

Guidance

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~~RHO-ET2 Price Control Financial Handbook G08~~

Effective ~~ET2~~ ET3 Price Control Financial Handbook

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This is the ~~RHO-ET2~~ ET3 Price Control Financial Handbook which forms part of Special Condition 8.1 (Governance of the ~~RHO-ET2~~ ET3 Price Control Financial Instruments) of the Electricity Transmission ~~licence~~ licences held by ~~Electricity~~ Electricity transmission network operators.

This document consists of:

- a) ~~a description of~~ requirements for how licensees must use the ~~RHO-ET2~~ ET3 Price Control Financial Model (PCFM) and the Annual Iteration Process (AIP) for it; ~~used to calculate licensee's~~ determine Allowed Revenue during the course of the ~~RHO-ET2~~ ET3 Price Control Period;

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- b) an overview of the variable values used in the ~~RHO-ET2-PCFM during the AIP, in accordance with the Special Conditions of the licence~~ ET3 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 ~~RHO-ET2-PCFM~~ ET3 Price Control Financial Model are contained in Special Condition 8.1 and up to date versions of ~~both~~ this handbook and the ET3 Price Control Financial Model can be accessed on the Ofgem website.

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1. Introduction

~~1.1.—Under RHO-ET2, Special Condition 2.1 (Revenue ~~Restriction~~restriction) determines the annual Allowed Revenue a licensee can recover in respect of ~~its network business through charges. Network Charges.~~ The ~~calculation of annual Allowed Revenue is performed using the RHO-ET2~~ET3 Price Control Financial Model (PCFM):~~

1.1 ~~Each year, certain~~ET3 PCFM) is an ~~an~~ET3 Price Control Financial Instrument which provides for the calculation of Allowed Revenue. Certain inputs to the ~~RHO-ET2~~ET3 PCFM (the ~~variable values~~PCFM Variable Values) are updated ~~through the Annual Iteration Process (AIP),~~ resulting in updates to Allowed Revenue within the ~~RHO-2~~Price Control Period. ~~These inputs reflect a range of factors including past and forecast performance and activity levels, and changes in the cost of capital.~~

~~1.2.—We have chosen to have a RHO-ET2~~This handbook sets out how licensees must use the ~~ET3~~ PCFM ~~with an AIP because it:~~

- ~~a) incorporates 'real time' adjustments to financial allowances;~~
- ~~b) uses a financial model for the purpose of computing interactions between financial adjustments where the relevant algebra would be excessively complicated to set out on the face of Special Conditions;~~
- ~~c) provides transparency on adjustments to~~to determine Allowed Revenue, ~~since the licence, this handbook, the RHO-ET2 PCFM and variable values are published; and~~
- ~~d) allows stakeholders to keep abreast of Allowed Revenue levels and to carry out business sensitivity analysis.~~

1.2 This document is the RHO-ET2 Price Control Financial Handbook (PCFH, or handbook) and, along with the RHO-ET2 PCFM, is an RHO-ET2 Price Control Financial Instrument, which forms part of Special Condition 8.1. The PCFH and RHO-ET2 PCFM are subject to a formal change control process set out in Special Condition 8.1.

1.3 This handbook ~~supports the annual determination of Allowed Revenue by providing~~provides:

- a) a description of the ~~RHO-ET2~~ET3 PCFM ~~and the AIP;~~
- b) the process the licensee must follow in calculating Allowed Revenue;
- ~~b)c)~~ an overview of the ~~variable values~~PCFM Variable Values used in the ~~RHO-ET2~~ET3 PCFM ~~during the AIP;~~ and

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~~c)~~ d) details of how certain ~~variable values~~ PCFM Variable Values are revised ~~or~~ and calculated.

Related documents

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

~~a) Final Determinations¹~~

a) Special Conditions

b) ~~RIIO-ET2~~ ET3 PCFM

c) Associated Documents and Regulatory Instructions and Guidance (including the PCFM Guidance ~~(see Table 3.1).~~)

d) Final Determinations² [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) ~~the~~ this handbook

c) the ~~RIIO-ET2~~ ET3 PCFM

d) NARM handbook and Network Asset Risk Workbook

e) Associated Documents and Regulatory Instructions and Guidance (including the PCFM Guidance)

f) Final Determinations.³

¹ ~~<https://www.ofgem.gov.uk/publications-and-updates/riio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator>~~

² <https://www.ofgem.gov.uk/decision/riio-3-final-determinations-electricity-transmission-gas-distribution-and-gas-transmission-sectors>

³ 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 ~~1.7~~ 1.5 a-e.

Document structure

1.6 The remainder of this handbook is structured as follows:

- a) Section ~~22~~ provides an overview of the ~~RHO-ET2~~ET3 PCFM ~~and details of the AIP~~.
- b) Section ~~33~~ lists the variable values used in the ~~RHO-ET2~~ET3 PCFM ~~and updated through the AIP~~.
- c) subsequent sections provide details of how certain variable values are revised or calculated (along with further details on the ~~RHO-ET2~~ET3 PCFM).

1. The RIIO-ET2 PCFM and the Annual Iteration Process

Definitions

1.7 This section provides an overview of the RIIO-ET2 PCFM, the handbook uses defined terms of reference for the PCFM Working Group (, which reviews issues arising are capitalised throughout this handbook, with respect to the form or usage of meaning found in the RIIO-ET2 following locations:

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

<u>Base Annual PSED Allowance</u>	<u>means the allowance relating to pensions set out in chapter 7, section 3 of this handbook.</u>
<u>CPI</u>	<u>means the Consumer Prices Index.</u>
<u>CPIH</u>	<u>means the Consumer Prices Index Including Owner Occupiers' Housing Costs.</u>
<u>Defined Benefit Scheme</u>	<u>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.</u>
<u>ET2 Price Control Period</u>	<u>means the period of five Regulatory Years commencing on 1 April 2021.</u>
<u>ET2 Variable Value</u>	<u>means the values in the table of that name in the ET2 Price Control Financial Handbook.</u>
<u>ET3 PCFM</u>	<u>means the ET3 Price Control Financial Model.</u>
<u>PCFM Guidance</u>	<u>means the annex of that name to the RIGs.</u>
<u>Reasonableness Review</u>	<u>means the pensions review set out in paragraph 7.30 of Chapter 7, section 2 of this handbook.</u>

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<u>RIGs</u>	<u>means the document published by the Authority in accordance with Standard Condition B15 (Regulatory Instructions and Guidance).</u>
<u>RPI</u>	<u>means the Retail Prices Index.</u>
<u>Time Value of Money</u>	<u>means the interest rate used to apply to year-on-year true-ups and adjustments made during the ET3 Price Control and is based on the nominal WACC set out in the “AllowedRevenueAR” sheet in the ET3 PCFM.</u>
<u>Triennial Valuation</u>	<u>An actuarial valuation of a pension scheme, published on a 3-yearly cycle, which has been carried out to comply with 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.</u>
<u>Updated Valuation</u>	<u>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.</u>

2. ~~The ET3 PCFM), and details on the AIP through which the variable values and~~ and Calculation of Allowed Revenue are updated annually.

The Price Control Financial Model

~~1.1.~~—For each Regulatory Year, the ~~RHO-ET2~~ET3 PCFM provides for the calculation of:

- ~~‘Live’ Calculated Revenue (R_t), which is updated at least annually to reflect new information~~
- ~~The value of Adjusted Revenue, a nominal revenue allowance reflecting true-ups for retroactive updates to the PCFM Variable Values in the RHO-2 Price Control Period~~

2.1 ~~Allowed Revenue, which is the sum of Adjusted Revenue, corrections for charging over/under-recovery (K_t), and a true-up for changes prior to the RHO-2 Price Control Period (LAR_t);~~ in accordance with Special Condition 2.1 (Revenue restriction).

2.2 The ~~RHO-ET2~~ET3 PCFM contains both fixed values and a variable values table input area for the licensee. The Allowed Revenue figure for the licensee for each Regulatory Year of the Price Control Period is calculated ~~as per~~ in accordance with Special Condition 2.1, using the fixed values, the variable values, and the formulae and functions embedded in the ~~RHO-ET2~~ET3 PCFM.

~~1.2.~~—At the ~~outset~~beginning of the Price Control Period, Allowed Revenue is calculated by the ~~RHO-ET2~~ET3 PCFM, using the ~~variable values at~~PCFM Variable Values completed by the Authority in accordance with the Final Determinations. From that time. Each year, through the AIP (Special Condition 8.2), the variable values must be point, PCFM Variable Values are updated, resulting in updated Calculated Revenues (R_t) and consequently updated Adjusted Revenue, flowing through to Allowed Revenue. To understand the factors that can change Allowed Revenue, it is helpful to discuss its three components:

$$\del{AR_t = ADJR_t^* + K_t + LAR_t}$$

Adjusted Revenue (ADJR_t)

1.3.—ADJR_t^{*} is a value published by Ofgem as part of the AIP based on the PCFM inputs available at the time. These values are recorded by the RIIO-ET2 PCFM at the time of publication (the Saved Results tab). The published value for the Regulatory Year *t* is the sum of the current view of Calculated Revenue (*R_t*) in nominal prices ($R_t \frac{PI_t}{PI_{2018/19}}$), plus an adjustment for revisions to years that have already passed (ADJ_t):

$$ADJR_t = R_t \frac{PI_t}{PI_{2018/19}} + ADJ_t$$

1.4.—When time value of money adjustments are made for retroactive changes, it is with reference to these previously published values of ADJR_t^{*}. Revisions to Calculated Revenue (*R_t*) and the inflation forecast are trued up at Vanilla WACC via the ADJ term, as defined in the RIIO-ET2 PCFM (see the time value of money section):

Calculated Revenue (R_t)

1.5.—Calculated Revenue (*R_t*) is a ‘live’ calculation of real revenue allowances (in 2018/19 price terms) licensee in accordance with Part E (Formula for calculating the Calculated Revenue term (*R_t*)) of Special Condition 2: the document hierarchy in 1. It is a ‘live’ calculation in that Calculated Revenue (*R_t*) for a given Regulatory Year will be different at different points in time if the inputs are changed:

1.6.—Chapter 3 of this Handbook details the variable values that can change through the Annual Iteration Process, including those that result in updates to Calculated Revenue (*R_t*):

Return Adjustment (RTNA_t)

1.7.—Return Adjustment (RTNA_t) is a RIIO-2 close-out estimate (in 2018/19 price terms) in accordance with Special Condition 2.3. It is not linked to revenue allowances during RIIO-2

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for the following reasons. First, $RTNA_t$ requires close-out values for other PCFM inputs, which will not be available until RIIO-2 ends, and it requires the Authority's final direction as a result of a review of Operational Outperformance. Second, the implementation of $RTNA_t$ is subject to variation requests from any affected company, in line with RIIO-2 Final Determinations.⁴

1.8.—The $RTNA_t$ term calculated on row 67 of the ReturnAdj sheet of the RIIO-ET2 PCFM will be linked to the $RTNA_t$ line in the "Revenue" sheet after the end of the Price Control Period, following the Authority review of Operational Performance.

1.9.—The inclusion of $RTNA_t$ within the RIIO-ET2 PCFM improves transparency during the RIIO-2 period, and will support the close-out of RIIO-2 during the AIP(s) we plan to conduct during January 2027 and January 2028.

Correction Term (K_t)

1.10.— K_t provides for the correction of over or under recovery of revenue in previous years, compared to the corresponding value of Allowed Revenue:

1.11.—This recovery error is trued up with interest equal to the average SONIA rate in the year plus 1.15%. In the GD and GT sector, a penal rate of interest of +/- 1.15% is applied if there are under or over-recoveries in excess of 6% from a target revenue. This penal rate of interest may be waived by direction of the Authority.

1.12.—If, during an AIP, the variable value for recovered revenue for the upcoming year is set assuming collection will equal Allowed Revenue, then at the next AIP this value can be updated if there is a better estimate available (forecast, as the Regulatory Year is not yet

⁴See paragraph 8.21 of the Draft Determinations Finance Annex for example:
https://www.ofgem.gov.uk/system/files/docs/2020/12/final_determinations_-_finance_annex.pdf#page=107

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complete). This allows for an up to date calculation of the K correction factor on a one-year lag.

Legacy Adjustments (LAR_t)

- 2.3 The LAR_t term is an adjustment in nominal prices reflecting true-ups from the RIIO-1 Price Control Period. It is described in Chapter 8.5.

Price base

- 2.4 When ascertaining Calculated Revenue (R_t), the RIIO-ET2 PCFM works in a constant 2018/19 price base, except in respect of some calculations internal to the model that use nominal prices, e.g. tax, various pass-through costs and legacy calculations. The price base of each PCFM Variable Value input is labelled in the PCFM. Certain calculations relating to the indexation of the RAV also make use of a semi-nominal price index. The use of nominal prices in the RIIO-ET2 PCFM tax calculations is meant used in order to more accurately reflect the licensee's tax expenses profile in revenue allowance calculations.

1.13. Where variable values need to be deflated from a nominal price base to the 2018/19 price base used in the RIIO-ET2 PCFM, the following formula will be used:

$$\text{value}_{2018/19 \text{ prices}} = \text{value}_{\text{nominal}} \cdot \frac{PI_{2018/2019}}{PI_t}$$

Where:

$\text{value}_{2018/19 \text{ prices}}$ means the deflated/restated value in 2018/19 prices

$\text{value}_{\text{nominal}}$ means the value in a nominal price base or in prices of a Regulatory Year other than 2018/19

PI_t is the arithmetic average value of each of the twelve monthly values measure of PI_m from 1 April to 31 March within Regulatory Year t derived in accordance with the following formula:

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$$PI_m = \begin{cases} RPI_m, & \text{if } m < \text{April 2021} \\ PI_{m-1} \left(0.5 \frac{CPIH_m}{CPIH_{m-1}} + 0.5 \frac{RPI_m}{RPI_{m-1}} \right), & \text{if } m = \text{April 2021} \\ PI_{m-1} \cdot \frac{CPIH_m}{CPIH_{m-1}}, & \text{if } m > \text{April 2021} \end{cases}$$

where:

m refers to a year and month;

RPI_m means the Retail Prices Index (all items) (series: CHAW) published by the Office for National Statistics (ONS) for the year and month m .⁵

- 2.5 $CPIH_m$ means the “Consumer Price inflation including owner-occupiers’ housing costs” (series L522) published by the ONS for the year and month m .⁶, 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 ~~At From 2026, a~~ After receipt of the final inflation update from Ofgem each ~~AIP~~, November, the licensee will update outturn data for RPI_m and $CPIH_m$ will be updated by Ofgem, for the period to June of the prior until September of the current year (e.g. for AIP in November 2021, for Regulatory Year 22/23 2026⁵, the outturn data values ~~will~~ would only be entered to ~~June 2021~~ September 2026⁵).
- 2.7 The ET3 PCFM “~~Monthly Inflation~~ **Main Inputs Transform**” and “~~Annual~~ Inflation” tabs contain a method for forecasting future price index values, given ~~calendar~~ financial year forecast assumptions. The ~~calendar~~ financial year ~~forecasts are~~ forecast is labelled “ $CYRPIF_t$ ” and “ $CYCPIH_t$ ”, $FYCPIHF_t$ ”.
- 2.8 These forecasts will be the Office for Budget Responsibility’s (OBR) forecast of ~~GPI and RPI~~ $CPIH$ from the “economic and fiscal outlook”. Ofgem will update and provide the forecast assumptions to the licensee from the most recent outlook available ~~as at 31 October at~~ during November each ~~AIP~~ year. The data will be sourced from ~~the~~ following

⁵ <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/chaw/mm23>

⁶ Historical data – <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l522/mm23>

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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 database⁷, ~~tabs “CPI” and “RPI”~~, tab “CPIH”
- 2 The charts and tables datafile published with the economic and fiscal outlook (specifically, the Detailed Forecast Tables: Economy File); and
- 3 The economic and fiscal outlook document

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

$$\begin{aligned} RPI_m &= RPI_{m-1} \cdot (1 + CYRPIF_m)^{\frac{1}{12}} \\ CPIH_m &= CPIH_{m-1} \cdot (1 + FYCPIHF_m)^{\frac{1}{12}} \end{aligned}$$

where,

RPI _m CPIH _m	is the RPI CPIH price index value for a given year-month “m”.
CYRPIF _m FYCPIHF _m	Means means the OBR RPI CPIH forecast (annual rate) applicable to year-month m, where the OBR forecast for a calendar financial year is applicable from 6 months prior to the start of that calendar financial year, to six months after (e.g. the 2021 2026 OBR forecast would be applicable from July 2020 <u>October 2025</u> to June 2021 <u>September 2026</u>). If the forecast year-month falls after the range covered by OBR forecasts, the longest dated forecast year is used (e.g. if the November OBR forecast covered 2020 -2024/25-2028/29, then the forecast for year 2024 2028/29 would be used for 2025 2029/30 and 2026 2030/31).

⁷ <https://obr.uk/data/>

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~~1.14. The forecast for $CPIH_m$ is calculated in the same way as above, substituting in the $CPIH$ values.~~

Long term inflation assumption ($LTCPIH_t$)

2.10 ~~To correspond to the~~ The long-term assumption used in the WACC allowance model, the long term inflation assumption (labelled $LTCPIH_t$) will be the $CPIH$ (financial year basis) 5 year ahead forecast updated for the upcoming Regulatory Year from the OBR forecast published prior to October/December in the Regulatory Year $t-1$. For example, the assumption for 2021/22/2026/27 will be from the March 2020/November 2025 outlook. The percentage will be rounded to two decimal place (e.g. places (eg. 2.00%). fixed at 2.0%) % from 2026/27 onwards.

Provision of updated inflation variable values

2.11 Ofgem will perform the above updates to the PCFM Variable Values $CPIH_m$ and to the $FYCPIH_t$ and will 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 ET3 PCFM.

Temporal convention

~~2.12~~ 2.12 The following conventions apply throughout this handbook:

- Relative references: The AR_t term is the licensee's Allowed Revenue for each Regulatory Year t during the Price Control Period. References in this handbook to Regulatory Years are made relative to that usage. For example, in the context of AR_t for Regulatory Year 2022/23/2027/28, a reference in the same context to Regulatory Year $t-1$ would mean 2021/22/2026/27 and so on.
- Absolute references: A reference to, for example, 'the EDE value for 2022/23/2026/27' means the EDE value in the 2022/23/2026/27 column of the variable values table for the licensee contained in the RIIO-ET2/ET3 PCFM.

Forecast variable values

~~2.13~~ 2.13 In calculating Allowed Revenue for Regulatory Year t , the RIIO-ET2/ET3 PCFM uses some forecast ~~variable values both for Regulatory Year t and preceding Regulatory Years.~~ 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~~ 2.14 The licensee must ~~submit updates to~~ forecast ~~variable values annually, through the AIP,~~ PCFM Variable Values in accordance with the requirements of ~~the~~

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~~PCFM Guidance:~~ this handbook and in accordance with the RIGs. These updates can apply to all Regulatory Years of the Price Control Period.

~~2.14~~ 2.15 For the avoidance of doubt, while a licence condition may refer to actual ~~delivered~~ costs, revenue and outputs, for future ~~years this relates to forecasts of delivered outputs~~ periods, the equivalent data should be forecast.

Time Value ~~Of~~ Money (TVOM)

~~2.15~~ 2.16 The ~~RIIO-ET2~~ ET3 PCFM uses a ‘time value of money’ adjustment to incorporate the financial impact of the timing of cash flows, ~~e.g.~~ from switching revenues between ~~years~~ Regulatory Years as a result of changes to previous years’ Allowed Revenue. ~~Ofgem will use two TVOM approaches⁸ in RIIO-ET2 Price Control Period as follows:~~ or to correct charging errors for any over or under-recovery.

- ~~a) – nominal Vanilla Weighted Average Cost of Capital (WACC) for revisions to allowances, including but not limited to totex, output delivery incentives, and pass-through costs as reflected in the AIP adjustment term (ADJ.); and~~
- ~~b) – a twelve-month average⁹ of the daily overnight SONIA (the Sterling Overnight Index Average, expressed as a nominal rate, published by the Bank of England¹⁰ (series IUDSOIA)) rate plus a 115bp margin for correction term K_i or any other adjustments where appropriate.~~

~~1.15: – For future years, forecasts of SONIA and WACC¹¹ will be used and updated at subsequent AIPs when out-turn data are available. SONIA will be forecast using a Bank of England instantaneous forward curve¹² as published on the Bank of England website and will be updated during the AIP with outturn values.~~

⁸ ~~Ofgem will review the case for use of one TVOM approach applicable to all revisions and corrections and will consult on any changes to its TVOM approaches where appropriate.~~

⁹ ~~the annual arithmetic averages from 01 April to 31 March, inclusive, for each year.~~

¹⁰ ~~<https://www.bankofengland.co.uk/>~~

¹¹ ~~Forecast for WACC is based on the forecasting approach for GDE and RFR described in section 4 of this handbook.~~

¹² ~~<https://www.bankofengland.co.uk/statistics/yield-curves>~~

Changing the RIIO-ET2 PCFM

2.17 The ~~RIIO-ET2 PCFM exists as~~ time value of money rate used in the ET3 PCFM is based on the licensee's nominal WACC, set out in the “**Allowed RevenueAR**” sheet in the ET3 PCFM.

Changing the ET3 PCFM

~~1.16.–~~ The ET3 PCFM is a ET3 **P**price **C**ontrol **F**inancial Instrument and, therefore, **is** a constituent part of Special Condition 8.1 ~~and will be maintained by Ofgem on in its website as well as internally. The RIIO-ET2 PCFM.~~ It can be changed in two ways:

- ~~a)–~~ an Annual Iteration Process—which will change the variable values and recalculated values which are directly or indirectly dependent upon them modified under the process set out in Special Condition 8.2; or
- ~~b)–~~ a modification of the RIIO-ET2 PCFM under the procedures set out in Special Condition 8.1 (Governance of RIIO-ET2 Price Control Financial Instruments) or section 11A of the Act.

~~1.17.–~~ A copy of the RIIO-ET2 PCFM in its latest state will be maintained on the Ofgem website, and Ofgem will upload an updated copy by 31 January¹³ each year (after each AIP). This will allow the licensee and other stakeholders to make copies of the RIIO-ET2 PCFM so that they can:

- ~~a)–~~ use their own forecasts of variable value revisions to forecast Allowed Revenue and conduct sensitivity analysis; and
- ~~b)–~~ reproduce the calculation of Allowed Revenue.

2.162.18 ~~Ofgem will keep a log of~~ Certain specified modifications ~~to the RIIO-ET2 PCFM and publish this log on its website~~ can be made in accordance with Special Condition 8.1.

¹³ ~~Except when the AIP is not completed by 31 January, as stated in Special Condition 8.2, Part C.~~

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Error in the functionality of the ~~RHO-ET2~~ET3 PCFM

~~1.18. In the event that~~ If an error of functionality is discovered in the ~~RHO-ET2 PCFM~~, the following procedure will be followed:

~~2.17~~2.19 ~~ET3 PCFM~~, the issue will be considered at the earliest opportunity by the PCFM Working Group (see next section), and a corrective modification will be proposed by Ofgem.

~~if~~ Calculation of Allowed Revenue

2.20 In determining the ~~functional error has distorted the calculation of a previously published~~ value of Allowed Revenue, the ~~determined modification will include~~ licensee must use the latest version of the ET3 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 ET3 PCFM except for the removal of the data within those input sheets which are not relevant to the licensee, the completion or updating of the PCFM Variable Values, updating the inflation input values provided by Ofgem within the "Inflation" sheet of the ET3 PCFM with outturn data to 30 September, updating the "Cover" tab in accordance with paragraph 2.29 and updating the "UserInterface" tab of the ET3 PCFM.

2.23 Where a PCFM Variable Value is not known at the time of calculating Allowed Revenue, the licensee must determine that value ~~of money adjustments necessary to~~ in accordance with the ET3 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.

~~2.18~~2.24 The licensee must seek advice from the Authority if it is uncertain of the correct ~~for that distortion in the next calculation of Allowed Revenue; and~~ 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 ~~procedure~~ 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 ET3 PCFM on the licensee's website in accordance with Part A of Special Condition 2.1 (Revenue restriction), the licensee must provide the Authority with:

- a) a copy of the ET3 PCFM which the licensee intends to publish on its website; and

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- b) a commentary describing any changes since the last submission of the ET3 PCFM to the Authority.

2.27 Where the Authority requires the licensee to change the ET3 PCFM following its provision by the licensee 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.

2.28 Prior to publication on the licensee's website in accordance with paragraph 2.1.5 of Special Condition 2.1 (Revenue restriction), the licensee must reduce the ET3 PCFM made available under Part D of Special Condition 8.1 ~~for modifications to the RIIO-ET2~~ (Governance of the ET3 Price Control Financial Model), in accordance with instructions provided by the Authority, so that it is specific to each licensee.

2.29 The licensee must update the “publication date” label on the “Cover” tab of the ET3 PCFM with the date the model was made public on the licensee’s website.

2.30 The licensee must use the following file naming convention:

ET3 PCFM Licensee 20XX-XX Allowed Revenue YYYYMMDD

where:

YYYYMMDD means the year, month, and day the ET3 PCFM was published.

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

Licensee means one of NGET, SHET or SPTL.

~~2.19~~ 2.31 The ET3 PCFM will be ~~followed~~ used for the purpose of determining the value of Allowed Revenue up to and including Regulatory Year 2030/31.

The ~~RIIO-ET2~~ET3 Price Control Financial Model Working Group

~~2.20~~ 2.32 Ofgem will facilitate an industry expert working group to review issues arising with respect to the form or usage of the ~~RIIO-ET2~~ET3 PCFM. The terms of reference for ~~The PCFM~~ The ET3 Price Control Financial Model Working Group (‘the working group’) are set out below.

Terms of reference

Purposes of the working group

~~2.21~~ 2.33 The purposes of the working group are:

- a) to review the ongoing effectiveness of the ~~RIIO-ET2~~ET3 PCFM in producing a value for Allowed Revenue and capturing financial performance data for each Regulatory Year

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- b) _____ to provide, when requested by the Authority, its views to the Authority on the impact of any proposed modifications on the ~~RIIO-ET2~~ET3 PCFM; and
- c) _____ to provide such views or recommendations to the Authority with regard to the RIIO-~~ET2~~ET3 PCFM (including ~~as~~in relation to proposals to modify the ~~RIIO-ET2~~ET3 PCFM) as it sees fit.

Composition

~~2.22~~2.34 _____ The composition of the group will be:

- a) _____ Chair (Ofgem-~~chair~~)
- b) _____ Secretary (Ofgem-~~secretary~~); and
- c) _____ one representative per ETO; ~~and~~
- ~~a) – Energy Networks Association representative (optional).~~

Timing and duration of the group's work

~~2.23~~2.35 _____ The working group's incumbency will run from 01 April ~~2021~~2026 to 31 March ~~2026~~2031.

~~2.24~~2.36 _____ The group will meet at least once between 01 January and 01 April during each calendar year, but may meet more frequently if required, in particular in relation to the provision of views on the impact of proposed ~~RIIO-ET2~~ET3 PCFM modifications (~~as per paragraph 2.28 b of this Handbook~~).₁

~~2.25~~2.37 _____ In convening any meeting of the working group, Ofgem will give at least 10 working days' notice of the proposed meeting date to ~~the~~each licensee.

~~2.26~~2.38 _____ Representatives may attend meetings in person or through video or telephone conferencing facilities.

~~1.19. – A meeting of the working group will be quorate, for the purpose of expressing a view or recommendation in respect of the RIIO-ET2 PCFM, when at least one representative from Ofgem, and at least one representative from every different ETO ownership group are present (in person or virtually).~~

Resources

~~2.38.~~ 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 ~~RIIO-ET2~~ET3 PCFM.

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A ~~copy~~ draft of the ~~record of each~~ meeting ~~notes~~ will be ~~provided~~ circulated to the licensee for comment and approval as soon as is reasonably practicable ~~and to~~ ~~representatives who attended~~ following the meeting; ~~and~~. Ofgem will take account of any comments received in finalising the record.

The ~~Annual Iteration Process (AIP)~~

3. ~~The AIP is the process carried out by the licensee~~ET3
PCFM and ~~Authority each year~~¹⁴ ~~in order to calculate~~
Calculation of Allowed Revenue (AR_t for Regulatory Year t)
~~by updating the variable value inputs to the RIIO-ET2~~
PCFM.

~~1.20.—The AIP will be completed by 31 January prior to each Regulatory Year t, or as soon as is reasonably practicable thereafter. The deadline of 31 January reflects the need for the licensee to have confirmation of its Allowed Revenue in time to calculate and set its use of system charges.~~

~~1.21.—The steps of the AIP are specified in Special Condition 8.2, Part A and the process is further described below.~~

~~Submission of RIIO-ET2 PCFM~~

~~1.22.—The licensee must use the version of the RIIO-ET2 PCFM provided to it by the Authority and which incorporates any modifications made to it following the PCFM Working Group. This version of the RIIO-ET2 PCFM will be the one used in the upcoming AIP and will be published by the Authority by the functional cut-off dates set out in Table 2.1.~~

~~1.23.—Prior to each Regulatory Year, the licensee must submit to the Authority the RIIO-ET2 PCFM by the submission date listed in Table 2.1 and, with a completed variable values table~~

¹⁴Except for 2025/26, when there will be no AIP (see Special Condition 8.2.15).

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(covering activity in the prior Regulatory Year and changes to forecast activity¹⁵), which has been run to calculate AR_t .

1.24. – This submitted version of the RIIO-ET2 PCFM may contain provisional values for variable values that are unknown at the time of submission. An example of a variable values which will not be known by 30 September is a re-opener term which is subject to an outstanding decision by the Authority.

1.25. – Where a variable value is unknown at the time of submission, the licensee must calculate a provisional value using the approach specified within this handbook or the RIIO-ET2 PCFM Guidance, as applicable, and otherwise provide its best estimate with the information available at the time.

1.26. – Ofgem will review the submitted RIIO-ET2 PCFM and confirm whether these have been prepared in accordance with the PCFM guidance. Where values have not been prepared in accordance with the PCFM guidance, Ofgem will amend such variable values, as appropriate and taking into account any decisions it has made in relation to those values.

Dry Runs process

1.27. – This process of confirming and amending values will normally take place over a number of months from 30 September to mid-December and will be iterative to account for updates to the variable values as they become known.

¹⁵ Variable values for Regulatory Years later than Regulatory Year t do not feed into the calculation of the term AR_t and $ADJR_t$. Therefore, calculated values in the RIIO-ET2 PCFM for Regulatory Years later than Regulatory Year t represent only a forecast. This is without prejudice to the status of the variable values concerned, which may have been decided and/or directed under licence conditions and which may or may not be subject to subsequent revision.

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~~1.28. – There will be one or more dry runs of the RIIO-ET2 PCFM between the licensee’s initial submission of the RIIO-ET2 PCFM on 30 September and the final run in mid-December. The number of dry runs needed will depend on the number and timing of variable value updates required for the licensee in any particular Regulatory Year.~~

~~1.29. – Where the Authority amends a variable value from an earlier licensee submission, either due to a licensee error or to reflect updates to a provisional value, it will notify the licensee and request a resubmission of the RIIO-ET2 PCFM. Following updates to variable values, the RIIO-ET2 PCFM should be re-run and AR_t should be recalculated to reflect the impact of the updated values.~~

~~1.30. – Where a licensee has not complied with Step 1 of Special Condition 8.2, Part A and has failed to submit a populated RIIO-ET2 PCFM by 30 September, Ofgem will complete the variable values table and run the macro on the User Interface sheet of the model to calculate AR_t .~~

~~1.31. – In order to facilitate publication of AR_t and $ADJR_t$ by 31 January, Ofgem will normally expect to apply the following annual cut-off dates:~~

- ~~a) 1 July in respect of functional changes to the RIIO-ET2 PCFM, PCFH and PCFM Guidance; and~~
- ~~a) 5 December in respect of information submitted by the licensee.¹⁶~~

¹⁶ ~~In applying this cut-off date, Ofgem will, through business correspondence, apprise the licensee of any provisionality it has attached to information submissions, that might involve a restatement of the information by the licensee for the purpose of making a further revision to the variable value(s) concerned for use in a subsequent Annual Iteration Process.~~

November Run

1.32. ~~Ofgem will provide the licensee with updated Ofgem-determined variable values and the underlying models used to calculate these.~~

1.33. ~~These are, the WACC allowance model, RPE model, and the grey inflation input values within the Annual Inflation and Monthly Inflation sheets of the PCFM. These are dependent on third-party data that is normally published in the first week of November and will normally be provided to the licensee by 10 November. The WACC allowance model and inflation indices within the PCFM will be updated using data available up to 31 October, while the RPE model will be updated using data available after 31 October and no later than 10 November.~~

1.34. ~~The licensee must include these Ofgem-determined values in all its subsequent dry run submissions.~~

Final Run

1.35. ~~The licensee will have a further opportunity to provide an updated RIIO-ET2 PCFM dry run in early December to reflect any updates actual or forecast variable values since the previous dry run. The Authority will review and confirm or amend the variable values, which will normally take place by mid-December and before the AIP notice is issued.~~

AIP notice

1.36. ~~The Authority will give the licensee at least 14 days' notice of the values for AR_t and $ADJR_t$, and a copy of the RIIO-ET2 PCFM used to calculate them (including the licensee's variable values, which may have been revised through the AIP), in accordance with Special Condition 8.2, to allow for any representations. This will normally take place by 15 December to allow enough time for the licensee to notify the Electricity System Operator of the value for AR_t in early January.~~

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1.37. ~~—To meet its obligation under Special Condition 2.1.3, the licensee should use the AR_t and $ADJR_t$ values in the version of the RIIO-ET2 PCFM that the Authority provides along with the 14-day notice of the AIP publication, when notifying the Electricity System Operator and when setting network charges for the forthcoming Regulatory Year. For the avoidance of doubt, this is the version of the RIIO-ET2 PCFM referred to in paragraph 2.63 of this Handbook.~~

1.38. ~~—The values of K_t or LAR_t used in setting network charges may be revised by the licensee after the AIP notice is issued by the Authority.~~

AIP publication

1.39. ~~—The Authority will then (by 31 January in Regulatory Year $t-1$, or as soon as is reasonably practicable thereafter) publish the values of AR_t and $ADJR_t$ and a copy of the RIIO-ET2 PCFM used to calculate AR_t and $ADJR_t$. The values of AR_t and $ADJR_t$ in the publication will be stated in £ millions to one decimal place.~~

1.40. ~~—Where certain information is considered to be commercially sensitive, the licensee may request that this information be redacted before the RIIO-ET2 PCFM is published. The Authority will consider the request and will share the version of the RIIO-ET2 PCFM for publication including any redactions as considered necessary with the licensee in advance of the publication.~~

1.41. ~~—Part C of Special Condition 8.2 specifies what will happen if the Authority does not publish a value for AR_t and $ADJR_t$ by 31 January in Regulatory Year $t-1$.¹⁷~~

1.42. ~~—Table 2.1 below summarises the timings for the AIP during the Price Control Period:~~

¹⁷ Except for 2025/26, when there will be no AIP (see Special Condition 8.2.15).

Table 2.1 – Summary of timings for the Annual Iteration Process¹⁸

AIP Year	Licensee submits populated RIIO-ET2 PGFM	RIIO-ET2 PGFM functional change cut-off	Regulatory reporting information cut-off	Notice of proposed variable-value revisions by	AIP completed and ARi and ADJRi published by	Regulatory Year in which ARi applies
Nov-2021	31-Aug-21	01-Jun-21	31-Oct-21	15-Nov-21	30-Nov-21	2022/23
Nov-2022	31-Aug-22	01-Jun-22	31-Oct-22	15-Nov-22	30-Nov-22	2023/24
Jan-2024	30-Sep-23	01-Jul-23	05-Dec-23	15-Dec-23	31-Jan-24	2024/25
Jan-2025	30-Sep-24	01-Jul-24	05-Dec-24	15-Dec-24	31-Jan-25	2025/26

1.43. Some financial adjustments provided for under the RIIO-ET2 Final Determinations will remain outstanding at the end of the Price Control Period, because relevant data will not be available in time for inclusion in the last AIP. For example, adjustments under the Totex Incentive Mechanism relating to actual and allowed expenditure levels in Regulatory Years 2024/25 and 2025/26 will remain outstanding. For the avoidance of doubt, adjustments of this type will be addressed as part of the close out of RIIO-2 or as part of the RIIO-ET3 price control arrangements.

The PGFM variable values

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

PGFM Variable Values

1.44. The variable values that can be revised during an AIP are set out in Table 3.1 below.

¹⁸ Use previous working day if these dates fall on a weekend or bank holiday.

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- 3.2 For each variable value, the table provides a description, cross-references to the relevant Special Condition(s) (where appropriate), and details of Associated Documents (where relevant). It also identifies the variable values for which further details are provided in subsequent sections of this handbook. This includes the approaches to variable values calculated by Ofgem (e.g. 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 (e.g. taxation and pensions).

Processing of different types of variable values

Table 3.1 Types of PCFM Variable Values

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

Totex allowance

- 3.4 The following types of variable values contribute to the calculation of the totex allowance¹⁹ through the Totex Incentive Mechanism:
- a) Variant Allowances (adjustments to totex allowances); and
 - b) Actual totex.
- 3.5 These types of variable values are used in the Totex Incentive Mechanism to determine the amounts that should, subject to the Totex Capitalisation Rate for the licensee, be processed as:
- a) Fast Money (FM_t) – flowing directly into the Calculated Revenue (R_t) figure for the Regulatory Year to which the amount relates; and
 - b) Slow Money – addition to the licensee's RAV in the Regulatory Year to which the amount relates, contributing indirectly to Calculated Revenue (R_t) through the return (RTN_t) on RAV and depreciation (DPN_t) over multiple Regulatory Years.

¹⁹ Subject to "Capitalisation rate 1" and "Capitalisation rate 2" which relates to "Ex-ante Baseline totex + PCDs" and "Uncertainty Mechanisms only" respectively. Non-variant allowances also contribute to the calculation of totex but are not variable.

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Pass-through expenditure

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

Incentive Revenue

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

Other Revenue Allowances

- 3.8 This type of variable value comprises ~~expenditure incurred on innovation projects (by means of Network Innovation Allowance), and any other such allowances that can be processed as Fast Money (FM_t) which flows~~ allowances that flow directly into Calculated Revenue (R_t).

Legacy Adjustments

- 3.9 This type of variable value relates to adjustments for previous price controls and comprises:
- a) Legacy Revenue adjustments (LAR_t): These types of adjustments flow directly into Allowed Revenue (AR_t);
 - b) Legacy RAV Additions Adjustment ($LRAV_t$): These variable values contribute indirectly to Calculated Revenue (R_t); and
 - c) Tax balances brought forward (OGP_t , $OSRP_t$, $ODRP_t$, $LODRP_t$, $OSBP_t$, **LOSBP_t** and OTL_t): These variable values contribute to the tax allowance (TAX_t).

Directly Remunerated Services (DRS)

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

Finance Inputs

- 3.11 This category comprises:

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- a) Cost of capital percentage (~~SHETLCDE~~, ~~iBTA_t~~, iBAFY_t, ~~iBAAO_t~~, RFR_t)²⁰: These types of variable value affect the allowance provided to the licensee for financing their capital needs and contributes to Calculated Revenue (R_t) indirectly.
- b) Allowed Revenue setting: This type of variable value is used in the calculation of Allowed Revenue and comprises ~~SONIA~~, ~~RIIO-1 Allowed Revenue and Recovered Revenue~~, the price index term, K correction factor, the Forecasting Penalty term and Calculated Revenue (R_t).
- c) Tax allowance_t²¹: This type of variable value relates to taxation of the licensee and contributes indirectly to Calculated Revenue (R_t) or, in the case of TAXA_t, flows directly into Calculated Revenue (R_t).
- d) Real Price Effects (RPE_t)²²: This is the annual growth rate used for the derivation of the RPE indexation values. These in turn are applied to the relevant allowed totex spend, to derive the related RPE totex allowance.

Forecasting Penalty inputs

3.12 This type of variable value is used in the calculation of the Forecasting Penalty (FP_t) and comprises the Base Revenue Forecasting Penalty (BRFP_t), Base Revenue (BR_t) and Base Revenue as published (AR^*_t).

Inflation Inputs

3.13 The ET3 PCFM contains the following PCFM Variable Values relating to the price index:

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

3.14 These inputs enable the model to be able to calculate Pl_t as well as calculate a forecast in accordance with the methodology above.

Totex Variant Allowances Allocation Percentages (TVAA_t)

~~3.12~~ 3.15 These variable values comprise totex variant allowance allocation percentages, used in the ~~RIIO-ET2~~ ET3 PCFM to allocate variant totex allowances between the six categories of totex as listed below:

²⁰ See Section 4 of this handbook.

²¹ See Section 6 of this handbook.

²² See Section 5 of this handbook.

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- a) Load related capex
- b) Asset replacement capex
- c) Other capex
- d) Network operating costs (opex)
- e) Indirects (opex)
- f) Non-operational capex

~~3.13~~3.16 These allocation rates enable actual and forecast allowances to feed into Calculated Revenue (R_t) through the Totex Incentive Mechanism (see para 3.656) and relate specifically to any re-opener or uncertainty mechanism, which have not been pre-populated in the ~~RIIO-ET2~~ET3 PCFM as a “yellow box” hard-coded input.

List of PCFM Variable Values

Table 3.1.1 - PCFM Variable Values (VV)

Variant Totex Allowances

VV	Description	SpC	Cross-reference / Associated Document
NARM _t	Baseline Network Risk Output	SpC 3.1	PCFM Guidance, Network Asset Risk Workbook, NARM Handbook
CR OT _t CY _t	Cyber resilience OT Baseline <u>baseline term</u>	SpC 3.2	PCFM Guidance, PCD Reporting Requirements and Methodology Document
CR OTRE _t CYRE _t	Cyber resilience OT non-baseline <u>term</u>	SpC 3.2	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements and Methodology Document</u>
CR IT _t CYU _t	<u>Cyber resilience</u> IT Baseline <u>Use it or lose it allowance</u>	SpC 3.32	PCFM Guidance, PCD Reporting <u>Re-opener Guidance and Application Requirements and Methodology Document</u>
CR ITRE _t RESRE _t	Cyber resilience IT non-baseline <u>Resilience Activity Re-opener</u>	SpC 3.3	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements and Methodology Document</u>
PSUP _t	Physical Security Price Control Deliverable	SpC 3.43	PCFM Guidance, PCD Reporting Requirements and Methodology Document
PSRUPRE _t	Physical Security Re-Opener	SpC 3.43	PCFM Guidance, Re-opener Guidance and Application Requirements

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VV	Description	SpC	Cross-reference / Associated Document
RDF_t	Net Zero And Re-opener Development Fund use it or lose it allowance	SpC 3.5	PCFM Guidance
NZ_tDEP_t	Net zero Decarbonisation and Environmental Policy Re- opener	SpC 3.6	PCFM Guidance, Re- opener Guidance and Application Requirements
$NOIRE_tDIGI_t$	Non-operational IT Capex Reopener Digitalisation Re- opener	SpC 3.7	PCFM Guidance, Re- opener Guidance and Application Requirements
CAM_t	Coordinated adjustment mechanism Re-opener	SpC 3.8	PCFM Guidance, Re- opener Guidance and Application Requirements
WW_tOTEC_t	Wider Works Operational transport emissions carbon reduction Price Control Deliverable	SpC 3.9	PCFM Guidance
EPI_tNLR_t	Enhancing Pre-existing Infrastructure Projects allowance Non-Load Re- opener term	SpC 3.10	PCFM Guidance, PCD Reporting Requirements and Methodology Document
$VIMRE_t$	Visual Impact Mitigation Re- opener	SpC 3.10	PCFM Guidance, Re- opener Guidance and Application Requirements
GCE_t	Generation Connections volume driver	SpC 3.11	PCFM Guidance
DRI_t	Demand Connections volume driver (SPTL and NGET only)	SpC 3.12	PCFM Guidance
$LOTIA_tCAI_t$	Large Onshore Transmission Investment Re-opener Project 1 – Hinckley Sea Bank Closely Associated Indirects	SpC 3.13	PCFM Guidance, LOTI Guidance and Submissions Requirement Document
$LOTIRE_t$	Large Onshore Transmission Investment Re-opener Project 2 – Shetland	SpC 3.13	PCFM Guidance, LOTI Guidance and Submissions Requirement Document

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VV	Description	SpC	Cross-reference / Associated Document
MSIPRE <u>BSCR_t</u>	Medium Sized Investment Projects <u>Business Support Costs</u> Re-opener	SpC 3.14	PCFM Guidance, Re-opener Guidance and Application Requirements
PCF _t	Pre-Construction Funding Price Control Deliverable	SpC 3.15	PCFM Guidance, PCD Reporting Requirements and Methodology Document
PCFRE _t	Pre-Construction Funding Re-Opener	SpC 3.15	PCFM Guidance, Re-opener Guidance and Application Requirements
<u>APM_t</u>	<u>Advanced Procurement Mechanism</u>	<u>SpC 3.16</u>	<u>PCFM Guidance, APM Governance Document</u>
<u>LI_t</u>	<u>Load use it or lose it allowance</u>	<u>SpC 3.17</u>	<u>PCFM Guidance, PCD Reporting Requirements and Methodology Document</u>
ARR <u>LR_t</u>	Access Reform Change <u>Load Re-Opener</u>	SpC 3. 16 <u>18</u>	PCFM Guidance, Re-opener Guidance and Application , <u>PCD Reporting Requirements and Methodology Document</u>
<u>CSNPR_t</u>	<u>CSNP Re-opener</u>	<u>SpC 3.19</u>	<u>Re-opener Guidance and Submissions Requirements Document.</u>
APCF <u>SS_t</u>	Shared Schemes <u>ASTI Pre-Construction Funding Price Control Deliverable (SHET and SPTL only)</u>	SpC 3. 17 <u>20</u>	PCFM Guidance, PCD Reporting Requirements and Methodology Document <u>Re-opener Guidance</u>
ASTIR <u>RO_t</u>	Resilience and Operability Price Control Deliverable (SHET and SPTL only) <u>Accelerated strategic transmission investment Re-opener</u>	SpC 3. 18 <u>21</u>	PCFM Guidance, PCD Reporting Requirements, <u>Re-opener Guidance</u> and Methodology Document
EER <u>EECA_t</u>	Enhanced Environmental Requirements <u>use it or lose</u>	SpC 3. 19 <u>22</u>	PCFM Guidance

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VV	Description	SpC	Cross-reference / Associated Document
	it Entry and exit connection asset allowance (SPTL and SHETL only)		
<u>T2ACA_t</u>	<u>ET2/ET3 Crossover adjustments</u>	<u>SpC 3.23</u>	<u>PCFM Guidance</u>
<u>LOE_t</u>	<u>Legacy Opex Escalator</u>	<u>SpC 3.24</u>	<u>PCFM Guidance</u>
<u>SF6_t</u> GRI_t	Generation-Related Infrastructure SF6 asset intervention Price Control Deliverable (NGET and SHETL only)	<u>SpC 3.25</u> 25	PCFM Guidance, PCD Reporting Requirements and Methodology Document
<u>SCR_t</u>	<u>Subsea Cable Re-opener (SHETL only)</u>	<u>SpC 3.26</u>	<u>PCFM Guidance, Re-opener Guidance and Application Requirements</u>
<u>PR_t</u>	<u>Property Re-opener (SHETL only)</u>	<u>SpC 3.27</u>	<u>PCFM Guidance, Re-opener Guidance and Application Requirements</u>
OTC_t <u>PRNIC_t</u>	Operational transport carbon reduction Protection Replacement And Control Price Control Deliverable (NGET <u>SHETL only</u>)	<u>SpC 3.28</u> 28	<u>PCFM Guidance, PCD Reporting Requirements</u>
InT_t <u>OXCB_t</u>	Instrument Transformer OX36 Circuit Breaker Replacement Price Control Deliverable (NGET <u>SHETL only</u>)	<u>SpC 3.29</u> 29	<u>PCFM Guidance, PCD Reporting Requirements</u>
<u>BA_t</u> <u>SCB_t</u>	Bay Assets 132kV Circuit Breakers Replacement at REDACTED substation Price Control Deliverable (NGET <u>SHETL only</u>)	<u>SpC 3.30</u> 30	<u>PCFM Guidance, PCD Reporting Requirements</u>
<u>PC_t</u> <u>ECB_t</u>	Protection and Control 132kV Circuit Breakers Replacement at REDACTED substation Price Control Deliverable (NGET <u>SHETL only</u>)	<u>SpC 3.31</u> 31	<u>PCFM Guidance, PCD Reporting Requirements</u>
OC_t <u>FPS_t</u>	Overhead Line Conductor REDACTED Power Station Price Control Deliverable (NGET <u>SHETL only</u>)	<u>SpC 3.32</u> 32	<u>PCFM Guidance, PCD Reporting Requirements</u>

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VV	Description	SpC	Cross-reference / Associated Document
SAS_t SPS _t	Substation Auxiliary Systems use it or lose it allowance (NGET only) REDACTED Power Station Price Control Deliverable (SHET only)	SpC 3. 26 33	PCFM Guidance, <u>PCD Reporting Requirements</u>
KPS_t SF6_t	SF6-asset intervention REDACTED Power Station Price Control Deliverable (NGET SHET only)	SpC 3. 27 34	PCFM Guidance, <u>PCD Reporting Requirements</u>
SF6RE_t APS _t	SF6-asset intervention Re-opener (NGET only) REDACTED Power Station Price Control Deliverable (SHET only)	SpC 3. 27 35	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
SCR_t OSU _t	Sub-sea Cable Re-opener REDACTED Substation Upgrade Price Control Deliverable (SHET only)	SpC 3. 28 36	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
UNLRE_t WCSU _t	Uncertain non-load related projects Re-opener (SPTL only) REDACTED Substation Upgrade Price Control Deliverable (SHET only)	SpC 3. 29 37	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
WWW_t DSU _t	Wider Works Volume Driver (NGET only) Substation Upgrade Price Control Deliverable (SHET only)	SpC 3. 30 38	PCFM Guidance, <u>PCD Reporting Requirements</u>
<u>FM_t</u>	<u>Flood Mitigation Price Control Deliverable (SHET only)</u>	<u>SpC 3.39</u>	<u>PCFM Guidance, PCD Reporting Requirements</u>
FWR_t NSR _t	Fibre Wrap Replacement NESO Separation Re- opener Opener (NGET only)	SpC 3. 31 40	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
CWR_t PRA _t	Civil Related Works Property Re-opener <u>Alpha</u> (NGET only)	SpC 3. 32 41	PCFM Guidance, Re-opener Guidance and Application Requirements
TSF_t PRB _t	Tower Steelworks and Foundations Property Re-opener <u>Beta</u> (NGET only)	SpC 3. 33 42	PCFM Guidance, Re-opener Guidance and

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VV	Description	SpC	Cross-reference / Associated Document
			Application Requirements
TCR _t	Tyne Crossing Project Re-opener (NGET only)	SpC 3.3443	PCFM Guidance, Re-opener Guidance and Application Requirements
BRG _t	Bengeworth Road GSP Project Price Control Deliverable Re-opener (NGET only)	SpC 3.3544	PCFM Guidance, <u>PCD Reporting Requirements</u> , Re-opener Guidance and Application Requirements
OE _t	Opex escalator	SpC 3.36	PCFM Guidance
EECA _t	Entry and Exit Connection Asset Allowance	SpC 3.37	PCFM Guidance
T1OA_t IASU _t	RIIO-ET1/RIIO-ET2 offset adjustment REDACTED Substation upgrade Price Control Deliverable (NGET only)	SpC 3.3845	PCFM Guidance, <u>PCD Reporting Requirements</u>
LGCE_t S _t	Legacy Baseline Connections Volume Driver (SHET only) Sizewell Substation Project Price Control Deliverable (NGET only)	SpC 3.39 46	<u>PCFM Guidance, PCD Reporting Requirements</u>
NGETNLMP_t APOF _t	Accelerated strategic transmission investment Pre-Construction Funding Re-opener <u>NGET Non-Load Related Major Projects Re-opener</u> (NGET only)	SpC 3.4047	PCFM Guidance, <u>PCD Reporting Requirements</u> , Re-opener Guidance and Application Requirements
NPA_t ASTIR _t	Accelerated strategic transmission investment Re-opener <u>NLRE Named Price Control Deliverable</u> (NGET only)	SpC 3.41 SpC 3.48	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
CC_t VPA _t	Consequential Costs of ESO Separation <u>NLRE Volume Price Control Deliverable</u> (NGET only)	SpC 3.42 SpC 3.49	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>

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VV	Description	SpC	Cross-reference / Associated Document
APM <u>CPA</u> _t	Advanced Procurement Mechanism Re-Opener <u>NLRE Combi Price Control Deliverable (NGET only)</u>	SpC 3.43 <u>SpC 3.50</u>	PCFM Guidance, Re-opener Guidance and Application <u>PCD Reporting Requirements</u>
DF <u>NGET</u> <u>VS</u> _{B,t}	Development Funding <u>NGET V-String Busbars and Price Control Deliverable (NGET only)</u>	SpC 3.44 <u>51</u>	PCFM Guidance, <u>PCD Reporting Requirements</u>
DTPCF <u>NGET</u> <u>RC</u> _t	Delivery Track Pre Construction Funding Re-Opener <u>NGET Reactive Compensation Reopener (NGET only)</u>	SpC 3.45 <u>52</u>	PCFM Guidance, <u>PCD Reporting Requirements</u> , <u>Re-opener Guidance and Application Requirements</u>

Actual Totex (Capitalisation rate 1)

VV	Description	SpC	Cross-reference / Associated Document
ALC <u>ALC</u> _t	Actual load related capex expenditure		PCFM Guidance
ARC <u>ARC</u> _t	Actual asset replacement capex expenditure		PCFM Guidance
AOC <u>AOC</u> _t	Actual other capex expenditure		PCFM Guidance
ACO <u>ACO</u> _t	Actual network operating costs (opex)		PCFM Guidance
AIO <u>AIO</u> _t	Actual Indirects (opex)		PCFM Guidance
ANC <u>ANC</u> _t	Actual non-operational capex		PCFM Guidance

Actual Totex (Capitalisation rate 2)

VV	Description	SpC	Cross-reference / Associated Document
ALCU <u>ALCU</u> _t	Actual load related capex expenditure		PCFM Guidance

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ARCU <u>ARCU_t</u>	Actual asset replacement capex expenditure		PCFM Guidance
AOCU <u>AOCU_t</u>	Actual other capex expenditure		PCFM Guidance
ACOU <u>ACOU_t</u>	Actual network operating costs (opex)		PCFM Guidance
AIQU <u>AIQU_t</u>	Actual Indirects (opex)		PCFM Guidance
ANCU <u>ANCU_t</u>	Actual non-operational capex		PCFM Guidance

Pass-through expenditure

VV	Description	SpC	Cross-reference / Associated Document
RB _t	Prescribed Rates	SpC 6.1, Part B	PCFM Guidance
EDE _t	Pension Scheme Established Deficit Repair	SpC 6.1, Part A	PCFM Guidance
TPD _t	Temporary physical disconnection costs	SpC 6.1, Part A	PCFM Guidance
SHCP_t	Energy Note Supplied Compensatory scheme (SHET only)	SpC 6.2	PCFM Guidance
ESOP _t	ES <u>NGESO Pension Transfer Costs</u>	SpC 6.1, Part <u>B</u>	PCFM Guidance
<u>CF_t</u>	<u>Community funds for transmission infrastructure</u>	<u>SpC 6.1, Part D</u>	<u>PCFM Guidance</u>
<u>TSA_t</u>	<u>Tender support activities costs</u>	<u>SpC 6.1, Part E</u>	<u>PCFM Guidance</u>
<u>MP_t</u>	<u>Miscellaneous pass-through costs</u>	<u>SpC 6.1, Part A</u>	<u>PCFM Guidance</u>
<u>ITA_t</u>	<u>Independent Technical Adviser</u>	<u>SpC 6.1, Part A</u>	<u>PCFM Guidance</u>

Incentive Revenue

VV	Description	SpC	Cross-reference / Associated Document
ENSI _t	Energy Not Supplied ODI	SpC 4.2	PCFM Guidance
IIGI _t	Insulation and Interruption Gas emissions ODI	SpC 4.3	PCFM Guidance
CONADI_t <u>CON_t</u>	Timely connections ODI	SpC 4.4	PCFM Guidance
QCS_t <u>IDI_t</u>	Quality of connections satisfaction survey ODI <u>Innovative Delivery ODI</u>	SpC 4.5	PCFM Guidance

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ESI_t	Environmental Scorecard ODI	SpC 4.6	PCFM Guidance
SOTO _t	SO TO Optimisation ODI	SpC 4. 7 <u>6</u>	PCFM Guidance, SO-TO Optimisation Governance
ASTII_t	ASTI ODI	SpC 4.7	PCFM Guidance
MPI _t	Major Projects ODI	SpC 4. 8 <u>7</u>	PCFM Guidance

Other Revenue Allowances

VV	Description	SpC	Cross-reference / Associated Document
NIA _t	RIIO- 22 <u>3</u> network innovation allowance	SpC 5.2	PCFM Guidance, RIIO- 2 <u>3</u> NIA Governance Document
CNIA _t	Carry-over Network Innovation Allowance	SpC 5.3	PCFM Guidance, RIIO- 1 <u>2</u> NIA Governance Document
NTMP_t <u>LEIP_t</u>	Non-Technical Mitigation Landscape Enhancement Initiative Projects allowance	SpC 5.4	PCFM Guidance
NZF_t <u>CCO_t</u>	Net Zero Fund Carbon Compensation use it or lose it allowance (SHET and SPTL only)	SpC 5.5	PCFM Guidance
NZ3C_t	Net zero carbon Capital Construction use it or lose it allowance (NGET only)	SpC 5.6	PCFM Guidance
TIRG _t	Transmission investment for renewable generation (SHET and SPTL only)	SpC 5.6 (SHET) SpC 5.7(SPT)	PCFM Guidance
PRPN _t	Pre-RIIO-1 pension true-up	SpC 5.1	PCFM Guidance

Legacy Adjustments

VV	Description	SpC	Cross-reference / Associated Document
LPT_t	Close-out of RIIO-ET1 pass-through items	SpC 7.2	PCFH section 8, PCFM Guidance
LMOD_t <u>LADJ_t</u>	Legacy MOD Adjustment term	SpC 7. 3 <u>2</u>	PCFH section 8, PCFM Guidance

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LK_t	Legacy K correction	SpC 7.43	PCFH section 8, PCFM Guidance
$\cancel{L}TRU_t \cancel{L}RAV_t$	RIIO-2 Legacy TRU term net RAV additions (after disposals)	SpC 7.54	PCFH section 8, PCFM Guidance
$\cancel{L}SSO_t \cancel{OGP}_t$	Close-out of RIIO-ET1 stakeholder satisfaction output General pool capital allowance opening balance brought forward	SpC 7.64	PCFH section 8, PCFM Guidance, Stakeholder Engagement Reward Guidance
$\cancel{L}EDR_t \cancel{OSRP}_t$	Close-out of RIIO-ET1 environmental discretionary reward scheme adjustment Special Rate capital allowance opening balance brought forward	SpC 7.74	PCFH section 8, PCFM Guidance, Environmental Discretionary Reward Scheme
$\cancel{L}SFI_t \cancel{OSBP}_t$	Close-out of RIIO-ET1 sulphur hexafluoride gas emissions incentive Structures and buildings capital allowance opening balance brought forward	SpC 7.84	PCFH section 8, PCFM Guidance
$\cancel{L}RI_t \cancel{ODRP}_t$	Close-out of RIIO-ET1 energy not-supplied reliability incentive Deferred revenue expenditure opening balance brought forward	SpC 7.94	PCFH section 8, PCFM Guidance
$\cancel{N}OGG_t \cancel{L}OSBP_t$	Close-out of RIIO-ET1 network outputs Structures and buildings pool additions (RIIO2) plus opening balance at start of RIIO2	SpC 7.104	PCFH section 8, PCFM Guidance
$\cancel{L}RAV_t \cancel{L}ODRP_t$	RIIO-1 net RAV Deferred revenue pool additions (after disposals) RIIO2 plus opening balance at start of RIIO2	SpC 7.124	PCFH section 8, PCFM Guidance
$\cancel{C}OA \cancel{OTL}_t$	Closeout adjustment Tax loss brought forward	SpC 7.34	PCFH section 8, PCFM Guidance
REV_t	Revenue for TRU term	SpC 7.5	PCFM Guidance
$RPIF_t$	RIIO-1 RPI forecast term	SpC 7.5	PCFM Guidance

Directly Remunerated Services

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

Finance Inputs

VV	Description	SpC	Cross-reference / Associated Document
RFR RFR _t	Risk-free rate		PCFH section 4, PCFM Guidance
iBTA iBTA _t , iBTAFY iBTAFY _t	iBoxx trailing average Nominal iBoxx average (financial year)		PCFH section 4, PCFM Guidance
iBAFY iBAFY _t	iBoxx average (Financial Year)	-	PCFH section 4, PCFM Guidance
iBAO iBAO _t	iBoxx average (April – October)	-	PCFH section 4, PCFM Guidance
t t _t	Sterling Overnight Index Average (SONIA)	SpC 1.1, Part B	PCFH section 2, PCFM Guidance
RPE _t	RPE annual growth		PCFM Guidance
AND _t	Adjusted net debt		<u>PCFH section 6, PCFM Guidance</u>
TDNI _t	Tax deductible net interest cost		<u>PCFH section 6, PCFM Guidance</u>
TAXA _t	Tax allowance adjustment	SpC 2.2	PCFH section 6, PCFM Guidance
TTE _t	Tax liability allowance adjustments - driven by tax trigger events		PCFH section 6, PCFM Guidance
OGPA _t	General pool opening balance adjustment		PCFM Guidance
OSRPA _t	Special Rate pool opening balance adjustment		PCFM Guidance

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ΘGP_t	General pool capital allowance opening balance brought forward	-	PCFM Guidance
ΘSRP_t	Special Rate capital allowance opening balance brought forward	-	PCFM Guidance
ΘSBP_t	Structures and buildings capital allowance opening balance brought forward	-	PCFM Guidance
ΘDRP_t	Deferred revenue expenditure opening balance brought forward	-	PCFM Guidance
$L\Theta DRP_t$	Deferred revenue pool additions (RIIO1) plus opening balance at start of RIIO1	-	PCFM Guidance
ΘTL_t	Tax loss brought forward	-	PCFM Guidance
$ARGP_t$	Totex allocation to "General" tax pool		PCFM Guidance
$ARSR_t$	Allocation to "Special Rate" tax pool		PCFM Guidance
$ARSB_t$	Allocation to "Structures and Buildings" tax pool		PCFM Guidance
$ARDR_t$	Allocation to "Deferred Revenue" tax pool		PCFM Guidance
$ARRe_t$	Allocation to "Revenue" tax pool		PCFM Guidance
$ARNQ_t$	Allocation to "Non-Qualifying" tax pool		PCFM Guidance
CT_t	Corporation tax rate		PCFM Guidance
GCA_t	General pool capital allowance rate		PCFM Guidance
$SRCA_t$	Special Rates capital allowance rate		PCFM Guidance
$SBCA_t$	Structures and buildings capital allowance rate		PCFM Guidance
$DRCA_t$	Deferred Revenue Expenditure capital allowance rate		PCFM Guidance
<u>$FEGP_t$</u>	<u>General pool additions qualifying for full expensing allowance</u>		<u>PCFM Guidance</u>

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<u>FESR_t</u>	<u>Special rate pool additions qualifying for full expensing allowance</u>		<u>PCFM Guidance</u>
RIIO-1 AR_t BRFPA_t	RIIO-1 allowed <u>Base revenue forecasting penalty adjustment</u>	SpC 2.1 Part G	<u>PCFM Guidance</u>
<u>RR_t</u>	<u>Recovered revenue</u>	<u>SpC 2.1, Part B</u>	<u>PCFM Guidance</u>
<u>RPA_t</u>	<u>Revenue profiling adjustment</u>	<u>SpC 2.1, Part D</u>	

Forecasting Penalty inputs

<u>VV</u>	<u>Description</u>	<u>SpC</u>	<u>Cross-reference / Associated Document</u>
<u>BR*_t</u>	<u>Base revenue (as published)</u>	<u>SpC 2.1</u>	
<u>BRFPA_t</u>	<u>Base revenue forecasting penalty adjustment</u>	<u>SpC 2.1</u>	

Inflation inputs

<u>VV</u>	<u>Description</u>	<u>SpC</u>	<u>Cross-reference / Associated Document</u>
<u>CPIH_m</u>	<u>Outturn CPIH monthly data</u>		<u>PCFH, Chapter 2</u>
<u>FYCPIH_t</u>	<u>Financial year CPIH forecast data</u>		<u>PCFH, Chapter 2</u>
<u>LTCPIH_t</u>	<u>Long term CPIH inflation forecast</u>		<u>PCFH, Chapter 2</u>

Totex variant allowances allocation percentages

<u>VV</u>	<u>Description</u>	<u>SpC</u>	<u>Cross-reference / Associated Document</u>
<u>TVAAt</u>	The range of totex variant allowance allocation percentages relating to any re-opener or uncertainty mechanism, which have not been pre-populated in the RIIO-ET2 ET3 PCFM as a “yellow box” hard-coded input.		PCFM Guidance

~~Guidance~~

Guidance ET3 Price Control Financial Handbook

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4. Cost of debt and cost of equity indexation

- 4.1 The licensee's Calculated Revenue (R_t) includes amounts which cover the efficient cost of raising finance for the transmission 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~~ ~~a~~ ~~Allowed~~ ~~r~~ ~~Return~~ ~~on~~ ~~Capital~~ ~~c~~ ~~Capital~~ is Ofgem's estimate of the transmission ~~businesses' Weighted Average Cost~~ ~~businesses's~~ ~~Semi-Nominal~~ ~~W~~ ~~Weighted~~ ~~a~~ ~~Average~~ ~~c~~ ~~Cost~~ ~~of~~ ~~Capital~~ ~~c~~ ~~Capital~~ (WACC). ~~This is calculated on a real basis, determined using a pre-tax real allowed return on debt percentage, a post-tax real allowed return on equity percentage and a notional gearing percentage weighting. semi-nominal WACC.~~ Please see the end of the chapter for the calculation.
- 4.2 Under the RIIO-~~ET2~~ ~~ET3~~ price control, the notional gearing ~~percentage~~ is fixed for the Price Control Period. However, there are annual revisions to:
- the ~~cost of~~ allowed return on debt ~~percentages~~ (GDE; and SHETLCDE)²³ and
 - the ~~cost of~~ allowed return on equity ~~percentage~~ ~~annually~~ through changes to the real (CPIH based) risk-free rate (RFR) ~~are updated by Ofgem on an annual basis.~~

~~1.45:—The updates are given effect through by updating the AIP and the approaches to determining the updated variable values are described below:~~

~~Cost of debt~~

~~1.46:—The RIIO-ET2 PCFM in its state as at 01 April 2021 includes opening cost of debt percentages GDE for the licensee for every Regulatory Year of the Price Control Period:~~

~~1.47:—Revised GDE values for National Grid Electricity (NGET) and Scottish Power Transmission (SPT) for all future Regulatory Years in the Price Control Period will be~~

²³ Also referred to as "Allowed return on debt" in RIIO-ET2 PCFM. The two variable values ie GDE and SHETLCDE apply to ("National Grid Electricity (NGET) and Scottish Power Transmission (SPT)" and "SHE Transmission Plc (SHETPLC)" respectively. The RIIO-ET2 PCFM needs both GDE values to be updated each year.

~~calculated by Ofgem~~ Variable Values in accordance with the ~~approach set out below~~ and published in respect of each AIP. ~~In brief, revised CDE values will be determined using an iBoxx Trailing Average (iBTA_t)²⁴ of the pounds sterling indices of bonds issued by utilities that have a remaining maturity of 10 or more years contained in the Markit iBoxx® database of bond market data, or forecasts of the same. The averaging periods for the Daily Utilities Index (DUI_t), set via the AIP, commence with an eleven-year period,²⁵ and then extend by one year as each Regulatory Year of the Price Control Period elapses.~~

~~4.3 The steps Ofgem will~~ methodologies which follow to determine revised CDE and iBTA_t

~~4.4~~ The updates will also incorporate the Regulatory Year t-1, replacing previously forecasted values with outturn values.

Cost of debt

~~1.48. values are:~~

~~4.5 This section considers the calculation of the allowed return on fixed rate debt (KdFRD_t) and the allowed return on index-linked debt (KdILD_t).~~

~~4.6 The licensee must use the following methodology to update the PCFM Variable Values~~ iBAFY_t to enable the ET3 PCFM to calculate the KdFRD_t and KdILD_t values.

~~4.7 The values of KdFRD_t and KdILD_t must be updated annually.~~

Methodology

Step 1 – obtain or forecast nominal bond yields which form the Daily Utilities Index (DUI_t) for each trading day

~~4.24.8~~ For each day from 01 November 2010 to 31 October 2024 ~~March 2030~~, obtain a nominal ~~bond~~ annual yield as follows:

²⁴ ~~RIIO-ET2 PCFM uses a different approach for cost of debt calculation for SHE Transmission Plc (SHETPLC) as described in paragraphs 4.15 – 4.17, based on three iBoxx averages ie iBTA_t, iBAFA_t and iBAAQ_t~~

²⁵ ~~A ten-year period having been used to set opening CDE values at the outset of the Price Control Period.~~

- a) for days up to and including 31 October in the year in which the AIP update is being conducted, obtain from the Markit data service, the nominal annual yield in % for the iBoxx Utilities 10yr+ index GBP A (ISIN reference DE0005996532); and: DE000A0JY837) and iBoxx GBP BBB (ISIN reference: DE000A0JZAH1) Non-Financials 10+ corporate indices and calculate a simple arithmetic average of the two indices for each corresponding trading day.
- a) – for all other days, forecast a nominal annual yield as the sum of:
- b) the 3-year trailing average spread between the yield on iBoxx Utilities 10yr+ index and the yield for British government securities, 10-year nominal zero coupon (series reference IUDMNZC),²⁶ using data up to and including 31 October in the year in which the AIP average of the last full calendar month of outturn data available in which the update is being conducted.
- i. a forecast of the yield for British government securities, 10-year nominal zero coupon. The forecast is derived from the Bank of England’s estimated nominal yield curves for British government securities²⁷ (using data up to and including 31 October in the year in which the AIP is being conducted) by a no arbitrage condition, where a 10 year rate x years in the future can be derived from the x year rate and 10+x year rate. The forecast is made for dates on half yearly intervals, and then linearly interpolated between those dates.

Step 2 – obtain (π_t) inflation forecast values

4.34.9 For each day from 01 ~~November 2010~~ April 2012 to 31 ~~October 2024~~ March 2030, obtain an inflation value from the OBR’s Historical official forecasts database²⁸, as follows:

- a) For days up prior to 01 April 2012, the inflation forecasts used will be 2% for CPIH.
- a)b) For days on or after 01 April 2012 and up to and including 31 ~~October in the year in which the AIP is being conducted~~ March 2025, the inflation value is

²⁶ Sourced from the statistics page of the Bank of England’s website: <https://www.bankofengland.co.uk/>

²⁷ <https://www.bankofengland.co.uk/statistics/yield-curves>

²⁸ Sourced from the data page of the OBR website: <https://obr.uk/download/historical-official-forecasts-database/>

the latest Office for Budget Responsibility (OBR) year 5²⁹ 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~~ For days on or after 31 March 2025 and up to and including the 31 March in the year in which the update is being made, the inflation value is the latest OBR year 5 forecast of CPIH 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. If the year 5 forecast is not available, in each case use the year 4 forecast for the year.

a) ~~For all other days, the inflation value is the latest OBR year 5 forecast of CPI~~ ~~CPIH~~ available on 31 October in the year in which the ~~AIP~~ update is being conducted,

b)d) ~~in each case using the year 4 forecast for the year if the year 5 forecast is not available.~~

1.49:—Currently as per Historical Official forecasts database on OBR website, there are generally two publications in a year. Publication in October in a given year for the period ‘November to March’ shows a year 5 forecast and publication in March for the period ‘April to October’ shows a year 4 forecast. For example, the inflation values for 01 November 2018, are the OBR year 5 forecasts of CPI (for 2023) published in October 2018 and the inflation values for 31 October 2018 are the OBR year 4 forecasts of CPI (for 2022) published in March 2018.

e) Calculate the arithmetic average value of the daily inflation values for the Regulatory Year to obtain π for any given year.

Step 3 – calculate ~~real Daily Utilities Index (DUI_t) for each trading day~~

1.50:—This step converts the nominal bond yields to a real value, incorporating additional costs of borrowing. For each day in the period from 01 November 2010 to 31

²⁹ The longest horizon available from this database is currently the inflation forecast for 5 years time. However, if a longer horizon is published then the longest horizon available will be used in all instances where a year 5 forecast is mentioned in this chapter for the purposes of return allowance calculations.

~~October 2024, add 25 basis points (for additional costs of borrowing) to the daily yield figures obtained under Step 1, and deflate using the inflation figure obtained under Step 2, using the following formula:~~

$$\text{DUI}_t = \left(1 + \frac{\text{the iBoxx} + [0.0025]}{\text{Financial Year Average (iBAFY}_t\text{)}} \right) / (1 + \pi_t) - 1$$

where:

DUI_t — is the “Daily Utilities index”, obtained as the daily real value of iBoxx utilities bond yield plus 25 basis points (additional costs of borrowing);

iBoxx — is the daily yield figure obtained under Step 1 expressed as a Decimal Percentage; and

π_t — is the inflation figure obtained under Step 2.

~~Step 4 — calculate iBoxx Trailing Average (iBTA_t) and average allowed return on debt (CDE) for trailing period~~

4.10 For each Regulatory Year, calculate the arithmetic average value of the DUI_t from the values derived in step 1.

4.11 The arithmetic averages derived above are rounded to two decimal places ie $x.xx\%$.

Step 3 4— calculate the iBoxx Trailing Average (iBTAN_t)

~~4.4.12~~ For each Regulatory Year, calculate the arithmetic average value of the iBAFY_t , DUI_t using the periods shown in Table 4.1. from the PCFM Variable Values derived in steps **1-3**.

4.13 The arithmetic averages derived above are rounded to two decimal places ie $x.xx\%$.

Table 4.11 – time periods for calculation of iBoxx Trailing Average (iBTA, iBTAN_t) by Regulatory Year

Regulatory Year	Time period for calculation
2022/23 2026/27	01 November 2010 1 April 2012 to 31 October 2021March 2026
2023/242027/28	01 November 20101 April 2013 to 31 October 2022March 2027

2024/25 2028/29	01 November 2010 1 April 2014 to 31 October 2023 March 2028
2029/30	1 April 2015 to 31 March 2029
2025/26 2030/31	01 November 2010 1 April 2016 to 31 October 2024 March 2030

4.5.4.14 The resulting averages, expressed as a percentage, constitute the revised variable value ET3 PCFM Variable V value for $iBTAN_t$ for each Regulatory Year.

In Step 4.5 – calculate the RIIO-ET2 PCFM allowed return on fixed rate debt ($KdFRD_t$)

4.15 For each Regulatory Year, the $iBTAN_t$ percentages ET3 PCFM will the calculate the RAV-weighted average value of the $iBTAN_t$ using the periods shown from the Variable V values derived above in steps 2.4 and the RAV-weighted $iBAFY_t$ derived in step 3, after which the applying following formulae are rounded to two decimal places and result in derivation of applied:

For $t \leq 2027/28$

$$KdFRD_t = \frac{\text{Opening } RAV_{2013/14} \times iBTAN_t + \sum_{i=2013/14}^{t-1} iBAFY_i \times DRAV_i}{\text{Closing } RAV_{t-1}} + KdUP$$

For $t > 2027/28$

$$KdFRD_t = \frac{\text{Opening } RAV_{2013/14} \times iBTAN_t + \sum_{i=2013/14}^{t-1} iBAFY_i \times DRAV_i + \sum_{i=2027/28}^{t-1} iBAFY_i \times DRAV_{t-14}}{\text{Closing } RAV_{t-1}} + KdUP$$

where:

$\text{Opening } RAV_{2013/14}$

means the opening RAV for Regulatory Year 2013/2014

$\text{Closing } RAV_{t-1}$

means the closing RAV for Regulatory Year t-1

$iBAFY_i$

means the average of iBoxx £ A and £ BBB 10+ Non Financials for each Financial Year (and Regulatory year) i in nominal terms

$iBTAN_t$

means the simple trailing average of $iBAFY_i$ for Regulatory Year t in nominal terms

$DRAV_i$

means the change in RAV for year i

$KdUP$

means the adjustment to the cost of debt as set out in paragraph 4.14

4.16 The ET3 PCFM will apply the following adjustments to the computed values:

- 26 basis points for additional costs of borrowing; and
- 39.43 basis points calibration adjustment.

~~4.6.4.17~~ The resulting averages, expressed as a ~~CDE value~~ percentage, constitute the $KdFRD_t$ for each Regulatory Year.

Step 5.6 – calculate the allowed return on index-linked debt ($KdILD_t$)

4.18 The ~~ET3~~ PCFM calculates the $KdILD_t$ utilising the following formula for each Regulatory Year:

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

~~4.7.4.19~~ Ofgem will provide the licensee with a copy of the data and spreadsheet used to calculate the, $IBAFY_t$ (WACC Rates Model), revised $iBTA_t$ and ~~CDE values at the same time as giving the notice (paragraph 2.60).~~ $iBTA_t$, $IBTAN_t$, $KdFRD_t$ and $KdILD_t$ (ET3 PCFM) by no later than 30 November in each Regulatory Year or as soon as reasonably practicable.

~~4.8.4.20~~ The data and spreadsheet used to calculate revised $iBTA_t$, $IBTAN_t$, $IBAFY_t$, $KdFRD_t$ 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 (see para 2.63)).

Variation of approach Close out adjustment mechanism for **SHE Transmission plc**

SHE Transmission plc (SHETPLC) had a higher RAV growth in RIIO-1 than other networks and ~~is~~ costs arising from the expected to have a higher RAV growth in RIIO-2 (although the difference in RIIO-2 is not expected to be as large as in RIIO-1). A notional company with greater RAV growth than adjustment of the average notional company could be expected to raise a greater proportion of its debt than the average network during that period of growth. Because of this, SHETPLC's cost of debt is calculated differently from other networks. RPI methodology in 2030.

1.51. SHETPLC's cost of debt $SHEL CDE_t$ is calculated in the RIIO-ET2 PCFM using the formulation below, which applies weights, based on changes to SHETPLC's RAV during the RIIO-1 and RIIO-2 periods, to annual yield figures:

$$\begin{aligned} SHEL CDE_t = & \left[iBTA_t \times \frac{OpeningRAV_{2013/14}}{ClosingRAV_{t-1}} \right] \\ & + \left[\sum_{i=2013/14}^{t-2} iBAFY_i \times \left(\frac{ChangeinRAV_i}{ClosingRAV_{t-1}} \right) \right] \\ & + \left[iBAAO_{t-1} \times \frac{ChangeinRAV_{t-1}}{ClosingRAV_{t-1}} \right] \end{aligned}$$

where:

~~SHETL CDE_t means the revised SHETL CDE value for SHETPLC for Regulatory Year t.~~

~~iBTA_t means the “iBoxx Trailing Average”, variable value determined under Steps 1 to 4 above~~

~~iBAFY_t means the “iBoxx Average (Financial year)”, variable value obtained as an arithmetic average of the daily real value of iBoxx utilities bond yield plus 25 basis points ie DUI, a term described under Step 3 above, for the period April to March in a Regulatory Year.~~

~~iBAAO_t means the “iBoxx Average (April-October)”, variable value obtained as an arithmetic average of the daily real value of iBoxx utilities bond yield plus 25 basis points ie DUI, a term described under Step 3 above for the period April to October in a Regulatory Year.~~

~~RAV means the Regulatory Asset Value for SHETPLC (inclusive of ‘Non-Core RAV’³⁰) for the specified Relevant Years, expressed in nominal prices as calculated in the RIIO-ET2 PCFM.~~

~~1.52.—It should be noted that the RAV values for SHETPLC, recorded in the RIIO-ET2 PCFM, and used in calculating values of the term CDE for SHET may subsequently be changed by other aspects of Annual Iteration Processes. In those instances, revised CDE values for SHETPLC will be calculated and directed for any affected Relevant Years.~~

4.21 The purpose of this section is to enable the Authority to review and amend, where appropriate, to direct an adjustment to the calculation of additional costs of borrowing. This contributes to the calculation of the terms KdFRD and KdILD.

³⁰ See Glossary

4.22 The amendment may adjust the **KdFRD_i** 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.

4.23 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.

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

4.25 In determining the relevant size of the adjustment, if any, the Authority shall consider what costs would **efficiently 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.

4.26 **Subject to Standard Special Condition A26**, 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.

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

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

4.29 Before making a direction under paragraphs **fx14.25** 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

~~4.9~~4.30 If, for any reason, the iBoxx, (used in paragraph 4.8(a)), or the OBR series ~~identified above cease~~ CPIH forecasts ceases to be published ~~(or data is missing for a period considered material by Ofgem)~~,³¹ 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. ~~If~~ To facilitate licensees using the ET3 PCFM prior to the completion of the consultation ~~is not completed in time to determine revised variable values for the cost of debt for any AIP~~, Ofgem may direct the use of an interim approach ~~to ensure timely completion of an AIP~~.³¹ Any such interim approach for a given Regulatory Year will be revised ~~at the subsequent AIP~~ following a decision on the alternative data.

~~4.10~~4.31 If, for reasons other than stated in paragraph ~~4.18~~ 4.30 ~~4.26~~4.23, iBoxx data (paragraph ~~4.6~~ 4.8(a)) are unavailable for ~~an entire trading days~~ a period ~~in of~~ time ~~to determine revised variable values for the cost of debt for any AIP then, for such that AIP only, the trading days period concerned will be deemed to have ended on the last trading day for which data has been published; 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 above in paragraph 4.87~~ (Error! Reference source not found.). If the data concerned is subsequently published, revised variable values for the affected Regulatory Years will be ~~determined and published~~ calculated at the next update.

Cost of equity – risk-free rate

~~1.53. – The RIIO-ET2 PCFM in its state as at 01 April 2021 includes opening real (CPIH) risk-free rates (RFR) for the licensee for every Regulatory Year of the Price Control~~

³¹ This interim approach would only be used if the index or series ceased to be published but is not restricted to using the value from the most recent publication that did contain the value (as required of the licensee under Special Condition 8.2.9 (b)).

Period. Changes in RFR result in changes to the cost of equity percentage value used in determining the Allowed Return on Equity (determined in the RIIO-ET2 PCFM).

1.54. Revised RFR values for all future Regulatory Years in the Price Control Period will be calculated by Ofgem in accordance with the approach set out below and published in respect of each AIP. In brief, revised RFR values will be calculated using yields on government securities (20-year real zero coupon) and applying an adjustment for the difference between RPI and CPIH inflation expectations.

1.55. The steps Ofgem will follow to calculate the revised RFR values are:

4.32 The RFR_t is calculated annually to be the 1-month (October, daily) arithmetic average of 20-year index linked gilt (ILG) yields, plus an inflation wedge: $((1 + \text{pre wedge ILG}) * (1 + \text{wedge})) - 1$. The average October index linked gilt yields should be calculated by licensees 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 by the Authority in the November prior to the start of the Price Control Period.

Methodology

4.33 The methodology the Authority will follow to update the PCFM Variable Value RFR_t is as follows.

Step 1 — obtain real government bond yields

1.56. For each Regulatory Year, obtain a real government bond the average index linked gilt yield for the days shown in Table 4.2, as follows:

for days up to and including 31 month of October in the each year in which the AIP is being conducted, obtain the yield (these figures being percentages) for British government securities, 20-year real zero coupon (series reference IUDLRZC)³²; and

a) for all other days, forecast a yield (percentages) for British government securities, 20-year real zero coupon. The forecast is derived from the Bank of

³² Sourced from the statistics page of the Bank of England's website: <https://www.bankofengland.co.uk/>

England's estimated real yield curves for British government securities³³ (using data up to and including 31 October in the year in which the AIP is being conducted) by a no arbitrage condition, where a 20-year rate x years in the future can be derived from the x year rate and $20+x$ year rate.³⁴ The forecast is made for dates on half-yearly intervals, and then linearly interpolated between those dates.

4.34 Table 4.2 – time periods for The RFR _{t} for each year of the price control is based on the 1-month arithmetic average (of the preceding October) of the 20-year index linked gilt (ILG) yield.

4.35 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.³⁵

Step 2 derive an RPI-CPIH inflation wedge

4.36 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.

4.37 Estimating the CPIH-RPI wedge is complicated by the fact that the calculation of risk-free 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.

4.38 The inflation wedge is calculated assessing official forecasts of CPIH and RPI over 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.

4.39 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.³⁶ The OBR inflation data is presented in financial year form.

³³ <https://www.bankofengland.co.uk/statistics/yield-curves>

³⁴ For example, if A is the current $20+x$ year spot rate and B is the current x year rate, the 20-year rate x years into the future is given by $[A*(20+x) - B*x]/20$

³⁵ Sourced from the yield curves page of the Bank of England's website:
<https://www.bankofengland.co.uk/statistics/yield-curves>

³⁶ 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

4.40 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.

4.41 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.

4.42 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 RFR_t

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

4.44 The ET3 PCFM will use the value of RFR_t to calculate the allowed return in equity in accordance with the following formula: (note TMR means total market return)

$$ARoE_t = RFR_t + \text{equity beta} \times (TMR - RFR_t)$$

Semi-nominal WACC

4.45 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 GD and GT licensees gas is 30% and for ET licensees companies is 10%. This is multiplied by the gearing percentage to achieve the ILD portion in the formula below, i.e. for GD and GT this is 30% x 60% = 18% for the ILD portion and 70% x 60% = 42% for the fixed rate portion. For ET this is 10% x 55% = 5.5% for the ILD portion and 90% x 55% = 49.5% for the fixed rate portion.

$$SnomWACC_t = (KdFRD_t \times \text{fixed rate by-portion} \times g) + (KdILD_t \times \text{ILD portion} \times g) + ((ARoE_t \times (1 - g)))$$

Nominal WACC

4.46 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 proportion of debt for GD & GT is 60% and for ET companies is 55%. The nominal cost of equity is the real cost of equity inflated by an inflation assumption.

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

Provision and publication of the WACC Rates model

4.47 Ofgem will provide licensees with a model containing the methodology to derive (and forecast) the PCFM Variable Values sRFR_t and iBAFY_t and iBTAN_t (“the WACC Rates Model”).

4.48 Ofgem will update the WACC Rates Model 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 or as soon as reasonably practicable.

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

4.114.50 The data and the spreadsheet used to calculate the revised sRFR_t and iBAFY_t , iBTAN_t values 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.

Regulatory Year	Time period for calculation
2022/23	01 October 2021 to 31 October 2021
2023/24	01 October 2022 to 31 October 2022
2024/25	01 October 2023 to 31 October 2023
2025/26	01 October 2024 to 31 October 2024

Step 2 – obtain RPI and CPI inflation forecasts

1.57. – For each Regulatory Year, obtain inflation forecasts of CPI and RPI for the days shown in Table 4.2 from the OBR’s Historical official forecasts database³⁷, as follows:

- a) – for days up to and including 31 October in the year in which the AIP is being conducted, the inflation forecasts are the latest OBR year 5 forecast of CPI and year 5 forecast of RPI available on that given day, subject to the assumption that

³⁷ Sourced from the data page of the OBR website: <https://obr.uk/download/historical-Official-forecasts-database/>

~~the OBR forecast is available from the first day of the month following the month of publication; and~~

- ~~b) for all other days, the inflation forecasts are the latest OBR year 5 forecast of CPI and year 5 forecast of RPI available on 31 October in the year in which the AIP is being conducted, subject to the assumption that the OBR forecast is available from the first day of the month following the month of publication;~~

~~in each case using the year 4 forecast for the year if the year 5 forecast is not available.~~

~~1.58:—Currently as per Historical Official forecasts database on OBR website, there are generally two publications in a year. Publication in October in a given year for the period ‘November to March’ shows a year 5 forecast and publication in March for the period ‘April to October’ shows a year 4 forecast. For example, the inflation values for 01 November 2018, are the OBR year 5 forecasts of CPI and RPI (for 2023) published in October 2018 and the inflation values for 31 October 2018 are the OBR year 4 forecasts of CPI and RPI (for 2022) published in March 2018.~~

~~Step 3—derive an RPI-CPIH inflation wedge~~

~~1.59:—For each day in the periods shown in Table 4.2, calculate an RPI-CPIH wedge using inflation values from step 2 and applying the following formula:~~

$$\text{Wedge} = \frac{1 + \text{RPI year 5 forecast}}{1 + \text{CPI year 5 forecast}} - 1$$

~~Step 4—calculate real risk-free rate (RFR) for each day~~

~~1.60:—This step converts each of the daily real (RPI) 20-year gilt yields collected in Step 1 to daily real (CPIH) RFR by using the RPI-CPIH wedge calculated in Step 3 according to the following formula:~~

$$\text{Real (CPIH) RFR} = (\text{real 20yr gilt yields} + 1) * (1 + \text{wedge}) - 1$$

~~Step 5—calculate average real (CPIH) RFR~~

~~1.61.—For each Regulatory Year, calculate the arithmetic average value of the real (CPIH) risk-free rates from Step 4 across the periods shown in Table 4.2.~~

~~1.62.—The resulting averages, expressed as a percentage and stated to two decimal places, constitutes the revised variable value for the real risk-free rate (RFR value) for each Regulatory Year.~~

~~1.63.—Ofgem will provide the licensee with a copy of the spreadsheet used to calculate revised (RFR) values at the same time as giving the notice (paragraph 2.60).~~

~~1.64.—The data and spreadsheet used to calculate revised (RFR) values will be published on the Ofgem Website (by 31 January in each Regulatory Year, or as soon as reasonably practicable thereafter (see para 2.63).~~

~~Non-availability or changes to basis of data for cost of equity— risk-free rate~~

~~1.65.—If, for any reason, the Bank of England, or OBR series identified above cease to be published (or data is missing for a period considered material by Ofgem), 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. If the consultation is not completed in time to determine revised variable values for the risk-free rate for any AIP, Ofgem may use an interim approach to ensure timely completion of an AIP.³⁸ Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP.~~

³⁸ This interim approach would only be used if the index or series ceased to be published but is not restricted to using the value from the most recent publication that did contain the value (as required of the licensee under Special Condition 8.2.9 (b)).

~~1.66. – If, for reasons other than stated in paragraph 4.32, Bank of England data (20-year real zero coupon, para 4.23) are unavailable for an entire trading days period in time to determine revised variable values for the RFR for any AIP then, for that AIP only, the trading days period concerned will be deemed to have ended on the last trading day for which data has been published. If the data concerned is subsequently published, revised variable values for the affected Regulatory Years will be determined and published.~~

5. Real Price Effects

- 5.1 The ~~RHO-ET2~~ET3 price control includes an allowance for differences between the Price Index applied to AR_t and certain input price indices. We refer to these differences as Real Price Effects.
- 5.2 The variable value RPE_t , expressed as a percentage ~~to two decimal places~~, identifies annual differences between the price control inflation and input price indices inflation.
- 5.3 The variable value RPE_t is used in the ~~RHO-ET2~~ET3 PCFM to derive the RPE Index ($RPEI_t$) applied to certain totex allowances (in ~~2018/19~~2023/24 price terms) to allow for Real Price Effects. The totex allowances to which the variable value RPE_t applies are identified in the ~~RHO-ET2~~ET3 PCFM and the calculation of the allowance for Real Price Effects is done within the ~~RHO-ET2~~ET3 PCFM.

~~1.67. The RHO-ET2 PCFM, in its state as at 1 April 2021, includes opening RPE_t values for the licensee for every Regulatory Year of the Price Control Period based on forecasts of the Price Index and input price indices.~~

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

Formula for calculating the Real Price Effects (RPE_t) term

- ~~5.45.5~~ ~~Ofgem will revise~~ The value of RPE_t ~~values at each AIP~~ is derived in accordance with the following formula:

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

where,

$W_{j,t}$ means the weight applied to the input price index j in period t during, which ~~is fixed for~~ the Price Control Period and takes the ~~value~~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 F of Special Condition 2.1 (Revenue Restriction)

N where $N = 13$ for NGET, $N = 13$ for SHET, and $N = 9$ for SPT.

- ~~5.55.6~~ The input price indices (IP_j), their weightings ($W_{j,t}$) in the calculation of RPE_t , and the sources of out-turn values are in Table 5.1 below. The values presented in

Table 5.1 are rounded, but Ofgem will use unrounded inputs to update the RPE model in accordance with paragraph 5.12[5.19].

Table 5.1 – Input prices indices and weightings

Index 1, Labour, K54V, AWE: Private Sector Index: Seasonally Adjusted Total Pay Excluding Arrears
[Source: ONS]

Year		NGET Index weightsWeights for RPE (Wj),t) - NGET	SHET Index weightsWeights for RPE (Wj),t) - SHET	SPT Index weightsWeights for RPE (Wj),t) - SPT	Long Term Average Growth Rate	
		Labour				
1	K54V	AWE-Private Sector Index: Seasonally Adjusted Total Pay Excluding Arrears	ONS	14.90%	12.16%	10.34%
2026-2027		K5536.8%		12.160%	10.34% 13.2%	5.18%
32027-2028		BEAMA6.7%	Electrical engineering labour11.5%	BEAMA13.6%	14.90% 5.18%	
42028-2029		4/GE/016.9%	4/GE/01 Civil Engineering Labour11.1%	14.901%	12.16% 5.18%	
		Materials				
5	4/GE/24	4/GE/24 Plastic Products (including pipes)	PAFI published by BCIS	0.00%	0.00%	0.00%
6	3/S3	3/S3 Structural Steelwork- Materials: Civil Engineering Work	PAFI published by BCIS	0.00%	0.00%	0.00%
2029-2030		7.3%		11.894%	14.446%	5.18%
82030-2031		FOGOS7.7%		13.118%	11.8915.6%	14.445.18%
		Plant and Equipment				
9	70/2	70/2 Plant and Road Vehicles: Providing and Maintaining	PAFI published by BCIS	0.00%	9.47%	0.00%
10	K389	7112280000: Machinery & Equipment n.e.c.	ONS	0.00%	9.47%	0.00%

Index 2, Labour, K553, AWE: Construction Index: Seasonally Adjusted Total Pay Excluding Arrears
[Source: ONS]

Guidance – RIIO-ET2 Price Control Financial Handbook

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>6.8%</u>	<u>12.0%</u>	<u>13.2%</u>	<u>3.73%</u>
<u>2027-2028</u>	<u>6.7%</u>	<u>11.5%</u>	<u>13.6%</u>	<u>3.73%</u>
<u>2028-2029</u>	<u>6.9%</u>	<u>11.1%</u>	<u>14.1%</u>	<u>3.73%</u>
<u>2029-2030</u>	<u>7.3%</u>	<u>11.4%</u>	<u>14.6%</u>	<u>3.73%</u>
<u>2030-2031</u>	<u>7.7%</u>	<u>13.8%</u>	<u>15.6%</u>	<u>3.73%</u>

Index 3, Labour, 4/CE/01, Civil Engineering Labour [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>6.8%</u>	<u>12.0%</u>	<u>13.2%</u>	<u>3.67%</u>
<u>2027-2028</u>	<u>6.7%</u>	<u>11.5%</u>	<u>13.6%</u>	<u>3.67%</u>
<u>2028-2029</u>	<u>6.9%</u>	<u>11.1%</u>	<u>14.1%</u>	<u>3.67%</u>
<u>2029-2030</u>	<u>7.3%</u>	<u>11.4%</u>	<u>14.6%</u>	<u>3.67%</u>
<u>2030-2031</u>	<u>7.7%</u>	<u>13.8%</u>	<u>15.6%</u>	<u>3.67%</u>

Index 4, Labour, 4/CE/EL/01 Electrical Engineering Labour [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>6.8%</u>	<u>12.0%</u>	<u>13.2%</u>	<u>2.75%</u>
<u>2027-2028</u>	<u>6.7%</u>	<u>11.5%</u>	<u>13.6%</u>	<u>2.75%</u>
<u>2028-2029</u>	<u>6.9%</u>	<u>11.1%</u>	<u>14.1%</u>	<u>2.75%</u>
<u>2029-2030</u>	<u>7.3%</u>	<u>11.4%</u>	<u>14.6%</u>	<u>2.75%</u>
<u>2030-2031</u>	<u>7.7%</u>	<u>13.8%</u>	<u>15.6%</u>	<u>2.75%</u>

Index 5, Labour, BEAMA, Electrical Engineering Labour [Source: BEAMA]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>6.8%</u>	<u>12.0%</u>	<u>13.2%</u>	<u>3.98%</u>
<u>2027-2028</u>	<u>6.7%</u>	<u>11.5%</u>	<u>13.6%</u>	<u>3.98%</u>
<u>2028-2029</u>	<u>6.9%</u>	<u>11.1%</u>	<u>14.1%</u>	<u>3.98%</u>

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<u>2029-2030</u>	<u>7.3%</u>	<u>11.4%</u>	<u>14.6%</u>	<u>3.98%</u>
<u>2030-2031</u>	<u>7.7%</u>	<u>13.8%</u>	<u>15.6%</u>	<u>3.98%</u>

Index 6, Materials, 4/CE/EL/02, Electrical Engineering Materials [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>8.5%</u>	<u>5.0%</u>	<u>4.8%</u>	<u>3.70%</u>
<u>2027-2028</u>	<u>8.8%</u>	<u>5.4%</u>	<u>4.5%</u>	<u>3.70%</u>
<u>2028-2029</u>	<u>8.3%</u>	<u>5.6%</u>	<u>4.1%</u>	<u>3.70%</u>
<u>2029-2030</u>	<u>7.6%</u>	<u>5.4%</u>	<u>3.8%</u>	<u>3.70%</u>
<u>2030-2031</u>	<u>6.9%</u>	<u>3.9%</u>	<u>3.1%</u>	<u>3.70%</u>

Index 7, Materials, FOCOS, Resource Cost Index of Infrastructure: Materials FOCOS [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>8.5%</u>	<u>5.0%</u>	<u>4.8%</u>	<u>7.42%</u>
<u>2027-2028</u>	<u>8.8%</u>	<u>5.4%</u>	<u>4.5%</u>	<u>7.42%</u>
<u>2028-2029</u>	<u>8.3%</u>	<u>5.6%</u>	<u>4.1%</u>	<u>7.42%</u>
<u>2029-2030</u>	<u>7.6%</u>	<u>5.4%</u>	<u>3.8%</u>	<u>7.42%</u>
<u>2030-2031</u>	<u>6.9%</u>	<u>3.9%</u>	<u>3.1%</u>	<u>7.42%</u>

Index 8, Materials, BIE, BEAMA Industrial Electronics [Source: BEAMA]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>8.5%</u>	<u>5.0%</u>	<u>4.8%</u>	<u>12.92%</u>
<u>2027-2028</u>	<u>8.8%</u>	<u>5.4%</u>	<u>4.5%</u>	<u>12.92%</u>
<u>2028-2029</u>	<u>8.3%</u>	<u>5.6%</u>	<u>4.1%</u>	<u>12.92%</u>
<u>2029-2030</u>	<u>7.6%</u>	<u>5.4%</u>	<u>3.8%</u>	<u>12.92%</u>
<u>2030-2031</u>	<u>6.9%</u>	<u>3.9%</u>	<u>3.1%</u>	<u>12.92%</u>

Index 9, Materials, BLT, BEAMA Large Power Transformers [Source: BEAMA]

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<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>8.5%</u>	<u>5.0%</u>	<u>4.8%</u>	<u>4.01%</u>
<u>2027-2028</u>	<u>8.8%</u>	<u>5.4%</u>	<u>4.5%</u>	<u>4.01%</u>
<u>2028-2029</u>	<u>8.3%</u>	<u>5.6%</u>	<u>4.1%</u>	<u>4.01%</u>
<u>2029-2030</u>	<u>7.6%</u>	<u>5.4%</u>	<u>3.8%</u>	<u>4.01%</u>
<u>2030-2031</u>	<u>6.9%</u>	<u>3.9%</u>	<u>3.1%</u>	<u>4.01%</u>

Index 10, Plant and Equipment, 70/ 2 Plant and Road Vehicles: Providing and Maintaining [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>4.0%</u>	<u>3.4%</u>	<u>N/A</u>	<u>3.74%</u>
<u>2027-2028</u>	<u>4.1%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.74%</u>
<u>2028-2029</u>	<u>3.8%</u>	<u>3.8%</u>	<u>N/A</u>	<u>3.74%</u>
<u>2029-2030</u>	<u>3.5%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.74%</u>
<u>2030-2031</u>	<u>3.2%</u>	<u>2.5%</u>	<u>N/A</u>	<u>3.74%</u>

Index 11, Plant and Equipment, C28 Machinery and Equipment [Source: ONS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>4.0%</u>	<u>3.4%</u>	<u>N/A</u>	<u>4.77%</u>
<u>2027-2028</u>	<u>4.1%</u>	<u>3.6%</u>	<u>N/A</u>	<u>4.77%</u>
<u>2028-2029</u>	<u>3.8%</u>	<u>3.8%</u>	<u>N/A</u>	<u>4.77%</u>
<u>2029-2030</u>	<u>3.5%</u>	<u>3.6%</u>	<u>N/A</u>	<u>4.77%</u>
<u>2030-2031</u>	<u>3.2%</u>	<u>2.5%</u>	<u>N/A</u>	<u>4.77%</u>

Index 12, Plant and Equipment, 4/CE/04, Purchased Plant Including depreciation and maintenance [Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (Wj,t) - NGET</u>	<u>Index Weights for RPE (Wj,t) - SHET</u>	<u>Index Weights for RPE (Wj,t) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>4.0%</u>	<u>3.4%</u>	<u>N/A</u>	<u>3.62%</u>
<u>2027-2028</u>	<u>4.1%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.62%</u>

<u>2028-2029</u>	<u>3.8%</u>	<u>3.8%</u>	<u>N/A</u>	<u>3.62%</u>
<u>2029-2030</u>	<u>3.5%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.62%</u>
<u>2030-2031</u>	<u>3.2%</u>	<u>2.5%</u>	<u>N/A</u>	<u>3.62%</u>

Index 13, Plant and Equipment, 90/ 2 Plant and Road Vehicles Operatives and fuel are not included
[Source: BCIS]

<u>Year</u>	<u>Index Weights for RPE (W_{i,t}) - NGET</u>	<u>Index Weights for RPE (W_{i,t}) - SHET</u>	<u>Index Weights for RPE (W_{i,t}) - SPT</u>	<u>Long Term Average Growth Rate</u>
<u>2026-2027</u>	<u>4.0%</u>	<u>3.4%</u>	<u>N/A</u>	<u>3.72%</u>
<u>2027-2028</u>	<u>4.1%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.72%</u>
<u>2028-2029</u>	<u>3.8%</u>	<u>3.8%</u>	<u>N/A</u>	<u>3.72%</u>
<u>2029-2030</u>	<u>3.5%</u>	<u>3.6%</u>	<u>N/A</u>	<u>3.72%</u>
<u>2030-2031</u>	<u>3.2%</u>	<u>2.5%</u>	<u>N/A</u>	<u>3.72%</u>

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

Formulae for calculating the Real Price Effects Index (RPE_t) and RPE totex allowance (RPEA_t)

5.6 **5.7** The RPE_t values are used in the **RIIO-ET2** PCFM to derive the RPE indexation term RPE_t as follows:

$$RPE_t = \prod_{i=2019/20}^t (1 + RPE_i) \quad RPE_t = \prod_{i=2024/25}^t (1 + RPE_i)$$

5.7 **5.8** The RPE totex allowance (RPEA_t) is determined applying RPE_t to the applicable totex allowance:

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

where,

Tx_t means the Totex allowance for the Regulatory Year t to which RPE indexation applies. The applicable totex is identified in the **ET3** PCFM.

5.8 **5.9** The **RIIO-ET2** PCFM will allocate the RPEA values to the appropriate capitalisation rate buckets based on the capitalisation rate of the totex allowance the RPE was applied to.

Use Restatement of outturn values

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

Methodology for forecast values

5.11 The values of RPE 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 as soon as reasonably practicable 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 months/years where outturn values are not available then Ofgem will a forecast will be derived in accordance with the values as follows: following sections.

- a) For labour indices, outturn data will be updated to the month of June prior to the AIP September, and forecast monthly values will use a monthly growth rate calculated from the most recent average earnings forecast published by OBR³⁹ applied to the previous value:

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

where,

$IP_m IP_{j,m}$ is the labour input price index value for a given year-month “m”.

$OBREF_m$ $OBREF_{j,m}$ Means M means the OBR average earnings forecast (annual rate) applicable to year-month m, where the OBR forecast for a calendar financial year is applicable from 6 months prior to the start of that calendar financial year, to six months after (eg the 2021/2026 OBR forecast would be applicable from July 2020/2025 to June 2021/2026). 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 2020-2024/25-2028/29, then the forecast for year 2024/2028/29 would be used for 2025/2029/30 and 2026/2030/31).

³⁹ Sourced from the data page of the OBR website: <https://obr.uk/download/historical-Official-forecasts-database/> titled “Historical official forecast database – [Month][Year]”: <https://obr.uk/data>

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

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

where,

$IP_m IP_{j,m}$ is the **labour**-input price index value for a given year-month “m”.

$LTAG_m$ has the long-term average annual growth assumption applicable to that input prices index, given in **the list below**:

4/GE/Table 5.1 above. $LTAG(j,m)$ is the long-term average annual growth assumption based on historic average for the financial years 2019-20 to 2023-24: **2.29%** for index **j**.

• **3/S3: 4.02%**

• **4/GE/EL/02: 0.72%**

• **FOCOS: 4.32%**

• **70/2: 2.65%**

K389: 1.89%

1.68. At each AIP, Ofgem will also update the OBR inflation forecast and the “Monthly Inflation” tab of the PFCM for outturn RPI and CPIH index data that is available as of 31 October prior to each Regulatory Year t . The forecast values are calculated directly in the RIIO-ET2 PCFM using the same methodology the labour input price index with the latest available OBR forecasts for CPIH and RPI. The recalculated values of PI_t term will be used to calculate both RPE_t and Allowed Revenue (AR_t).

Obligation to ensure alignment of the price index PI_t

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

Provision and publication of RPE_t values

~~1.69:—Ofgem~~ Ofgem will perform the above updates to the spreadsheet used to calculate the RPE_t values and will provide the licensee with a copy of ~~the spreadsheet used to calculate RPE_t values at the same time as giving the notice (paragraph 2.60).~~

~~5.10~~ 5.14 ~~The data and that spreadsheet used to calculate revised RPE_t values no later than 30 November~~ or as soon as reasonably practicable. Licensees will ~~be published on~~ use the values distributed by Ofgem ~~Website by 31 January in each Regulatory Year~~.

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

Non-availability of data

~~5.11~~ 5.16 If, for any reason, the price indices used in calculating RPE_t cease to be published, or if Ofgem believes there is a material change in their basis, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements. ~~If~~ To facilitate licensees using the ET3 PCFM prior to the completion of the consultation ~~is not completed in time to determine a revised value for RPE_t for any AIP~~, Ofgem may direct the use of an interim approach ~~to ensure timely completion of an AIP~~.⁴⁰ Any such interim approach for a given Regulatory Year will be revised ~~at the subsequent AIP~~ following a decision on the alternative data.

⁴⁰ This interim approach is not restricted to using the value from the most recent publication that did contain the value (as required of the licensee under Special Condition 8.2.9(b)).

6. Tax liability allowances

6.1 The ~~RIIO-ET2~~ET3 PCFM calculates a licensee's tax liability allowance on a notional basis (~~ie~~i.e. as ~~a~~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 basis⁴¹, 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.

~~6.1~~6.5 Where corporation tax and capital allowance rate changes are announced, these ~~can~~must be reflected in the ~~RIIO-ET2~~ET3 PCFM by updating the variable values for these rates (CT_t , GCA_t , $SRCA_t$, $SBCA_t$ and $DRCA_t$) at each AIP.

~~6.2~~6.6 The ~~RIIO-ET2~~ET3 PCFM also calculates a tax clawback adjustment⁴². 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 ~~RIIO-ET2~~ET3 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 ~~RIIO-ET2~~ET3 PCFM.

~~6.3~~6.7 Tax liability allowances are also dependent on other variable values including:

⁴¹ 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.

⁴² ~~The tax clawback policy for RIIO-ET2 is to allow NGET some headroom as regards the notional gearing level to be used for tax clawback purposes. The notional gearing target for each Regulatory Year for tax clawback purposes is set out in Table 37 of the Ofgem Draft Determinations Finance Annex.~~

- a) Tax trigger events TTE - a licensee's notional tax liability⁴³ is subject to 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) – 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 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 (OGP_t, OSRP_t, OSBP_t, LOSBP_t, LODRP_t and ODRP_t). These balances will be rolled forward from the closing position in the RIIO-ET1ET2 Legacy PCFM following the close-out of the RIIO-ET1ET2 Price Control;
- d) Capital allowances: allocation rates – the RIIO-ET2ET3 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, ARRe_t, ARNQ_t); and
- e) Tax loss brought forward (OTL_t) – this represents the opening tax loss balance, which will be rolled forward from the closing position in the RIIO-ET1ET2 Legacy PCFM following the close-out of the RIIO-ET1ET2 Price Control.

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

6.56.9 The approach to determining or revising the variable values in paragraph 6.377 and/or the calculation in the RIIO-ET2ET3 PCFM are described, further below.

6.66.10 It should be noted that underlying tax liability allowances for the licensee within the RIIO-ET2ET3 PCFM may also change under the AIP as a consequence of other variable values, such as changes in allowed totex. However, these changes are distinct from the specific adjustments to tax liability allowances discussed in this chapter.

6.76.11 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

⁴³ The tax liability which would be modelled if the event was taken into account.

can be either positive or negative. This ‘tax allowance on tax allowance’ issue is dealt with by the functionality within the ~~RHO-ET2~~ET3 PCFM and is factored into Calculated Revenue (R_t) via the AIP.

Regulatory tax losses

~~6.8~~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 ~~RHO-ET2~~ET3 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.

~~6.9~~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.

~~6.10~~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 relief⁴⁴. Any such surrenders of group or consortium losses will therefore result in a difference between future tax liability allowances and the actual future Corporate tax liability of the licensee.

6.16 Losses are carried forward within the model, and are utilised on a carried forward basis using the statutory rules for trading losses⁴⁵. At the outset of the price control these rules, as enacted, require loss utilisation above a £5m de minimis 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 de minimis is treated as being available to each licensee. Adjustments to loss pools as a result of ~~T~~tax

⁴⁴ <https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm80530>

⁴⁵ HMRC manual - CTM05000

Trigger Events will be subject to the de minimis and restriction. Adjustments to loss pools as a result of Tax Clawback shall not be subject to the restriction.

Group tax arrangements

~~6.11~~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 ~~appendix 1 to Ofgem’s open letter dated 31 July 2009 (Claw-back of tax benefit due to excess gearing)~~.⁴⁶ paragraph 6.65.

~~6.12~~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

~~6.13~~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;⁴⁷
- b) Financial Reporting Standard 101, EU adopted IFRS with reduced disclosures; or
- c) UK GAAP under Financial Reporting Standard 102.

⁴⁶ ~~Open letter: Clawback of tax benefit due to excess gearing | Ofgem~~

⁴⁷ Including the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) where applicable.

Updating PCFM Variable values

6.20 When updating its PCFM Variable Values under chapter 2 and chapter 3 of this Handbook, the licensee must ensure that all tax-related values⁴⁸ 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 RIIO-3 price control licensees will be able to amend tax pool allocation variable values for both future and prior periods within the price control. This will limit divergence and the impact of such amendments will be reflected in Allowed Revenue to ensure parity.

Tax trigger events

~~6.14~~6.22 The ~~RIIO-ET2~~^{ET3} PCFM allows for changes to a licensee’s tax liability allowance, through TTE, for factors exogenous to the licensee, its owners or controllers that cause a change in its notional tax liabilities⁴⁹ for one or more Regulatory Years. -These factors exclude changes to the corporation tax rate and writing down allowance rates, which are accounted for with the variable values (CT_t, GCA_t, SRCA_t, SBCA_t and DRCA_t), but include:

- 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

~~6.15~~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

⁴⁸ Meaning variable values for Corporation Tax and capital allowance rates, and tax pool allocations.

⁴⁹ The tax liability, which would be modelled if the event were taken into account.

tax liability allowances. For the purpose of complying with this requirement, the licensee must ~~seek to~~ ensure that it identifies and records tax trigger events.

~~6.16~~6.24 If the licensee fails to notify Ofgem of any tax trigger events of which it becomes aware, or should be aware of then subject to the licensee demonstrating that it ~~uses~~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.

~~6.17~~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.~~7~~11 but should ignore the tax trigger deadband;
- d) any relevant information provided by HMRC in relation to the tax trigger event;
- e) evidence of mitigating measures that the licensee has taken to minimise any additional liabilities arising from the event; and
- f) ~~comments-~~ from the licensee on:
 - i. the relevance of the tax trigger event to its tax position;
 - ii. whether grounds exist to contest the applicability of the tax trigger event to the licensee; and
 - iii. the reporting treatment the licensee expects to apply in its tax submissions to HMRC and in its Regulatory Accounts or statutory accounts where Regulatory accounts are not prepared.

~~6.18~~6.26 The licensee’s notification should also state whether it considers that the materiality threshold (see paragraph 6.~~26~~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.

~~6.19~~6.27 Ofgem will review any notifications given to it by the licensee under paragraph 6.~~15~~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.

~~6.20~~6.28 Ofgem will by 05 December in the same Regulatory Year t-1 inform the licensee whether, in respect of each tax trigger ~~even~~, 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.

~~6.21~~6.29 In deciding which of the actions set out in paragraph ~~6.20~~6.28 should be taken, Ofgem will ~~not~~ consider whether the licensee has conclusively agreed its tax liabilities for the Regulatory Year concerned with HMRC. Where there has been a provisional agreement/determination or a deferral of consideration, the TTE values concerned will be subject to further revision in a later Regulatory Year.

~~6.22~~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.

~~6.23~~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.

~~6.24~~6.32 If Ofgem has not finished considering any matters raised by the licensee under paragraph ~~6.22~~6.30 or under paragraph ~~6.23~~6.31 before notifying the licensee of tax trigger events that it ~~proposed~~proposes to take into account, ~~the Authority~~Ofgem will through business correspondence, apprise the licensee of any provisionality it has applied in determining the revised TTE values that it proposes to apply, that might entail a further revision to those values for use in the next Regulatory Year.

~~6.25~~6.33 Where a tax trigger event changes the allocation of allowable expenditure into different statutory capital allowance pools, the applicable allocation and allowance rates will be adjusted to take into account the new expected allocation basis from the effective date of the new requirement. Ofgem will work with licensees to agree the financial effect of revised tax pool allocation requirements where these are not straightforward.

6.34 Some tax trigger events will impact all licensees in the sector, particularly changes to the capital allowances regime which, for example, create new types of capital allowance pools⁵⁰. 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 ET3 PCFM to accommodate the required calculations in line with the processes described in Chapter 2 of this document.

Materiality threshold and ‘deadband’

6.266.35 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 tax trigger deadband values on the ‘Finance & tax’ worksheet (Tax trigger calculations section) for the licensee in the ~~RIIO-ET2 PCFM~~. ET3 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:

- 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.

6.276.36 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.

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

⁵⁰ An example of this would be the introduction of structures and building allowances in Finance Act 2019

~~6.29~~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

~~6.30~~6.39 Ofgem will keep a log of tax trigger events that have been subject to notifications by it or by the licensee showing for each tax trigger event:

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

Tax review

~~6.31~~6.40 Special Condition 2.2 (Tax allowance adjustment) sets out that the Authority will direct any value of $TAXA_t$ that it considers should be made after a tax review.

~~6.32~~6.41 At the outset of the Price Control Period on 01 April ~~2021~~2026, the value of $TAXA_t$ is set at zero for the duration of the Price Control Period. Under Special Condition 2.2, Part A the licensee's Calculated Tax Allowance can be updated for any periods from 31 March ~~2021~~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

~~6.33~~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 Allowances and the Actual Corporation Tax Liability, which have not been adequately explained in the supporting commentary to the reconciliation⁵¹;

⁵¹ The reconciliation referred to is the Tax Reconciliation template reconciling the notional tax allowance per the ~~RIIO-ET2~~ET3 PCFM and actual tax liability per their latest CT600 forms. This template forms part of the licensee's annual RIGs submissions.

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 Values⁵², which Ofgem consider may not represent the values which would be used by a notional efficient company.

~~b)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

~~c)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.

Materiality

~~6.34~~6.43 _____ Under paragraph 6.~~3342,42~~, 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.~~26~~3526 of this handbook. For the avoidance of doubt, an unexplained difference is considered material if it exceeds the threshold described.

~~6.35~~6.44 _____ Where there are numerous unexplained differences in the submitted Tax Reconciliation, which are individually immaterial but when taken in aggregate are greater than the materiality threshold amount, the licensee is required to provide supporting explanation(s) in the commentary to the Tax Reconciliation ~~as per~~in accordance with the RIIO-~~23~~ Regulatory Financial Performance Reporting Regulatory Instructions and Guidance.

Notifying the Authority

~~6.36~~6.45 _____ Any notification by the licensee under paragraph 6.~~3342,42~~ 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;

⁵² Meaning variable values for Corporation Tax and capital allowance rates, and tax pool allocations.

- 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.

~~6.37~~6.46 Any notification by other stakeholders under paragraph 6.~~33~~(b)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 6.36. Where there are gaps in the information provided by the relevant stakeholder, Ofgem will engage with the applicable licensee to ascertain whether the licensee itself should submit a notification under paragraph 6.~~33~~(b)42(c).

~~6.38~~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~~3949 to 6.~~46~~4660, 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 ~~RIIO-ET2~~ET3 PCFM means that a Time Value of Money Adjustment will be applied.

~~6.39~~6.48 If an adjustment is made to the TAXA_t term for a period prior to the Regulatory Year in which the tax review is triggered, any resultant changes to Allowed Revenue will, subject to a Time Value of Money Adjustment, be brought forward. For the avoidance of doubt such an adjustment will not have any retrospective effect on a previously published value of Allowed Revenue.

Preliminary assessment

~~6.40~~6.49 Where one or more of the tax review trigger events under paragraph 6.~~33~~4242 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.

~~6.41~~6.50 This preliminary assessment may involve the Authority requesting further information from the affected licensee(s) and from the stakeholder who submitted the notification under 6.~~33~~(b)42(c) and explaining it is considering undertaking a tax review.

6.51 ~~Review~~ 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 Examiner (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).

6.54 Before making a direction, the Authority will consult on the proposed adjustment to the TAXA_t for no less than 28 days. The licensee shall, during this period, also be able to request that Ofgem undertake a formal tax review and appoint an AQIE.

Tax review process

~~6.42~~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_t adjustment is required, or the value of the adjustment cannot be readily ascertained, Ofgem may undertake a formal tax review, for which it will ~~require the affected licensee to procure, at its own expense, a~~ procure a review by an ~~Appropriately Qualified Independent Examiner~~ AQIE⁵³.

~~6.43~~6.56 ____ Ofgem will notify the licensee or licensees affected in accordance with Part A of Special Condition 2.2 (Tax allowance Adjustment) ~~that it intends to~~ commence the tax review.

~~6.44~~6.57 ____ Throughout the course of the tax review, the licensee will have opportunities to comment on the ~~Appropriately Qualified Independent Examiner's~~ AQIE's written findings and engage with both the examiner and Ofgem before the final report is submitted by the examiner to Ofgem. Ofgem shall communicate the AQIE's written findings to the licensee within 10 working days of receipt of the examiners report.

⁵³ The examiner would be a qualified tax accountant from a reputable firm regulated by a relevant professional body. ~~The examiner chosen by the licensee should be agreed to by Ofgem.~~ If appropriate, the examiner used may be the licensee's Appropriate auditors as defined in Standard Condition B1 of the Electricity Transmission licence.

After the review

~~6.45~~6.58 Following the tax review, the Authority will consider the findings of the Appropriately Qualified Independent Examiner report. Where the ~~examiner's~~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 $TAXA_t$ in accordance with Part B of Special Condition 2.2 (Tax allowance adjustment).

~~6.46~~6.59 Before making a direction, the Authority will consult on the proposed adjustment to the $TAXA_t$ for no less than 28 days.

~~6.47~~6.60 Where the ~~Appropriately Qualified Independent Examiner's~~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.

~~6.48~~6.61 The adjusted value will be reflected in the ~~RIIO-ET2~~ET3 PCFM and will be published ~~on the Ofgem Website by 31 January in each Regulatory Year~~ in accordance with Chapter 2 of this document.

~~6.49~~6.62 For the avoidance of doubt, there will be no duplication or double-counting of adjustments between the $TAXA_t$ term and the other tax mechanisms that feed into the TAX_t term.

6.63 The costs of the 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 $TAXA_t$ 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 $TAXA_t$ adjustment.

Capital allowances

Opening pool balances (legacy)

~~6.50~~6.64 Tax liability allowance calculations under the AIP make use of regulatory tax pool balance figures held within the ~~RIIO-ET2 PCFM. The opening balances (as at 01 April 2021)~~ET3 PCFM. The opening balances for these pools will be the closing balances from the ET2 Legacy PCFM. RIIO-ET2 dealt with First Year Allowances and Full-expensing using the Tax Trigger Event methodology. Adjustments to pool balances may be required in the opening period of RIIO-ET3 as a result. The opening balances (as at 01 April 2026) for these tax pools may be subject to legacy price control adjustments through revisions to (OGP_t , $OSRP_t$, $OSBP_t$, ~~$L\text{ODRP}_t$~~ $L\text{ODRP}_t$ and $ODRP_t$) variable values.

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

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

Adjusted Net Debt

6.66 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.

6.67 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; and
- Debt used to finance TNUoS assets/liabilities.

Tax Deductible Net Interest

6.68 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.

6.69 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; and
- Interest which has been excluded from deduction by the Corporate Interest Restriction rules.

6.70 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); and
- Interest relating to the financing of TNUoS assets/liabilities.

7. Pensions

Financial Adjustments - Pensions

7.1 The ~~RIIO-ET2~~ET3 PCFM contains a variable value (EDE) allowance⁵⁴ for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period. Opening values for EDE are based on the outcome of a pension reasonableness review concluded in November ~~2020~~2023. EDE (or the pensions allowance value) will be updated during the Price Control Period, through the AIP, according to the provisions of this chapter.

Expected timing of pensions allowance revisions

7.2 The intention is that pensions allowance values will only be revised periodically in light of triennial actuarial valuations of the relevant pension schemes. ~~Two~~During the Price Control Period, ~~two~~ pension scheme valuations ~~are expected, or reasonableness reviews thereof, will be in the RIIO-ET2 Price Control Period, process, as set out in Table 7.1~~ Table 7.1 with ~~only the first~~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 2022 2025	31 October 2023 2026 (rr = 2023/24 2026/27)	30 November 2023 2026
31 March 2025 2028	31 October 2026 2029 (rr = 2026/27 2029/30)	30 November 2026 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~~ 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 ~~7.12~~), ~~or 7.12~~, or a scheme valuation or completion of a Reasonableness Review (see from paragraph ~~7.30~~) ~~7.30~~ is delayed. In those

⁵⁴ 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_c) in the ~~RIIO-ET2~~ET3 PCFM, ie it is not subject to the TIM.

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~~. Table 7.1.

7.4 Licensees whose scheme triennial valuation dates differ to those shown in the first column of ~~Table 7.1~~ 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 Methodology⁵⁵, published in the Triennial Pension Reporting Pack as part of the Regulatory Instructions Guidance.

7.5 The remainder of this chapter sets out:

- Section 1: general provisions ~~—in section 1~~
- Section 2: the timetable and process for revising pension allowance values, including details of the Reasonableness Review ~~—in section 2~~
- Section 3: the calculation of revised pensions allowance values ~~—in section 3~~
- Section 4: the calculation of the ESOPt term (applicable to NGET only)

Section 1 – General provisions

Price control pension principles

7.6 The Authority's price control pension principles are set out in Ofgem's guidance note on price control pension principles under RIIO issued as Appendix 3 to the decision letter, 'Decision on the Authority's policy for funding Pension Scheme Established Deficits' dated 7 April 2017.⁵⁶

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 2012
- 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

⁵⁵

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/2023-06/Pension%20Regulatory%20Instructions%20and%20Guidance%20Version%203.1%20%28Clean%29.pdf>

⁵⁶ https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_pseeds.pdf

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 transmission business; and
- ii. attributable to pensionable service up to and including the cut-off date.⁵⁷

7.8 The licensee's PSED will be calculated using:

- a) the triennial actuarial valuation of the pension scheme or schemes that contain the PSED described in paragraph ~~7.7 b)~~; 7.7 b);
- b) the allocation of assets and liabilities in the scheme(s) referred to in subparagraph ~~a)~~ 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~~); Table 7.1); and
- d) the Reasonableness Review with respect to the price control pension principles which could, exceptionally, result in adjustments to the PSED figure on account of errors in methodology or data.

7.9 While the Price Control Period ends on 31 March ~~2026~~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

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

⁵⁷ This definition applies even if the value derived is a negative amount (a surplus position) and may be described as an "established surplus".

- 7.11 In the event that an established surplus arises, it may be appropriate for a licensee and the pension scheme trustees to agree a programme of pension contributions below the level that would otherwise be necessary to fund the accruals of benefits for active members and any deficit relating to post cut-off service. These reduced contributions can be called a contribution holiday. It is important that a pension contribution holiday, to the extent that it is attributable to an established surplus, is returned to consumers.
- 7.12 As part of the Reasonableness Review (see paragraph ~~7.30~~ 7.30) we will conduct an initial review of any established surplus to identify whether a more detailed review is required. This more detailed review would occur as part of the close out of RIIO-~~ET2~~ET3, 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-~~ET2~~ET3 close-out.

Pension costs outside the scope of this chapter

- 7.13 The following costs are dealt with as totex in the relevant price control and therefore fall outside the scope of this chapter:
- a. pension costs associated with employee service after the cut-off date
 - b. accrued liability costs associated with employee service after the cut-off date (Pension Scheme Incremental Deficit costs), and
 - c. pension scheme administration costs and Pension Protection Fund levy costs.

Asset-backed funding arrangements

- 7.14 The licensee may choose to enter into asset-backed funding arrangements with pension scheme trustees, either directly or indirectly through related parties. Such arrangements might include a range of alternative funding arrangements, for example, mechanisms involving contingent assets or loan notes benefitting relevant pension schemes.
- 7.15 Any asset-backed funding arrangements must be fully compliant with all conditions, for example relating to the ring fence, in the licensee's licence (except where appropriate consent has been granted under the terms of a condition).
- 7.16 Notwithstanding that an arrangement may be fully compliant with licence conditions, the licensee is encouraged to provide information on any such mechanism or prospective mechanism to the Authority at the earliest opportunity. In general, the Authority would encourage asset-backed funding arrangements that would facilitate the return of funds to consumers in the event that a pension scheme deficit turns out to be smaller than anticipated.

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

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

Reasons for updating pensions allowance values

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

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

Process steps in a year in which a reasonableness review is being conducted⁵⁸

Step 1: by 31 July

⁵⁸ 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.

- 7.19 The Authority will be in receipt of price control review information from the licensee for Regulatory Years up to and including the last complete Regulatory Year.
- 7.20 The Authority will obtain the licensee's Scheme Valuation Data Set for the relevant valuation of the licensee's defined-benefit pension schemes by 31 July and commence a Reasonableness Review.
- 7.21 The Scheme Valuation Data Set should comprise:
- 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 Methodology⁵⁹
 - each scheme's statement of funding principles
 - each scheme's statement of investment principles, and
 - any other information reasonably required.

Step 2: by 31 August

- 7.22 The licensee will submit:
- Explanations and supporting evidence where appropriate ~~for~~of how it has interpreted the interest of consumers to inform its participation in the governance of pension schemes, including setting investment and risk strategies
 - Explanation of how it has responded to any recommendations set out by the Authority in preceding Reasonableness Reviews.
- 7.23 The licensee will also submit Pension Deficit Allocation Methodology information and its PSED figure as at the relevant valuation date indicated in ~~Table 7.1~~Table 7.1 showing the movements from the previous valuation date.

Step 3: by 14 September

- 7.24 The licensee will submit:
- its proposals with supporting explanation for;
 - Base Annual PSED Allowances (PBAPAy), under paragraph ~~7.46~~7.45
 - payment history allowances (PPHy), under paragraph ~~7.52~~7.51
 - any proposed prospective discounting basis for payment history variances, reflected in PhDRy, under paragraph ~~7.52~~7.51

⁵⁹ <https://ofgem.gov.uk/publications-and-updates/notice-modify-regulatory-instructions-and-guidance-held-network-operators>

- 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.

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

Step 4: by 30 September

7.26 The Authority will provisionally decide whether:

- a. any change should be made to the licensee's proposals for Base Annual PSED Allowances and payment history allowances for reasons anticipated in paragraph ~~7.32 a) and b)~~, and ~~7.33~~ 7.31 a) and b), and ~~7.32~~ 7.32
- b. to apply an existing adjustment factor, introduce a new adjustment factor or extend the scope or effect of an existing adjustment factor for reasons anticipated in paragraph ~~7.34~~. 7.33. Adjustment factor can be either upwards or downwards
- c. to set out any recommendation to the licensee to adopt good practice before the next reasonableness review under paragraph ~~7.36~~. 7.37

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

Step 5: by 31 October

7.28 The Authority will complete its Reasonableness Review:

- a) determine the values BAPAy, 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~~ 7.45
- b) determine the values PHy, 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~~ 7.51
- c) determine the values AFy, representing any adjustment factors, for each of the three years following the Reasonableness Review
- d) calculate the Pensions Allowance values for each of the three years following the Reasonableness Review, such that:

$$EDE_y = BAPA_y + PH_y + AF_y$$

- e) set out any recommendation to the licensee to adopt good practice before the next Reasonableness Review;
- f) determine the discount rates for payment history allowances, hDRy, 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~~7.51
- g) confirm whether a more detailed review of any established surplus is required (see paragraph ~~7.12~~7.12).

Step 6: by 30 November

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

Reasonableness Reviews and adjustment factors

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

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

~~1.70.~~—The review referred to in paragraph ~~7.30~~7.30 is termed the Reasonableness Review for the purposes of this methodology.

7.31 Having completed the ~~review~~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~~ 7.45 and 7.51
- c. continuing to apply, modifying the scope or modifying the effect of any existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review
- d. applying any new adjustment factor under paragraph ~~7.34~~ 7.33, and
- e. conducting a more detailed review of any established surplus (see paragraph ~~7.12~~ 7.12).

7.32 The Authority will only make a determination in respect of paragraph ~~7.32 b)~~ 7.31 b) if it considers the licensee's proposals under paragraphs ~~7.46~~ 7.45 and ~~7.52~~ 7.51 do not appropriately protect the interests of consumers, taking into account statutory and regulatory factors affecting the relevant pension schemes, which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED.

7.33 Consistent with its price control pensions Principle 3,⁶⁰ the Authority will only apply adjustment factors referred to in paragraph ~~7.32 c)~~ 7.31 c) and ~~7.32 d)~~ 7.31 d) to the extent necessary to disallow any excess costs arising from a material failure in the licensee's responsibility for taking good care of entrusted pension scheme resources on behalf of consumers. New adjustment factors will only arise in the following limited circumstances:

- a. where the Authority has established the licensee's recklessness, negligence, fraud or breach of fiduciary duty towards consumers, such as failures in its participation in the governance of a pension scheme to correct for poor governance or management of the scheme's resources, including any undue risk of a stranded surplus
- b. inequitable charges for consumers arising from using the time value of money in paragraphs ~~2.28~~ 2.16 and ~~2.29~~ 2.17 in ascertaining the cumulative payment history variance under paragraph ~~7.49~~ 7.48 for any materially accelerated PSED payments that would otherwise have been determined with reference to the discount rate specified in the licensee's Scheme Valuation Data Set

⁶⁰ See Appendix 3, of https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_pseeds.pdf

- c. the licensee's failure to respond adequately to any recommendations set out by the Authority in preceding Reasonableness Reviews.
- 7.34 Any modification to the effect of existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review will be made after taking equitable account of the time value of money involved, in general with reference to hDRy.
- 7.35 Before deciding to make determinations referred to in paragraphs ~~7.32 b)~~, ~~7.32 c)~~ 7.31 b), 7.31 c) and ~~7.32 d)~~, 7.31 d), the Authority will consult with the licensee (see paragraph ~~7.27)~~, 7.27), giving its reasons with reference to paragraphs ~~7.33~~ 7.32 and ~~7.34~~ 7.33 and to the Pensions Principles referred to in paragraph ~~7.6~~ 7.6.
- 7.36 After, considering any representations made by the licensee, the Authority will:
- a. notify the licensee of its decision
 - b. set out the matters, referred to in paragraphs ~~7.33 and 7.34~~, 7.32 and 7.33, that have led to its decision, and
 - c. Set out the basis on which it considers any adjustment factors referred to in ~~7.32 c) or 7.32 d)~~ 7.31 c) or 7.31 d) might be discontinued at the next Reasonableness Review.
- 7.37 Where, after consulting with the licensee (paragraph ~~7.27)~~ 7.27) and giving due weight to the licensee's representations, the Authority considers the licensee is not following good practice which would have the effect of promoting consumer interests with respect to the PSED, the Authority will set out recommendations to the licensee for it to adopt before the next reasonableness review where:
- a. the Authority considers that adopting the recommendations would not conflict with statutory and regulatory factors affecting the relevant pension schemes
 - b. the Authority has taken into account the relative duties of the licensee and the pension scheme trustees and the extent to which the licensee is only able to influence trustee decisions
 - c. the Authority considers that adopting the recommendations would be in the interests of consumers and would not disproportionately impact the licensee
 - d. the Authority considers it is practical for the licensee to adopt the recommendations.

Section 3 – Proposals for revised pensions allowance values

- 7.38 This section describes what the licensee must take into account in making its proposals for:
- a. Base Annual PSED Allowances
 - b. payment history allowances.

Base Annual PSED Allowances

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

7.40 The licensee must set out its calculations of:

- a. the indicative further PSED repair period, see from paragraph ~~7.42~~ 7.41
- b. the indicative base annual PSED allowance, see from paragraph ~~7.44~~ and 7.43 and
1. its proposal for Base Annual PSED Allowances, see from paragraph ~~7.46~~ 7.45

Indicative further PSED repair period

7.41 The indicative further PSED repair period represents a number of years (not necessarily a whole number) from the valuation date specified in ~~Table 7.1~~ 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)~~ 7.7 b), expressed in ~~2018/19~~ 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)~~ 7.6), and

EBAPA is an average of the Base Annual PSED Allowance expressed in ~~2018/19~~ 2023/24 price terms for years $rr-1$ and rr , where the year rr is the Regulatory Year specified in ~~Table 7.1~~ Table 7.1 for the relevant Reasonableness Review.

and

- b) 15.

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

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

- a. 11.14, calculated under the formula at paragraph 7.42 a), 7.41 a), and
- b. 15.

Indicative Base Annual PSED Allowance

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

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

where:

irp _____ is the indicative further PSED repair period ascertained under paragraph 7.42.7.41.

7.44 For example, if the PSED was £1m in 2018/19 2023/24 prices, the Indicative further PSED repair period was 11.14 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be £100k. IBAPA will equal EBAPA unless irp is limited to 15.

Proposal for Base Annual PSED Allowances

7.45 Subject to its consideration of the factors set out in subparagraphs (a) to (d) below, the licensee may propose allowances in line with the Indicative Base Annual PSED Allowance calculated under paragraph 7.44.7.43. The licensee may propose, with its supporting rationale, an alternative profile of Base Annual PSED Allowances over a repair period that may be shorter or longer than the period determined by paragraph 7.42.7.41 if it considers that the indicative Base Annual PSED Allowance calculated by paragraph 7.44.7.43 above either:

- a. does not fairly represent a profile of repair payments that can be agreed with the scheme trustees,
- b. following consultation with the Authority, does not appropriately protect the interests of consumers,
- c. derives from an indicative further PSED repair period ascertained under paragraph 7.42.7.41 which is less than 5 years, or
- d. is otherwise inappropriate or inequitable.

7.46 The alternative proposal under paragraph 7.46.7.45 must represent a profile of Base Annual PSED Allowances, PBAPAy for each year y subsequent to the valuation date specified in Table 7.1 Table 7.1 such that

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

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) 7.48) up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 7.52) 7.51) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 7.52-7.51.

PBAP_{Ay} for years rr-1 and rr are the Base Annual PSED Allowances determined by the Authority for those years, and

~~"·" is a symbol for multiply (the mathematical operation of multiplication)~~

Payment history allowances

7.47 The determination of revisions to Pensions Allowance values for the licensee will include payment history allowances, which may be positive or negative, relating to the cumulative variance between the licensee's PSED repair payments and its historical allowances for PSED repair prior to the PSED valuation date. The payment history prior to a triennial valuation will affect that valuation, and thus the Base Annual PSED Allowances needed to fund it as described in paragraph 7.40-7.39 Payment history allowances ensure that customers are properly compensated if the licensee has, prior to the triennial valuation, paid less in funding the PSED than it has received from consumers, and that companies do not lose out if they have paid more.

7.48 The cumulative pre-valuation payment history variance value at the end of the Reasonableness Review year, V_{rr} , is ascertained using a method permitted by paragraph 7.51 or using the following formula:

$$V_{rr} = LTU + \sum_{y=pco1}^{rr-2} \left(\frac{(D_y - E_y)(1 - CT_y)}{(1 + g_y \times hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right) - \sum_{y=rr-1}^{rr} \left(\frac{PH_y(1 - CT_y)}{(1 + g_y \times hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right)$$

where:

LTU is the legacy true-up value specified in paragraph 7.50, where relevant

$pco1$ 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_y means the net sum of the following, which may be positive or negative, expressed in 2018/19 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 7.11.

plus any amounts determined by the Authority as advisory fees or other costs relating to the development or implementation of a pensions initiative, eg a contingent asset arrangement, following a review of evidence submitted by the licensee.

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

E_y ___ means the licensee's Base Annual PSED Allowances plus payment history allowances, PH_y (which may be positive or negative), included in revenue allowances for the year y expressed in ~~2018/19~~2023/24 prices in accordance with paragraph ~~7.48-7.47~~7.47. E_y excludes any adjustment factor value AF but includes any prior period history allowances included in revenue allowances in the period since pco1 relating to any true-up value in LTU and any other relevant allowances, including contingent asset allowances. With the written agreement of the Authority, the licensee may adjust prior period history allowances to exclude those attributable to legacy true-up values excluded from the LTU term in accordance with paragraph ~~7.50-7.49~~7.49.

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

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

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

for example:

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

hDR_y ___ means the discount rate values under any alternative discounting basis determined by the Authority in the relevant reasonableness review for year y (see ~~7.28 e)~~7.28 e) or, where no alternative discounting basis has been specified, the time value of money as described in paragraphs ~~2.28 and 2.29~~2.16 and 2.17

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

7.49 Where relevant,

- a. Subject to subparagraph b), the legacy true-up value, LTU, represents the present value as at the end of the Reasonableness Review year of any arrangement or arrangements previously agreed or determined by the Authority for the post cut-off true-up of the licensee's pension deficit

payment history or true-up of other pension-related costs prior to the cut-off date:

- b. With the Authority's written agreement, the licensee may attribute payment history allowances to legacy true up values identified in subparagraph a) on a present value neutral basis and exclude both attributable payment history allowances from the calculation of Ey in paragraph 7.49.48 and the attributable LTU value from the LTU term applied in paragraph 7.49.48.

7.50 The licensee may choose to present a truncated calculation of the term Vrr specified in paragraph 7.49.48, on a basis that is demonstrably consistent with the formula specified in paragraph 7.49.48. Such a truncated calculation would include cumulative pre-valuation payment history variance values calculated for a previous reasonableness review and rolled forward for payment history variances arising since the valuation date relevant to that earlier review, discount rates and, where relevant, changes in corporation tax rates.

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

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

PhDRy _____ means the discount rate for payment history allowances for year y proposed by the licensee, or the rate forecast for year y according to the licensee's proposed basis of determining discount rates, in either case framed in accordance with paragraph 7.25.25. Such a proposal may relate PhDRy to the value of DR, the time value of money or rates of return on asset-backed arrangements. In the absence of any proposal, PhDRy is the time value of money in period rr+1 calculated in accordance with paragraphs 2.28 and 2.29.2.16 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 ~~7.47~~7.46) and ABC agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, ABC should be set at the present value of ABV specified in paragraph ~~7.47~~7.46 as at the end of the reasonableness review year, after applying appropriate discount rates (generally hDR_y).

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

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

7.52 This licensee must adhere to the formula and principles laid out in Special Condition 6.1.8 and Ofgem’s ‘Decision on the pension scheme arrangements for National Grid employees transferring to the future System Operator’.⁶¹

⁶¹ <https://www.ofgem.gov.uk/decision/decision-pension-scheme-arrangements-national-grid-employees-transferring-future-system-operator>

8. Legacy Adjustments

Overview

1.71.—This section of the handbook provides an overview of the legacy price control adjustments, which are necessary to take account of:

- a)—activities carried out by the licensee;
- b)—incentivised performance by the licensee; and / or
- c)—costs or expenditure incurred by the licensee;

2.—

3.—relating to Regulatory Years prior to Regulatory Year 2021/22 (the “legacy period”).

1.72.—Legacy price control adjustments may be necessary where it was not possible to finalise values used in the calculation of the licensee’s price control revenue at final determinations, because of the non-availability of outturn data and other relevant information. Adjustments may also be necessary to correct anomalous positions, acknowledged by Ofgem and the licensee.

1.73.—Legacy price control adjustments are divided into two categories, listed below:

- a)—Legacy Adjustments to Revenue allowances = LAR_t^{62} ; and
- b)—Legacy Adjustments to RIIO-1 RAV additions = $LRAV_t$

1.74.—The variable values LAR_t^{63} and $LRAV_t$ give effect to legacy adjustments and represent respectively:

⁶²—The calculation of which is addressed in Special Condition 7.1.

⁶³—Note the LAR_t term is a licence term, the sub-components of which are PCFM Variable Values and can be seen in the calculation in Special Condition 7.1, in the PCFM Variable Values table in Chapter 6 of this handbook and on the RIIO-ET2 PCFM input sheet. The LAR_t term is an aggregation of these PCFM Variable Values and is not a PCFM Variable Value itself, however for ease of reference we refer to both the LAR_t the $LRAV_t$ terms as variable values throughout this chapter.

- a) ~~the net incremental changes (which may be positive or negative) to RHO-2 revenue allowances;~~
- ~~and~~
- b) ~~the RHO-1 Net RAV additions relating to the RHO-1 Price Control Period.~~

~~1.75.—Revisions to LAR_t and $LRAV_t$ affect the calculation of Allowed Revenue for the licensee, through the AIP, in the following ways:~~

- a) ~~adjustments to revenue allowances (LAR_t) flow directly into Allowed Revenue as fast money amounts~~
- b) ~~adjustments to the RHO-1 Net RAV additions ($LRAV_t$) flow into Calculated Revenue (R_t) indirectly, by giving rise to adjusted return on RAV and depreciation amounts.~~

~~1.76.—It should be noted, however, that revisions to LAR_t and $LRAV_t$ values will also have ancillary effects on other calculations which feed into Allowed Revenue, under the AIP.~~

~~1.77.—The revised LAR_t value and its component values are denoted in nominal terms. $LRAV_t$ values will be denoted in 2018/19 prices, consistent with the price base used in the RHO-ET2 PCFM.~~

8.1 On 1 April 2021, the LAR_t and $LRAV_t$ Adjustments relating to ET2 Variable Value methodologies and ET2 closeout methodologies, which are implemented in the ET2 Legacy Price Control Financial Model (ET2 Legacy PCFM), will be directed by the Authority.

8.2 The Authority will direct the values of LK, LADJ, LRAV, and tax pools (OGP, OSRP, OSBP, LOSBP, ODRP, LODRP and OTL) to be carried over into the ET3 PCFM in accordance with the procedure set out in Special Conditions 7.2 (Legacy AIP Adjustment term ($LADJ_t$)), 7.3 (Legacy K correction (LK_t)), and 7.4 (Legacy net RAV additions ($LRAV_t$) 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 ET2 Price Control Period in accordance with this chapter, and the Authority will direct the adjustments the licensee must make in the ET2 Legacy PCFM inputs. The direction will specify an ET2 Variable Value named in the version of the licence as in force on 31 March 2026 or otherwise specify row and column references in the ET2 Legacy PCFM.
- 8.4 After the Authority has directed values in accordance with paragraph 8.2, and the licensee has provided **RHO** ET2 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 must take the following steps when submitting the ET2 legacy PCFM:

ET2 Offline Tax-Trigger PCFM

- 1) Ensure the ET2 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.
- 2) Ensure the year selected on the 'UserInterface' worksheet is 2026
- 3) Update all variable values (other than TTE_t, OGPA_t and OSRPA_t) in the relevant licensee input sheet, in line with those in the ET2 legacy PCFM.
- 4) Update the % values in rows 13 and 14 of the 'Super_Tax' worksheet to reflect the percentage of additions qualifying for super-deductions and first year allowances.
- 5) Run the macro in the "UserInterface" sheet for the relevant company
- 6) The values in cells AR55:AT55, AR56:AT56 and AP58:AT58 of the 'Super_Tax' worksheet are the values to be input into the relevant row within the licensee worksheet of the ET2 legacy PCFM.

ET2 Legacy PCFM

- 7) Ensure the ET2 Legacy PCFM is adjusted in accordance with the methodologies set out in this chapter, and where these methodologies are not available their best estimates;
- 8) Ensure values for TTE_t, OGPA_t and OSRPA_t are copied into the ET2 Legacy PCFM from the ET2 Offline Tax-Trigger PCFM per the guidance described above
- 9) Ensure "31 Mar 2027" is selected on the "UserInterface tab" of the ET2 Legacy PCFM;
- 10) Update variable values **will be provisional. These values will** in the relevant licensee input sheet of the ET2 Legacy PCFM;

11) Values in the Legacy Summary worksheet which are listed in Table 8.2 can then be used to update the relevant terms in the ET3 PCFM

8.6 Except where paragraph 8.7 applies, the licensee must then populate the ET3 PCFM with the inputs directed by the Authority and listed in Table 8.1.

~~8.18.7 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 using forecast data at the . Until that time of final determinations for RIIO-ET2 and therefore will be adjusted when outturn data becomes available.~~ the licensee must use its best estimates.

Revision to Legacy Adjustments

~~1.78:—The Legacy PCFM variable values will be revised⁶⁴ as necessary during the Price Control Period. However, it is expected that legacy adjustments will be completed through the Close-out of the RIIO-1 price control, as part of the first two AIPs during the RIIO-2 Price Control Period.~~

~~1.79:—Where applicable, Ofgem will use forecasts to determine a provisional value for legacy adjustments, which will be updated in subsequent AIPs when the outturn data becomes available.~~

~~1.80:—It might be necessary for a legacy outturn value to be restated by the licensee or adjusted by Ofgem after it has been applied to the determination of a component term value because of:~~

- ~~• errors or omissions in the preparation of information or inconsistencies with the relevant Regulatory Instructions and Guidance (RIGs) or~~
- ~~4. —~~
- ~~• an efficiency review by Ofgem.~~

⁶⁴ ~~Except for LMOD₂₀₂₁₋₂₀₂₂, which will not change in the RIIO-ET2 PCFM after it has been set for the Regulatory Year 2020/21.~~

1.81.—In either of those circumstances, the restated/adjusted legacy outturn value would be applied in place of the original value in a subsequent determination of legacy term values, and reflected in a revision to the relevant PCFM Variable Value for the next AIP.

Legacy Adjustment to Revenue—(LAR_t)

1.82.— LAR_t is derived in accordance with the formula in Part A of Special Condition 7.1 and comprises several legacy adjustments (see table 8.1). These legacy adjustments are determined in accordance with the methodologies set out in Chapter 7 of the special conditions:

Table 8.1—Legacy Adjustments (LAR_t)

Table 8.1: ET2 Legacy PCFM Inputs for legacy inputs directed by the Authority

Legacy ADJ

LAR_t Components Licence Terms		DescriptionSpecial Condition
LPT_t LADJ		SpC 7.2 Part A
$LMOD_t$	Legacy MOD	SpC 7.3
LK_t	Legacy K correction	SpC 7.4
$LTRU_t$	Legacy TRU Term	SpC 7.5
$LSSO_t$	Close out of RIIO-ET1 Stakeholder Satisfaction Output	SpC 7.6
$LEDR_t$	Close out of the RIIO-1 adjustment in respect of the Environmental Discretionary Reward Scheme	SpC 7.7
$LSFI_t$	Close out of RIIO-ET1 Incentive in respect of Sulphur Hexafluoride (SF6) Gas Emissions incentive	SpC 7.8
LRI_t	Close out of RIIO-ET1 Reliability incentive in respect of Energy not Supplied	SpC 7.9
$NOCO_t$	Close out of RIIO-1 Network Outputs	SpC 7.10

1.83.—Where a methodology for the calculation of a component of LAR_t refers to a calculation as set out in the RIIO-ET1 special licence conditions in force on 31 March 2021, this should be done with the exception of the Retail Prices Index Forecast Growth Rate calculation, the definition of which refers to “the HM Treasury “Forecasts for the UK Economy” publication, published in November each year.”

1.84.—Instead, from 01 April 2021, the Retail Prices Index Forecast Growth Rate should be calculated with reference to the August publication of the HM Treasury Forecasts for the UK Economy publication as the calculation will need to be done in time to feed the LAR_t variable value into the November AIP before the cut-off date set out in Chapter 2 of this handbook.

1.85.—For this version of the handbook, further detail is only provided for $LMOD_t$ (Special Condition 7.3), a component term for LAR_t :

Legacy MOD_t ($LMOD_t$) K

1.86.—The Legacy MOD_t ($LMOD_t$) value represents an amount (either positive or negative) to be added to licensee’s Allowed Revenue, which relate to the Regulatory Years prior to the current Price Control Period.

$LMOD$ values for the first two years of RIIO-ET2

1.87.—Ofgem will take the last published RIIO-ET1 PCFM (the RIIO-ET1 Price Control Financial Model following the AIP 2019) and extend the calculations to output a MOD_t value for Regulatory Years following the conclusion of RIIO-ET1. This extended version of the last published RIIO-ET1 PCFM will be referred to as the Legacy RIIO-ET1 PCFM.

1.88.—As with the RIIO-1 process, a new MOD_t (eg $MOD_{2021/22}$ and $MOD_{2022/23}$) will be calculated and directed at each AIP, reflecting any changes related to the RIIO-1 variable values or from the closeout process.

1.89. ~~As in the RIIO-1 process, the PCFM Variable Values feeding into the Legacy RIIO-ET1 PCFM are to be derived in accordance with Chapter 6 (Annual Iteration Process – Adjustments to the Transmission Network Revenue Restriction) of the Electricity Transmission licence special conditions and the version of the RIIO-ET1 Price Control Financial Handbook as in force on 31 March 2021.~~

1.90. ~~These MOD_t values will be denoted in £m 09/10 prices, and then inflated by the $RPIF_t$ term consistent with the RIIO-1 methodology and regulatory reporting packs. This nominal MOD is used as the value of $LMOD_t$, and is added directly to Allowed Revenue in the RIIO-2 period.~~

1.91. ~~The RIIO-ET2 PCFM, in its state as at 1 April 2021 includes values for $LMOD_{2021/22}$ and $LMOD_{2022/23}$ (forecast), which are determined based on the calculations and formulae in the Legacy RIIO-ET1 PCFM and the data available at Final Determinations.~~

1.92. ~~The value for $LMOD_{2021/22}$ relating to Regulatory Year 2019/20 is derived from outturn data submitted by licensees by 31 July 2020 in accordance with the Regulatory Instructions & Guidance (RIGs). Values of $LMOD_t$ will not change in any subsequent AIP.~~

1.93. ~~In absence of outturn data⁶⁵, a provisional value will be calculated for $LMOD_{2022/23}$, as at 1 April 2021, based on forecast data. This will then be updated at the subsequent AIP in November 2021, following the submission of outturn expenditure data on 31 July 2021.~~

⁶⁵ There is a two-year lag in reflecting outturn data in Allowed Revenue i.e. outturn data relating to expenditure in Regulatory Year 2020/21 cannot be reflected until after the AIP in 2021 for the Regulatory Year 2022/23.

1.94.—To calculate the value of LMOD in Regulatory Years 2021/22 or beyond, PVF terms for Regulatory Years within RIIO-2 is required to make the appropriate time value of money adjustment.

1.95.—The PVF term will be the real rate that, when inflated by the corresponding RPI factor (RPIF), implies the same *nominal* time value of money (TVM_t) used in the RIIO-2 Price Control Financial model for that Regulatory Year.

1.96.—For example, if the RIIO-2 term TVM_t has a value of 4.55%, a value of PVF will be used such that when inflated by RPI, the nominal rate is also 4.55%.

~~5.—LMOD values to reflect the closeout of RIIO-ET1~~

1.97.—Ofgem will take the Legacy RIIO-ET1 PCFM, and modify it to calculate a closeout adjustment value (COA) using the same approach as the MOD calculation, applying the same time value of money as would apply to MOD_t in 2021/22.

1.98.—The value of $LMOD_t$ for 2023/24, 2024/25 and 2025/26 is derived in accordance with Special Condition 7.3, based on a value of COA (the closeout adjustment) that the Authority will direct.

1.99.—In order to direct the value of COA, the Authority will follow the following process:

- Coordinate adjustments to the legacy PCFM in accordance with the closeout methodologies listed in paragraph 8.32
- Ensure “31 March 2024” and the relevant licensee are selected on the “UserInterface” tab of the Legacy RIIO-ET1 PCFM
- Run the tax trigger, then switch the model back into licence model
- Calculate a value of COA using the modified Legacy RIIO-ET1 PCFM from paragraph 8.28
- Direct the value of “COA” (in 18/19 prices) from the “Legacy Summary” tab as the corresponding input to the ET2 PCFM.

~~1.100: Until the direction of COA, the value of the COA will remain provisional, and licensees will use their best forecast.~~

Closeout methodologies

~~1.101: In order to calculate a value of COA, the following adjustments will be made to the Legacy RIIO-ET1 PCFM company input tabs in accordance with the Decision on the closeout methodologies for RIIO-ET1⁶⁶ (“the decision”):~~

- ~~• Revise the Physical Site Security costs input (row 14) in accordance with Appendix 4 of the closeout methodology decision (enhanced physical site security costs)~~
- ~~• Revise the IWW value (row 19) in accordance with Appendix 3 and Appendix 8 of the closeout methodology decision (terminated wider works projects and crossover volume driver projects)~~
- ~~• Revise the enhancements to pre-existing infrastructure input (row 20) in accordance with Appendix 10 of the closeout methodology decision (SHET’s VISTA allowance)~~
- ~~• Revise the demand related infrastructure volume driver input (row 21) to account for Appendix 5 and Appendix 8 of the closeout methodology decision (Terminated connection projects and crossover volume driver projects)~~
- ~~• Revise the generation connections volume driver (row 23) in accordance with Appendix 5, Appendix 8 (NGET and SHET), and Appendix 9 (SPT) of the closeout methodology decision (terminated connection projects, crossover volume driver projects, and connection volume driver clawback)~~

⁶⁶Ofgem publication, “Decision on the closeout methodologies for RIIO-ET1”, published 24 May 2022; <https://www.ofgem.gov.uk/sites/default/files/2022-05/ET1%20closeout%20methodologies%2024May2022.pdf>

- ~~Revise non-variant allowed load related capex expenditure (row 84) in accordance with Appendix 2 and Appendix 6 of the closeout methodology decision (connection payments and pre-construction works)~~
- ~~Revise the excluded services revenue input (row 213) in accordance with Appendix 2 of the closeout methodology decision (connection payments)~~
- ~~Revise the RAV additions input (row 238) in accordance with Appendix 7 of the closeout methodology decision (asset and land related disposals)~~

1.102. In addition to the pre-existing ET1 Variable Value methodologies and closeout methodologies, the ET1 Legacy PCFM contained other closeout adjustments relating to previous decisions. If correctly made or unchanged, these adjustments would have been reflected in LMOD_{2021/22} and/or LMOD_{2022/23} and therefore not affect COA. However, in calculating the value of COA, the Authority will finalise and record:

- ~~SHE-T Only: Revisions to the Baseline and strategic wider works variable value (WWE) on row 18 for advanced construction costs referenced in paragraph 10.6, 10.7, and 10.17 of the closeout methodology decision~~
- ~~SHE-T Only: A revision to the Baseline and strategic wider works variable value (WWE) on row 18 for associated indirects allowance in accordance with paragraph 10.31 of the closeout methodology decision~~
- ~~SHE-T Only: A revision to the Baseline and strategic wider works variable value (WWE) on row 18 relating to the voluntary handback of capex efficiencies on the Gaithness Moray project.⁶⁷~~
- ~~NGET and SPTL only: For Adjustments relating to the WHVDC settlement in chapter 12 of the closeout methodology decision, including:~~
 - ~~Adjustment to Row 18, baseline and strategic wider works outputs adjustment (WWE)~~

⁶⁷ See the RIIO-ET1 Annual Report 2020-21 and the supplementary data file.

- ~~○ Adjustment to Row 31, Legacy price control adjustments to allowed revenue (LAR)~~
- ~~○ Adjustment to Row 32, legacy price control adjustments to RAV (LRAV)~~
- ~~● NGET Only: A revision to the Baseline and strategic wider works variable value (WWE) on row 18 for additional Hinkley allowances as approved in the “May decision” on 22 May 2020.⁶⁸~~

~~1.103. For the avoidance of doubt, relative to the ET1 PCFM published following the 2019 Annual Iteration Process, the final state of the ET1 Legacy PCFM will include the cumulative effect of:~~

- ~~● The pre-existing RIIO-ET1 Variable Value methodologies listed in paragraph 8.20~~
- ~~● Additional revisions made to the ET1 Legacy PCFM listed in paragraph 8.33~~
- ~~● The closeout decision methodologies listed in paragraph 8.32~~

Legacy Adjustment to RAV Additions (LRAV_t)

~~1.104. This section sets out the methodology by which the Authority will determine LRAV_t (Special Condition 7.12) values for the licensee:~~

~~LRAV values for the first two years of RIIO-ET2~~

~~1.105. The Authority will derive LRAV_t values relating to RIIO-ET1 Price Control Period, at Final Determinations in accordance with the applicable RIIO-ET1 Cost, Volume and Revenue Reporting Regulatory Instructions and Guidance (RIGs):~~

~~1.106. LRAV_t should be calculated in accordance with the PCFM Guidance. Ofgem will take the last published ET1 PCFM (the RIIO-ET1 Price Control Financial Model following the AIP 2019) and extend the calculations to enable the calculation of a RAV position for~~

⁶⁸ ~~<https://www.ofgem.gov.uk/publications/decision-our-project-assessment-hinkley-seabank-electricity-transmission-project>~~

the final Regulatory Year of RIIO-ET1. Any net additions to RAV balances during this period represent $LRAV_t$ values:

1.107. The $LRAV_t$ values for Regulatory Year 2020/21 are provisional and will be updated with outturn data received by the AIP ending November 2021.

1.108. By 31 October 2021, the Authority will derive finalised $LRAV_t$ values for the Regulatory Year 2020/21 for the licensee by inputting actual cost data submitted by 31 July 2021 into the ET1 PCFM and restating them to 2018/19 prices. There may also be subsequent updates to allowances or other RIIO-1 inputs following the 31 July data submission which will be processed in the same way.

1.109. The $LRAV_t$ values, as determined in para 8.36 and 8.39, are used in the PCFM Variable Values table as historical additions to RAV (RIIO-1 Net RAV additions (after disposals)) relating to RIIO-ET1 Price Control Period and will flow indirectly into RIIO-ET2 Calculated Revenue (R_t):

1.110. The $LRAV_t$ values are contained in the Regulatory Year columns for 2013/14 – 2020/21 (RIIO-ET1 Price Control Period) in RIIO-ET2 PCFM.

Directing final values of $LRAV_t$ and tax loss brought forward and capital allowance tax pool balances following the closeout of RIIO-ET1

1.111. In directing the value of COA in accordance with paragraph 8.30, the Authority will also direct the corresponding values of $LRAV_t$, tax loss brought forward and the capital allowance tax pool balances from the Legacy RIIO-ET1 PCFM following implementation of the closeout methodologies in paragraph 8.32.

Appendices

Index

Appendix <u>Licence</u> <u>Terms</u>	<u>Name of Appendix</u> <u>Special Condition</u>
1 <u>LK</u>	Glossary <u>SpC 7.3 Part A</u>

2 Totex Incentive Mechanism 96

Appendix 1 – Glossary

A

Allowed Return on Capital

Ofgem allowance based on the assessed weighted average cost of capital (WACC).

Allowed Return on Debt

Ofgem allowance in respect of the cost of debt, calculated on a pre-tax basis with reference to a trailing average index of debt costs.

Allowed Return on Equity

Ofgem allowance based on the assessed cost of equity. Ofgem calculates the allowed return on equity and cost of equity on a posttax basis.

Annual Iteration Process

The annual iteration process is the process of annually updating the variable values in the RIIO-ET2 PCFM and running the PCFM calculation functions in order to provide updated Allowed Revenue (AR_t) for a licensee, see Chapter 2, para 2.43

Associated Document

A supporting document needed to supplement the application or understanding of the variable values in [Table 3.1](#).

Authority's website

www.ofgem.gov.uk

B

Base Annual PSED Allowance

See chapter 7, [Section 3](#)

C

Capitalisation rate

The rate at which totex is added to RAV (ie treated as slow money). There are two rates for the RIIO-ET2 Price Control Period, Capitalisation rate 1 (base rate) and Capitalisation rate 2 (an uncertainty mechanism rate). Capitalisation rate 1 refers to the rate used for all relevant expenditure/ allowances not dealt with under the uncertainty mechanism capitalisation rate. The Capitalisation rate 2 is applied to expenditure/ allowances under the uncertainty mechanism.

Consumer Prices Index Including Owner Occupiers' Housing Costs (CPIH)

The monthly values of the “CPIH All Items”, series ID “L522”, published by the Office for National Statistics (ONS) or any other public body taking on its functions.

Also see chapter 2, para 2.17.

Cut-Off Date

Means 31 March 2010 for DNOs, 31 March 2013 for GDNs and 31 March 2012 for TOs and SOs, see Chapter 7, para 7.7.

D

Defined Benefit Scheme

A pension scheme where the benefits that accrue to members are normally based on a set formula taking into account the final salary and accrual of service in the scheme. It is also known as a final salary pension scheme.

E

ENA

Energy Networks Association

Established surpluses

See chapter 7, section 1, para 7.10-7.12.

ET2

~~Prefix/Suffix designating an item relevant to the RIIO-ET2 (electricity transmission) price control review which will be applicable for the five years running from 1 April 2021 until March 31, 2026.~~

F

Fast money

~~The proportion of Totex which is not added to the licensee's RAV balance and is effectively included in the licensee's revenue allowance for the year of expenditure.~~

Final Determinations

~~Means the document of that name published on the Authority's Website in relation to the RIIO-2 price control.~~

Funding Adjustment Rate

~~This is the percentage calculated as $1 - \text{Totex Incentive Strength Rate}$.~~

I

International Financial Reporting Standards (IFRS)

~~IFRS are accounting standards set by the International Accounting Standards board. These standards ensure comparability and accuracy of accounts.~~

L

Legacy RIIO-ET1 PCFM RAV

~~An extended version of the last published RIIO-ET1 PCFM used to calculate a legacy MOD_t value relating to RIIO-ET1 Regulatory Years, for inclusion in the LAR_t term.~~

N**NPV**

Net Present Value

Non-Core RAV

Refers to expenditure, already incurred, which has not yet been admitted to the licensee's formal RAV balance, but which is expected to be admitted at a future point. This is also referred to as "shadow RAV".

Θ**ΘBR**

Office of Budget Responsibility

Ofgem

The Office of the Gas and Electricity Markets Authority.

P**PCFM**

The RIIO-ET2 PCFM (see RIIO-ET2 Price Control Financial Model definition)

Pensions Allowance

See chapter 7, Section 3.

Pension Principles

See Chapter 7, para 7.6.

~~Pension Scheme Established Deficit (PSED)~~

~~The difference between assets and liabilities, determined at any point in time, attributable to pensionable service up to the end of the respective Cut-Off Dates and relating to Regulated Business Activities under Pension Principle 2. The term applies equally if there is a subsequent surplus.~~

~~Also see chapter 7, para 7.7.~~

PCFM

<u>Licence Terms</u>	<u>Special Condition</u>
<u>LRAV</u>	<u>SpC 7.4 Part A</u>

Legacy Tax Pools

<u>Licence Terms</u>	<u>Special Condition</u>
<u>OGP</u>	<u>SpC 7.4 Part B</u>
<u>OSRP</u>	<u>SpC 7.4 Part B</u>
<u>OSBP</u>	<u>SpC 7.4 Part B</u>
<u>ODRP</u>	<u>SpC 7.4 Part B</u>
<u>LOSBP</u>	<u>SpC 7.4 Part B</u>
<u>LODRP</u>	<u>SpC 7.4 Part B</u>
<u>OTL</u>	<u>SpC 7.4 Part B</u>

ET2 Variable ~~Values~~ Value Methodologies

~~The variable values in Table 3.1~~Revision of this handbook or the PCFM**ET2 Variable Values table**

8.8 The licensee must use the version of the licence as in force on 31 March 2026 to determine the ET2 Variable Values.

8.9 The licensee must populate the relevant fields in the ~~RIIO~~-ET2 Price ~~Control~~Legacy PCFM.

8.10 The ET2 Variable Values may be further adjusted by the closeout methodologies below.

ET2 Closeout Methodologies

8.11 The following sections set out how adjustments to the ET2 Legacy PCFM will be determined. The licensee must then adjust the ET2 Legacy PCFM input as directed in accordance with Table 8.2 below.

8.28.12 Table 8.2 lists the adjustments to the ET2 Legacy PCFM that the licensee must make for closeout methodologies, following the General Financial Model Adjustment Methodology in this chapter.

PCFM Guidance

~~An Associated Document issued by~~ Where a Special Condition (SpC) is cited in a methodology, it refers to the ~~Authority under Part F provisions of special condition 8.2 (Annual Iteration Process for the RIIO-~~licence as in force on 31 March 2026. These conditions may also refer to definitions within the ET2 Price Control Financial ~~Model~~), to be used by licensee to populate variable values in RIIO-ET2 PCFM for submission during AIP.

Price Control Period

~~8.38.13 The period of five years beginning on 1 April 2021 and ending~~ Handbook as in force on 31 March 2026.

R

RAV – Regulatory Asset Value

~~A financial balance representing expenditure by the licensee which has been capitalised under regulatory rules. The licensee receives a return and depreciation on its RAV as a part of its Allowed Revenue (AR).~~

Real Price Effects (RPE_t)

~~Ofgem sets price control allowances which can include a general inflation measure (CPIH) and certain price indices that reflect the external pressures on companies' costs. The difference between the Price Index (PI_t) and certain price indices are referred to as Real Price Effects (RPE_t).~~

Reasonableness Review

See Chapter 7, Table 8.2: Closeout adjustments in the ET2 Legacy PCFM

<u>Closeout methodology</u>	<u>Relevant ET2 licence reference</u>	<u>ET2 Legacy PCFM input adjusted</u>	<u>Basis for profiling adjustments</u>	<u>Direct ion Timing</u>
<u>[Rows of this table to be added once closeout methodologies are known]</u>				

Except where otherwise stated, all calculations under this section 2, from para 7.30

Regulatory Year

A period of twelve months commencing on 1 April at 05:00 and ending on the following 1 April immediately before 05:00. The first such Regulatory Year (t=1) commences on 1 April 2021 at 05:00 hours during the RIIO-2 Price Control Period.

Retail Price Index (RPI)

The monthly values of the “RPI All Items Index”, series ID “CHAW”, published by the Office for National Statistics (ONS) or any other public body acquiring its functions.

Also see Chapter 2, para 2.17.

RIIO

Revenue = Incentives + Innovation + Outputs, Ofgem's framework for the economic regulation of energy networks.

RIIO-ET2 (Electricity Transmission)

The price control arrangements which will apply to electricity transmission licensees from 1 April 2021 until 31 March 2026

8.48.14 ~~RIIO-ET2~~ of the ET3 Price Control Financial ~~Model (PCFM)~~ Handbook are to be made with reference to 2018/19 prices using the ET2 Price Control Period price base.

The model of that name including the suffix ‘November 20XX’ (where 20XX represents the calendar year containing the month of November in the Regulatory Year t-1):

~~(a) that is represented by a workbook in Microsoft Excel format maintained under that name detailed above, on the Authority’s website; and~~

~~(b) that the Authority will use to determine the values of the term AR through the application of the Annual Iteration Process, whether under Special Condition 2.1, Part C of ET license.~~

~~The RIIO-ET2 PCFM calculates updated Allowed Revenue through an Annual Iteration Process – see chapter 2, para 2.43.~~

~~Slow money~~

~~The proportion of Totex which is added to the licensee’s RAV balance on which the licensee receives a revenue allowance to cover finance (Vanilla Allowed Return on Capital) and depreciation costs.~~

~~SONIA~~

~~The daily values of the Sterling Overnight Index Average, series ID “IUDSOIA”, published by the Bank of England or any other government department acquiring its functions.~~

~~Also see chapter 2, para 2.28.~~

~~T~~

~~Tax Review~~

~~A review by the Authority of any material differences between the licensee’s Calculated Tax Allowance and its Actual Corporation Tax liability.~~

~~See chapter 6, from para 6.31-6.46.~~

~~Time Value of Money Adjustment~~

~~A multiplier used when the award or application of a financial value, attributable to a particular year, is deferred until a later year, even where the deferral is routine and in accordance with a price control mechanism.~~

~~In basic terms, for any one year, the multiplier is $(1+X)$ where: X is the WACC or twelve months average of the daily overnight SONIA (see definition) for the licensee applicable to the period of deferral.~~

Also see chapter 2, para 2.28.

Totex Incentive Mechanism (TIM)

See Appendix 2.

Totex Incentive Strength Rate (TIS)

See Appendix 2. It represents the percentage that a licensee bears in respect of an overspend against allowances or retains in respect of an underspend against allowances.

Triennial (pension scheme) Valuation

An actuarial valuation of a pension scheme 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. Interim updates to triennial valuations may also be produced.

Also see chapter 7, Section 2

U

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 - Regulatory Instructions and Guidance: Triennial Pension Reporting Pack supplement including pension deficit allocation methodology.

V

Vanilla Allowed Return on Capital

See Allowed Return on Capital

Vanilla WACC

See WACC

W

WACC

The Vanilla Weighted Average Cost of Capital is equal to the Allowed Return on Capital. Vanilla WACC is used in some time value of money adjustments. The use of Vanilla WACC means that the company's tax cost is separately calculated as a discrete allowance so that only the following have to be factored in:

- i) — the pre-tax cost of debt, and
- ii) — the post tax cost of equity

weighted according to the price control gearing assumption.

"Real Vanilla WACC" is used which gives a lower percentage than "Nominal Vanilla WACC" would (when inflation is positive):

Appendix 2 — 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 RIIO-ET2 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 RII-ET2 PCFM apportions post-TIM totex using the Totex Capitalisation Rate for the licensee as either fast money or slow money (see paragraph 3.6). The Totex Capitalisation Rate for the licensee for the relevant Regulatory Year is a fixed input value for the licensee in the RII-ET2 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 .

6.—

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

7.—

8.—

9.—

10.—

11.—

12.—

13.—

14.—

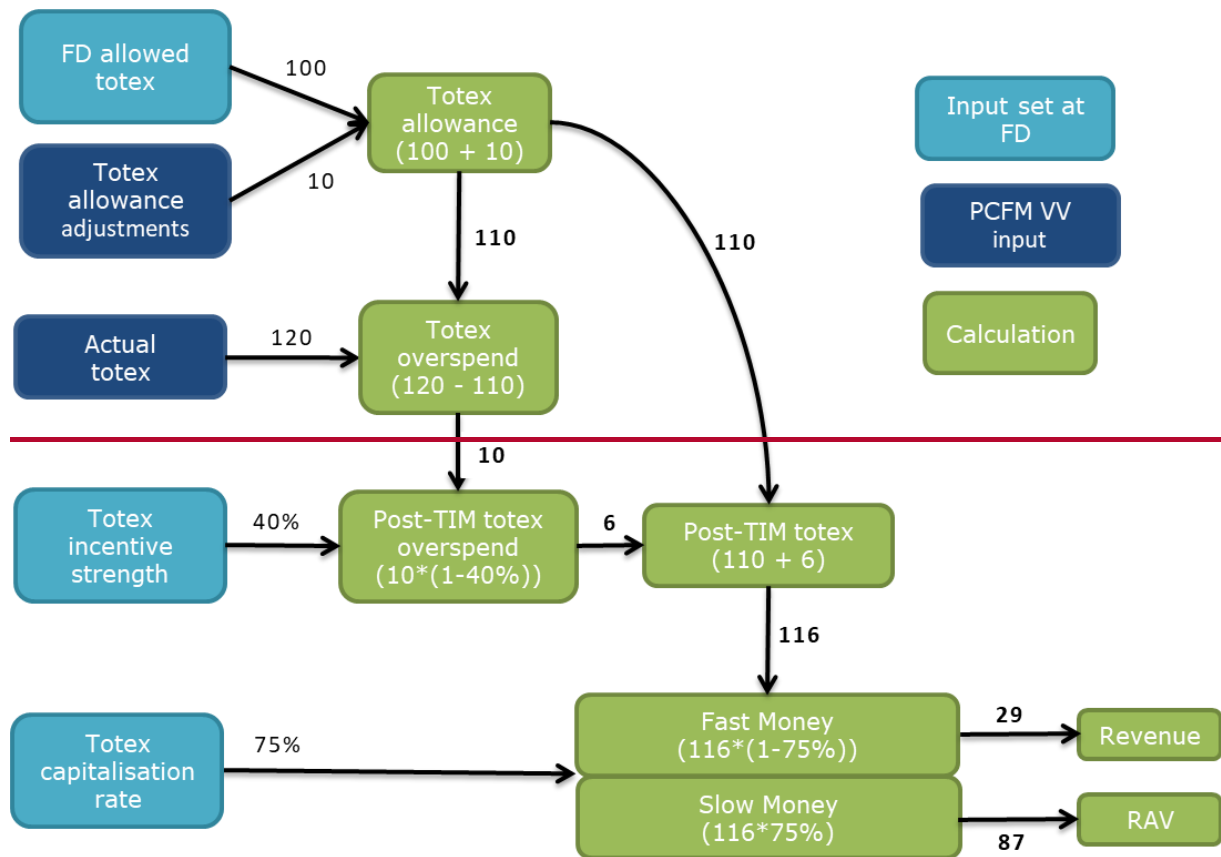
15.—

16.—

17.—

Figure A2.1: Illustration of the Totex Incentive Mechanism

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

