



Electricity distribution licensees,
gas transporter licensees,
electricity transmission licensees,
and other interested parties

*Promoting choice and
value for all customers*

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Date: 5 December 2008

Dear Colleagues,

Clawback of tax benefit due to excess gearing

As outlined in the TPCR, GDPCR and DPCR4 final proposals¹ we intend to implement an ex post adjustment which claws back from licensees the revenue benefit they obtain from lower tax costs as a result of high gearing.

The clawback is triggered when in any year (i) actual gearing exceeds notional gearing² and (ii) interest costs exceed those modelled at the relevant price control. In the case where both of these conditions are satisfied, we will clawback the tax benefit which results from the difference between actual and modelled interest costs in that year.

We have reviewed a number of practical issues that were not specifically addressed at the respective price controls regarding the definitions used and the timing of the clawback. We set out herein the conclusions of our review on the majority of these issues and we would like to invite your views on the issues where we have not made a definite decision.

RAV

For the purpose of calculating the actual gearing, we are using actual year-end RAV calculated in accordance with the relevant final proposals for each sector. As the RAV is finalised during the following price control review the clawback will be retroactive to cover the previous price control period (on the timing of the clawback see below). For transmission companies there is an additional issue which relates to the treatment of debt incurred and attributable for capex on items that are remunerated later in RAV (or otherwise) than in the current price control period. Examples of such costs are:

¹Electricity Distribution Price Control Review 4 – Final Proposals (265/04)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4>

Gas Distribution Price Control Review Final Proposals Consultation Document (285/07)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=362&refer=Networks/GasDistr/GDPCR7-13>

Transmission Price Control Review: Final Proposals (206/06)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses>

² Notional gearing was set at 57.5%, 60% and 62.5% in DPCR4, TPCR and GDPCR respectively.

- Specific projects / incremental capex
- Revenue Driver expenditure
- Transmission Investment in Renewable Generation (TIRG)
- Logged up costs (e.g. Security, BT21CN)

Currently, these items are accounted for in a “shadow” RAV until the next price control. The debt incurred to fund this capex may therefore push the licensee to breach the gearing ratio and interest payable (as modelled). To penalise a licensee because debt is included by “shadow” RAV would be asymmetric, consequently we propose to include the “shadow RAV” in the RAV for the purpose of the tax claw back gearing calculation. These issues do not currently apply in Gas or Electricity Distribution.

Interest and Net Debt definitions

We propose to adopt a refined definition of net debt and interest expense on which views are invited:

Interest should include:

- Actual net interest (payable less receivable) for the price controlled business extracted from regulatory accounts, used on an accruals basis
- Total interest on index-linked debt based on the charge to the income statement in regulatory accounts

Interest should exclude:

- Movements relating to pension fund liabilities reported in the regulatory accounts within net interest
- Fair value adjustments (e.g. losses on derivatives)
- Dividends on preference shares, as these are not tax deductible

Net debt should include:

- Cash at bank
- Bank overdrafts
- Short term investments
- External borrowings
- Inter-company borrowings
- Inter-company debtors/working capital³
- Inter-company creditors/working capital
- Preference shares, which are considered as debt under current accounting standards (see below)
- Loans to related parties (but see also below)

We invite views on whether it is appropriate to include preference shares in net debt as we are excluding their dividends. We assume all interest payable on modelled debt to be at typical debt rates and to be tax deductible, neither of which apply to preference share dividends and hence there is an asymmetry in treatment.

With respect to loans to related parties, we have a concern about the potentially low levels of net debt in cases where there are substantial amounts of lending from the licensee to the holding company. We are considering whether or not these intercompany loans should be netted off the licensee's debt. We have observed that where this occurs this produces

³ Inter-company working capital balances are included in net debt because of the practical difficulties in distinguishing such balances from inter-company debt.

very low gearing ratios. We invite views on whether such loans should be excluded from net debt in considering gearing and the claw back calculation.

Net debt should exclude:

- Year end balances fair value adjustments on derivatives in regulatory accounts
- Unamortised issue costs
- Fixed asset investments where not readily converted to cash

Tax losses

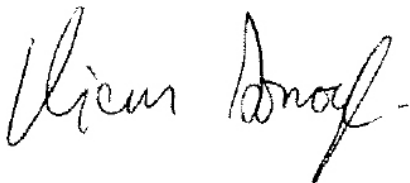
In GDPCR, a number of the GDNs had no tax allowance for some or all years, because the financial model tax calculation indicated corporation tax losses. In such situations, the claw back adjustment will not be a cash adjustment, but an adjustment to the regulatory tax losses. This will ultimately impact the licensee's tax allowance at the point at which we model them as having to pay corporation tax.

Amounts and Claw back period

Based on the calculations described we expect to make adjustments which we will notify to each licensee separately. We propose that the claw back period should be on a case-by-case basis provided it is NPV neutral. Our decision will be based on the materiality of the amount to be clawed back.

We look forward to receiving your responses on the issues we are seeking your views above, by 16 January 2009 at william.mckenzie@ofgem.gov.uk.

Yours sincerely,



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