Condition  
SpC 7.4 Part A

**Legacy Tax Pools**

Licence Terms  
OGP  
OSRP  
OSBP  
ODRP  
LODRP  
OTL

Special Condition  
SpC 7.4 Part B  
SpC 7.4 Part B  
SpC 7.4 Part B  
SpC 7.4 Part B  
SpC 7.4 Part B  
SpC 7.4 Part B

**System Operator Legacy ADJ**

Licence Terms  
SOLADJ

Special Condition  
SpC 7.6 Part A

**System Operator Legacy K**

Licence Terms  
SOLK

Special Condition  
SpC 7.7 Part A

**System Operator Legacy RAV**

Licence Terms  
SOLRAV

Special Condition  
SpC 7.8 Part A

**System Operator Legacy Tax Pools**

Licence Terms  
SOOGP  
SOOSRP  
SOOSBP  
SOODRP  
SOLODRP  
SOOTL

Special Condition  
SpC 7.8 Part B  
SpC 7.8 Part B  
SpC 7.8 Part B  
SpC 7.8 Part B  
SpC 7.8 Part B  
SpC 7.8 Part B

**GT2 Variable Value Methodologies**

**Revision of GT2 Variable Values**

8.8. The licensee must use the version of the licence as in force on 31 March 2026 to determine the GT2 Variable Values.

8.9. The licensee must populate the relevant fields in the GT2 Legacy PCFM.

8.10. The GT2 Variable Values may be further adjusted by the closeout methodologies below.

### GT2 Closeout Methodologies

8.11. The following sections set out how adjustments to the GT2 Legacy PCFM will be determined. The licensee must then adjust the GT2 Legacy PCFM input as directed in accordance with Table 8.2 below.

8.12. Table 8.2 lists the adjustments to the GT2 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 this licence as in force on 31 March 2026. These conditions may also refer to definitions within the GT2 Price Control Financial Handbook as in force on 31 March 2026.

Table **Error! No text of specified style in document..2**: Closeout adjustments in the GT2 Legacy PCFM

Closeout methodology	Relevant GT2 licence reference	GT2 Legacy PCFM input adjusted	Basis for profiling adjustments	Direction on Timing
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[Rows of this table to be added once closeout methodologies are known]

Except where otherwise stated, all calculations under this section of the GT3 Price Control Financial Handbook are to be made with reference to 2018/19 prices using the GT2 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 3.8). 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 A1: Illustration of the Totex Incentive Mechanism**

