Promoting choice and value
for all gas and electricity customers

GD1 Price Control Financial Handbook

This handbook and the constituent methodologies are development drafts and the content is subject to any decision at Final Proposals.

Reference:

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Overview:

This is the GD1 Price Control Financial Handbook which forms part of Special Condition GDC 57 (Governance of Price Control Financial Instruments) of the Gas Transporter Licence held by gas distribution network operators.

This document consists of:

a) a description of the GD1 Price Control Financial Model (PCFM) and the Annual Iteration Process for it, used to update licensees' base revenue allowances during the course of the RIIO-GD1 price control period;

b) an overview of the GD1 Price Control Financial Methodologies under which revisions to the variable values in the PCFM are determined for the Annual Iteration Process, in accordance with the special conditions of the Licence; and

c) a series of chapters containing the detailed methodologies relating to PCFM Variable Values.

The procedures relating to modification of this Handbook and the PCFM are contained in Special Condition GDC 57.

An up to date version of this Handbook and the PCFM (in Microsoft Excel® format) can be accessed on the Ofgem website.

Context

The RIIO-GD1 price control arrangements are the first to apply Ofgem's RIIO framework (Revenue = Incentives + Innovation + Outputs). The RIIO approach places more emphasis on incentivising network owners and managers to achieve the outputs needed to deliver sustainable energy networks at value for money for existing and future consumers.

The RIIO-GD1 price control is longer than the previous gas distribution price controls (known as GDPCR), running for eight years instead of five. This provides for a longer period of settled price control arrangements and should facilitate improved strategic planning and a long term approach to gas distribution infrastructure management.

However, the RIIO price control mechanisms are also more dynamic. Under the GDPCR price controls, base revenue allowances typically representing over 80per cent of network operation revenues, were set up-front for the whole of the price control period, changing only with RPI indexation. A number of significant adjustments to reflect activity levels and varying financial conditions were necessarily left in abeyance until the subsequent five-yearly review. Under RIIO-GD1, comprehensive adjustments to base revenue will be made each year in respect of the licensee's network business.

This more sophisticated approach involves an annual iteration of the GD1 Price Control Financial Model (PCFM) using updated variable values. This gives rise to a requirement for licence conditions and methodologies to govern the determination of revised PCFM Variable Values and the Annual Iteration Process.

This Handbook (which forms part of Price Control Licence Condition GDC 57) sets out the required processes and methodologies. To promote transparency, up to date copies of both the Handbook and the PCFM will be maintained on the Ofgem website.

Associated documents

a. GD1 Price Control Financial Model

[Hyperlink]

b. RIIO-GD1 Price Control Final Proposals

[Hyperlink]

c. Statutory Consultation on RIIO-GD1 licence conditions

[Hyperlink]

d. Decision letter: Clawback of tax benefit due to excess gearing

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=49&refer=Networks

Contents

Introduction

The GD1 Price Control Financial Handbook (this handbook) is one of the Price Control Financial Instruments referred to in Special Condition GDC 57 (Governance of Price Control Financial Instruments) of the Gas Transporter Licence held by gas distribution network operators. It describes the GD1 Price Control Financial Model (‘PCFM’) and the Annual Iteration Process for it, by which annual adjustments to licensees’ base revenues will be calculated. It also contains the Price Control Financial Methodologies (‘the methodologies’), specified in relevant price control licence conditions, which will be used to determine appropriate revisions to the variable values contained in the PCFM to facilitate calculations under the Annual Iteration Process. The methodologies also describe the intent and effects of revising the various revised PCFM Variable Values.

This handbook, the constituent methodologies and the PCFM (together the Price Control Financial Instruments) form part of Special Condition GDC 57. The Financial Instruments are subject to a formal change control process set out in that condition.

The PCFM Annual Iteration Process approach has been adopted because:

- it is consistent with the aims of the RIIO price control, embodying more ‘real time’ adjustments to financial allowances;
- it handles complex computational interactions between financial adjustments without the need for unwieldy algebra on the face of price control licence conditions;
- it provides for consistent treatment of the Totex[1] aspects of the price control;
- it maintains transparency on adjustments to base revenues, since the licence, methodologies, PCFM and variable values will be published; and
- it allows stakeholders to keep abreast of allowed revenue levels and to carry out business sensitivity analysis.

In any case of conflict of meaning, the following order of precedence applies:

(i) the licence,

(ii) the methodologies, and

(iii) the PCFM.

[1] Total Expenditure – see Glossary

Terms used in this handbook

References to the Authority and Ofgem

The Gas and Electricity Markets Authority ("the Authority") is established by section 1 of and Schedule 1 to the Utilities Act 2000. The Authority's staff are based at the Office of the Gas and Electricity Markets Authority ("Ofgem")

In this handbook the text refers to:

- 'the Authority' when an action or decision must be taken by the Authority itself as a "reserved matter" (or by a committee or individual with delegated authority to so act on its behalf); and
- 'Ofgem' when an action or decision relating to a "non-reserved matter" is to be taken by one or more of the Authority's staff under delegated authority or a regime or protocol approved by the Authority.

Throughout this handbook:

a) 'licence' means a Gas Transporter Licence issued under s7 of the Gas Act 1986 that includes "Standard Special Conditions applicable to all DN Licensees: Part D";

b) 'licensee' means every holder of a licence as defined at a) above, save that in the case of National Grid Gas plc, (and in accordance with the definition of Distribution Network at Special Condition E1 of its licence) any reference to the 'licensee' shall be a reference to each of the four individual Distribution Networks owned and operated by National Grid Gas plc (i.e. the East of England, London, North West and West Midlands Distribution Networks) together with the administrative and management resources deployed by National Grid Gas plc in operating each of those Distribution Networks, as though each of those Distribution Networks and the associated administrative and management resources were themselves the holder of a licence as defined at a) above;

c) 'this handbook' means this GD1 Price Control Financial Handbook;

d) 'Special Condition' means any one of the "Special Conditions contained in Special Conditions Applicable to the Licensee (DN): Part E – RDN" of the licensee's licence;

e) 'price control period' means the RIIO-GD1 price control period which runs from 1 April 2013 to 31 March 2021.

Where the meaning of other terms used in this handbook is not clear from the context, they will either be defined/explained in the chapter concerned or in the appended Glossary.

1. The GD1 Price Control Financial Model and the Annual Iteration Process

Overview

1.1. The special conditions specify the opening base revenue[2] levels for the licensee for each Formula Year of the price control period, reflecting the Authority's final proposals for the RIIO-GD1 price control settlement.

1.2. The GD1 Price Control Financial Model (PCFM) has been designed to calculate incremental changes to the licensee's opening base revenues for each Formula Year so that the updated base revenue allowances reflect the adjustment schemes specified in the licence and detailed in the methodologies in this handbook. The adjustments fall into three broad categories:

- legacy price control adjustments – the close out of schemes and mechanisms from preceding price control periods;
- financial adjustments covering tax, pension and cost of debt issues; and
- adjustments relating to actual and allowed Totex[3] expenditure and the Totex incentive mechanism.

1.3. The calculations take place under the Annual Iteration Process for the PCFM described below and are manifested as a PCFM output value for the term 'MOD' which is then applied as shown in the simplified formula below:

Base Revenue for year t = opening base revenue for year t + MOD for year t.

Price base

1.4. The model works predominantly in a constant 2009-10 price base. This is consistent with the opening base revenue values set down in the licence. The value of the term MOD is calculated in 2009-10 prices. Indexation is provided for in the base revenue formula set out in the special conditions.

1.5. Some tax calculations internal to the PCFM use nominal prices, based on embedded RPI forecast data. Interest cost and tax allowance calculations relate to the licensee's accounting profit and loss position. Since, for regulatory purposes, this is considered in nominal prices, the use of nominal prices in the PCFM tax

[2] Base Revenue is the largest component of the licensee's overall Allowed Revenue
[3] see Glossary

calculations ensures that revenue allowance calculations more accurately reflect the profile of tax expenses of the licensee.

Temporal convention

1.6. As indicated above, the MOD term is used to adjust the opening base revenue figure for each Formula Year t during the price control period[4]. References in this handbook to Formula Years are made relative to that usage. For example, in a context where MOD_t applied in the formula for base revenue in 2015-16, a reference in the same context to Formula Year t-1 would mean 2014-15 and so on.

The Price Control Financial Model and the Annual Iteration Process

1.7. The PCFM exists as a constituent part of Special Condition GDC 57 (Governance of GD1 Price Control Financial Instruments). It has an input area for each licensee containing both fixed values and a PCFM Variable Values table. The base revenue figure for each licensee for each Formula Year of the price control period is calculated using the fixed values, the PCFM Variable Values, and the formulae and functions embedded in the PCFM.

1.8. At the outset of the price control period, the base revenue figures calculated by the PCFM, using the variable values subsisting at that time, constitute the opening base revenue values for each licensee. Before the calculation of opening base revenues are performed, Ofgem will commission an external audit of the functionality of the PCFM.

1.9. By 30 November in each Formula Year t-1[6], Ofgem will determine whether any PCFM variable values for the licensee should be revised in accordance with the special conditions and methodologies referred to in chapters 3 to 10 of this handbook.

1.10. The Authority will give the licensee at least 14 days notice of any revised PCFM Variable Values in accordance with requirements in the licence to allow for any representations or objections. The Authority will then (by 30 November in Formula Year t-1) specify any PCFM Variable Value revisions in a formal direction to the licensee. The direction will also include a 'screenshot' of the PCFM Variable Values table for the licensee, showing the state of all variable values after the directed revisions, with revised values emboldened.

[4] In 2013-14, the first year of the price control period, the licence specifies that the value of MOD is zero.

1.11. Ofgem will then carry out the Annual Iteration Process:

- directed revisions to PCFM Variable Values will be inputted in the appropriate Formula Year column of the PCFM Variable Values Table for the licensee;
- the PCFM calculation functions will be re-run;
- all calculated values within the PCFM will be updated, including:
  - the base revenue figure for each licensee for each Formula Year of the price control period, and
  - the modelled RAV balance for each licensee;
- the PCFM will output the value of MOD for Formula Year t for each licensee.

1.12. The output value of MOD_t for the licensee will reflect the difference between the most recently calculated base revenue figures for the licensee held in the PCFM before the Annual Iteration Process and the most recent base revenue figures for the licensee held in the PCFM after the Annual Iteration Process recalculations. The PCFM calculations will apply appropriate time value of money[5]' adjustments to the calculation of MOD_t, so that the licensee will be in the same position as if adjustments to base revenue for years prior to Formula Year t had been notified to it in the Formula Year concerned.

1.13. Changes to base revenue figures calculated under the Annual Iteration Process may be upwards or downwards and, accordingly, the value of MOD_t may be positive or negative. A key point to note is that once the value of MOD has been directed for a particular Formula Year, it is not retrospectively changed as a result of a subsequent Annual Iteration Process – the value becomes a matter of record alongside the opening base revenue value for the same year.

1.14. The steps of the Annual Iteration Process are specified in Special Condition GDC 26 (Annual Iteration Process for the GD1 Price Control Financial Model).

1.15. The Authority will issue a direction to the licensee giving the value of MOD_t by 30 November in each Formula Year t-1[6]. In practice, it is expected that the value of MOD_t will be included in the direction of revised PCFM Variable Values referred to in paragraph 1.9. The value of MOD in the direction will be stated in £m to one decimal place.

1.16. The deadline of 30 November in Formula Year t-1 for the direction of PCFM Variable Value revisions and for the value of MOD_t reflects:

[5] See Glossary

[6] The first such direction will be given by 30 November 2013.

- the deadline of 31 July in Formula Year t-1 by which the licensee must submit its price control information returns (covering activity in Formula Year t-2) to Ofgem; and
- the need for the licensee to have confirmation of its allowed base revenue in time to calculate and issue its indicative use of system charges by 31 December in Formula Year t-1.

1.17. In the unlikely event that the Authority does not direct a value for MOD_t by 30 November in Formula Year t-1, paragraph 10 of Special Condition GDC 26 specifies that the value must be directed as soon as possible thereafter and that, in the meantime, the value of MOD_t shall be held to be equivalent to the value of MOD_{t-1}.

1.18. The table below shows the timings for updating the PCFM and running the Annual Iteration Process as described above.

1.19. Table [ ] timing of Annual Iteration Process

Annual iteration Process							Revenue adjustment for year MOD_t
Timing of AIP		Input and changes to the model			AIP finalisation		
Month	Regulatory year (t-1)	Latest RIGs data (t-2)	Functional cut-off	Data cut off	Provisional MOD circulated	AIP completed. MOD directed	Regulatory year (t)
There is no AIP run in Nov 2012. Final proposals determine Revenues for Regulatory year 13/14.							
Nov-13	**13/14**	31 Jul 13	30 Sep 13	31 Oct 13	15 Nov 13	30 Nov 13	**14/15**
Nov-14	**14/15**	31 Jul 14	30 Sep 14	31 Oct 14	15 Nov 14	30 Nov 14	**15/16**
Nov-15	**15/16**	31 Jul 15	30 Sep 15	31 Oct 15	15 Nov 15	30 Nov 15	**16/17**
Nov-16	**16/17**	31 Jul 16	30 Sep 16	31 Oct 16	15 Nov 16	29 Nov 16	**17/18**
Nov-17	**17/18**	31 Jul 17	30 Sep 17	31 Oct 17	15 Nov 17	30 Nov 17	**18/19**
Nov-18	**18/19**	31 Jul 18	30 Sep 18	31 Oct 18	15 Nov 18	30 Nov 18	**19/20**
Nov-19	**19/20**	31 Jul 19	30 Sep 19	31 Oct 19	15 Nov 19	30 Nov 19	**20/21**
Nov-20	**20/21**	31 Jul 20	30 Sep 20	31 Oct 20	15 Nov 20	30 Nov 20	**21/22**

1.20.

State of the GD1 Price Control Financial Model

1.21. As mentioned in paragraph 1.7, the PCFM exists as a constituent part of Special Condition GDC 57 and will be maintained by Ofgem in its official records. The state of the PCFM remains constant unless and until changed by either:

a) an Annual Iteration Process - which will change PCFM Variable Values and recalculated values which are directly or indirectly dependent upon them; or

b) a modification of the PCFM under the procedures set out in Special Condition GDC 57 (Governance of GD1 Price Control Financial Instruments).

1.22. Ofgem will keep a log of modifications to the PCFM.

1.23. A copy of the PCFM in its latest state will be maintained on the Ofgem website. This will allow licensees and other stakeholders to make copies of the PCFM so that they can:

- use their own forecasts of PCFM Variable Value revisions to forecast base revenue positions and to conduct sensitivity analysis; and
- reproduce the calculation of MOD_t by 30 November in each Formula Year t-1.

The model is designed to be as 'user friendly' as possible for this purpose.

1.24. An updated copy of the PCFM will be uploaded to the website by 30 November each year (after each Annual Iteration Process) and the file will be named "GD1 Price Control Financial Model 20XX-XX".

Error of functionality in the PCFM

1.25. In the unlikely event that an error of functionality is discovered in the PCFM, the following procedures would be followed:

- the issue would be considered at the earliest opportunity by the GD1 Price Control Financial Model Working Group (see next section) and a corrective modification determined by Ofgem;
- if the functional error had distorted the calculation of a previously directed value of the term MOD, the determined modification would include any adjustments necessary to correct for that distortion on an NPV neutral basis in the next calculation of the term MOD;
- the procedure in Special Condition GDC 57 for modifications to the PCFM would be followed;

The GD1 Price Control Financial Model Working Group

1.26. Ofgem will facilitate an industry expert working group to review issues arising with respect to the form or usage of the PCFM. The terms of reference for The GD1 Price Control Financial Model Working Group ('the working group') are set out below.

1.27. In accordance with the provisions of Part A of Special Condition GDC 57 (Governance of GD1 Price Control Financial Instruments), the Authority will have regard to any views expressed by the working group when assessing whether any proposed modification of the PCFM would be likely to have a significant impact on licensees or other stakeholders.

Terms of reference

Purpose of the working group

1.28. The purposes of the working group are:

(i). to review the ongoing effectiveness of the PCFM in producing a value for the term MOD for each Formula Year that appropriately adjusts the licensee's opening base revenue so that its allowed expenditures and performance under incentive schemes are properly reflected;

(ii). to provide, when requested by the Authority, its views to the Authority on the impact of any proposed modifications to the PCFM in accordance with Part A of Special Condition GDC 57; and

(iii). to provide such views or recommendations to the Authority with regard to the PCFM as it sees fit.

Composition

1.29. The composition of the group will be:

- Ofgem (chair);
- Ofgem (secretary);
- one representative per licensee;
- ENA representative (optional).

Timing and duration of the group's work

1.30. The working group's incumbency will run from 1 April 2013 to 31 March 2021.

1.31. The group will meet at least once between 1 January and 31 July 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 PCFM modifications (see paragraph 1.25(ii)).

1.32. Representatives may attend meetings in person, or at the discretion of the chair, through video or telephone conferencing facilities.

1.33. A meeting of the working group will be quorate, for the purpose of expressing a view or recommendation in respect of the PCFM, if at least one representative from

Ofgem, and at least two licensee representatives (each from a different licensee) are present.

Resources

1.34. 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 PCFM.

2. The GD1 Price Control Financial Methodologies

2.1. The GD1 Price Control Financial Methodologies set out in this handbook describe the basis for a range of annual adjustments to the licensee's opening base revenue allowances for the purposes of the RIIO-GD1 price control arrangements.

2.2. The main purpose of each methodology is to set out the way in which one or more PCFM Variable Values are to be revised for the purposes of the Annual Iteration Process for the GD1 Price Control Financial Model under which values of the term MOD_t are calculated (see chapter 1). Any revised PCFM Variable Values determined under the methodologies will replace (over-write) the existing values contained in the PCFM Variable Values Table for the licensee as part of the Annual Iteration Process.

2.3. The methodologies are presented in chapters 3 to 10 of this handbook, and are referenced in the associated special conditions of the licence. As constituent parts of this handbook, the methodologies are part of Special Condition GDC 57 (Governance of GD1 Price Control Financial Instruments) and are subject to the modification provisions set out in that condition.

2.4. The methodologies are subordinate to the special conditions of the licence. If there is any inconsistency between a licence condition and a methodology, then the licence condition takes precedence.

Methodologies in this handbook

2.5. The PCFM Variable Values to be determined under the methodologies in this handbook are listed in Table 1 below.

Table 2.1

No	PCFM Variable Value	Special Condition	Description	Type of variable value
	Specified financial adjustments			
1	EDE	27	Pension Scheme Established Deficit	revenue allowance
2	APFE	27	Pension Scheme Administration and PPF levy	revenue allowance
3	TTE	27	Tax liability – tax trigger events	revenue allowance
4	TGIE	27	Tax liability – gearing/interest costs	revenue allowance

No	PCFM Variable Value	Special Condition	Description	Type of variable value
5	CDE	27	Allowed percentage cost of debt	Percentage
	Totex incentive mechanism			
6	ALC	47	Actual load related capex expenditure	actual expenditure
7	AOC	47	Actual other capex expenditure	actual expenditure
8	ACO	47	Actual controllable opex	actual expenditure
9	ARE	47	Actual replacement expenditure	actual expenditure
10	ANC	47	Actual non-operational capex	actual expenditure
11	ACC	47	Contributions received	actual revenues (negative value)
	Allowed Totex expenditure adjustments			
12	IAEEPS	28	Uncertain costs – enhanced physical site security	actual expenditure
13	IAESW	28	Uncertain costs – specified street works	actual expenditure
14	IAECCB	28	Uncertain costs – connection charging boundary changes	actual expenditure
15	IAESM	28	Uncertain costs – smart metering roll out	actual expenditure
16	IAELLC	28	Uncertain costs – large load connections	actual expenditure
17	IAEFP	28	Uncertain costs – fuel poor network extensions	actual expenditure
18	IAECA	28	Uncertain costs – Central Agent	actual expenditure
19	RE	22	Mains and services replacement expenditure	allowed expenditure
20	IRM	9	Innovation roll out mechanism	allowed

No	PCFM Variable Value	Special Condition	Description	Type of variable value
				expenditure
	Legacy price control adjustments			
21	LAR	64	Legacy price control adjustments to allowed revenue	true-up revenue allowance
22	LRAV	64	Legacy price control adjustments to RAV	true-up RAV additions

2.6. Specified financial adjustments (numbers 1 to 5 in Table 2.1) relate to the adjustment mechanisms set out in the 'Finance Supporting Document' in the RIIO-GD1 Final Proposals. Overviews of the adjustments and the methodologies for determining revisions to the associated PCFM Variable Values are contained in chapters 3 to 5 of this handbook.

2.7. The Totex incentive mechanism (numbers 6 to 11 in Table 2.1) applies to any overspend or underspend by the licensee against its RIIO-GD1 Totex expenditure allowances. An overview of the mechanism and the methodology for determining revisions to the associated PCFM Variable Values is contained in chapter 6 of this handbook.

2.8. Allowed Totex expenditure adjustments (numbers 12 to 20 in Table 2.1) cover a range of Totex adjustment schemes under which allowed expenditure can be adjusted under a specified formula or through an application and assessment process. The methodologies for determining revisions to the associated PCFM Variable Values are contained in chapters 7 to 9 of this handbook.

2.9. Legacy price control adjustments relate to activities which took place in the price control period prior to RIIO-GD1 but in respect of which a financial adjustment is required because:

- the outturn data for Formula Year 2012/13 was not available when opening base revenue for the RIIO-GD1 price control;
- cost totals for items subject to true-up or logging-up were not available when opening base revenues for the RIIO-GD1 price control period were set; or
- it is possible for pre-RIIO-GD1 expenditure allowances to be adjusted under the terms of a RIIO-GD1 special condition.

Processing of different types of PCFM Variable Value under the Annual Iteration Process

2.10. In general terms, the different types of variable value specified in column 5 of Table 2.1 are processed under the Annual Iteration Process for the PCFM in the following ways:

Allowed expenditure

These amounts are modelled, subject to the Totex Capitalisation Rate, as:

- fast money – flowing directly to the base revenue figure for the Formula Year to which the allowed expenditure relates; and
- additions to the licensee's RAV in the Formula Year to which the allowed expenditure relates, generating a slow money adjustment to allowed revenues through the cost of capital return, depreciation and Totex incentive mechanism.

Revenue allowance

These amounts flow directly to the base revenue figure for the Formula Year to which the adjustment circumstance relates (although there will also be ancillary financial effects under the modelling treatment).

Percentage

This type of variable value applies to the cost of corporate debt only and revised values for Formula Year t will flow into calculations of the return on RAV component of slow money.

Actual expenditure

This type of variable value applies to the Totex incentive mechanism only and revised values affect fast and slow money calculations for the Formula Years concerned. These values will be obtained from the licensee Regulatory Reporting Pack relating to Formula Year t-2. Since the RRP contains values in nominal prices, these will be deflated to a 2009-10 price base using published RPI data so that they are consistent with the 2009-10 price base used in the PCFM.

True-up revenue allowance

These amounts will usually flow directly to the base revenue figure for Formula Year 2013-14, because they relate to activity levels or outturn values for the price control period prior to RIIO-GD1.

True-up RAV additions

These additions to the licensee's RAV will usually apply to Formula Year 2013-14, because they relate to activity levels or outturn values for the price control period prior to RIIO-GD1, and generate a slow money adjustment to allowed revenues through the cost of capital return, depreciation and Totex incentive mechanism.

2.11. During the Annual Iteration Process, appropriate automatic adjustments are also made as a consequence of revised PCFM Variable Values and the treatment summarised above. For example, the position on net debt and RAV will be automatically updated in the PCFM based on the revised VVT. This could impact on the amount of (or need for) and equity issuance (calculated in accordance with the rules included in the VVT). If the equity issuance calculation changes then the equity issuance cost allowance in automatically updated. Any change in the allowance would feed into the respective MOD calculation and be included in Revenue.

Atypical revisions

2.12. The GD1 Price Control Financial Methodologies describe the normal timing sequence for sequence for each PCFM Variable Value. For example, in relation to the driver for mains and services replacement expenditure (item 19 in Table 2.1) the normal sequence would be:

- activity level takes place in Formula Year t-2;
- activity level reported to Ofgem by 31 July in Formula Year t-1;
- revised PCFM Variable Value used in Annual Iteration Process to take place by 30 November in Formula Year t-1 (the variable value in the column equating to Formula Year t-2 on the PCFM Variable Values Table is the one which is revised, since that is when the activity level took place);
- incremental change to recalculated revenue position for Formula Year t-2 flows through to value of MODt i.e. it affects base revenue in Formula Year t.

2.13. A number of the special conditions provide for PCFM Variable Values to be directed for Formula Years outside the normal sequence. Where this is the case, the procedures are explained in the relevant methodologies in this handbook.

3. Pension allowances - financial adjustment methodologies

Part 1 - Overview

3.1. The opening base revenue allowances[7] ('PU' values) for the licensee set down in the table at Appendix 1 to Special Condition GDC 20 (Restriction of revenue in respect of the Distribution Network Transportation Activity) include allowances for:

(a) Pension Scheme Established Deficit repair expenditure; and

(b) Pension Scheme Administration and Pension Protection Fund (PPF) levy expenditure,

for each Formula Year of the RIIO-GD1 price control period.

3.2. These allowance are represented, respectively, by the opening EDE and APFE values[8] held in the PCFM Variable Values Table for the licensee, contained in the GD1 Price Control Financial Model (PCFM) and are expressed in 2009-10 prices. Opening EDE and APFE values are based on modelling assumptions and parameters applicable at the outset of the price control period, consistent with Ofgem's pension principles (see next section) and published pension funding policy.

3.3. The allowance levels will be updated during the RIIO-GD1 price control period by revising EDE and APFE values for the purposes of the Annual Iteration Process for the PCFM. This chapter sets out:

- the reasons for updating allowances;
- the methodologies for determining revised EDE and APFE values;
- the expected timing of revisions; and
- the effect on the licensee's base revenue[7] of revising EDE and APFE values for the Annual Iteration Process.

3.4. In the context of Established Deficit repair and Pension Scheme Administration/PPF costs, we refer to "allowances" rather than "allowed expenditure". This is because, subject to the reasonableness tests referred to in this chapter, EDE and APFE values are added in full to recalculated base revenue figures in the PCFM under the Annual Iteration Process – i.e. the amounts are treated as 100per cent fast money[9]. It should be noted, however, that revisions to EDE and APFE values will have ancillary effects on other calculations under the Annual Iteration Process which also feed into recalculated base revenue figures.

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[7] 'base Distribution Network Transportation Activity Revenue'

[8] as at 1 April 2013

[9] See Glossary

Price control pension principles

3.5. Ofgem's price control pension principles were set out in the March 2011 decision on strategy for the RIIO-GD1 price control[10] to which reference should be made. In summary, they include the following key points:

- customers should expect to fund the efficient cost of providing a competitive employment package including pensions costs in line with comparative benchmarks;
- customers should only fund the portion (of a wider group's pension costs) that is attributable to the gas transportation business;
- customers should not fund pension costs arising from a material failure of stewardship;
- pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice;
- under or over funding positions in preceding price control periods should be reflected in allowances, subject to being economic and efficient; and
- customers should not have to fund pension costs relating to severance arrangements.

Established Deficit

3.6. For the purposes of Special Condition GDC 27 (Specified financial adjustments) and this chapter, the term 'Established Deficit' means the difference between the assets and corresponding liabilities within a defined benefit pension scheme, sponsored by the licensee, which are:

- attributable to the licensee's transportation business; and
- attributable to pensionable service up to and including 31 March 2013.

3.7. The proportion of a wider group pension scheme deficit which is attributable to the licensee's transportation business will be determined in accordance with the deficit allocation methodology published by Ofgem in [detail of publication][11]. This amount may be adjusted by Ofgem informed by the results of the reasonableness review.

3.8. Allowances for Established Deficit repair are set at/revised to levels intended to allow the licensee to clear its Established Deficit (by making payments to the pension scheme's trustees) over a 15 year period, beginning on 1 April 2013 (the

[10] http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionfinance.pdf
[11] At [xx] October 2012 this methodology, which is being prepared jointly by the ENA and Ofgem, has yet to be finalised. It will be incorporated in the Regulatory Instructions and Guidance documents effective from 1 April 2013.

Cut-Off date) and ending on 31 March 2028. The RIIO-GD1 price control period ends on 31 March 2021, but EDE values will be determined having regard to the projected Established Deficit repair completion date of 31 March 2028.

Pension Scheme Administration and PPF levy

3.9. For the purposes of Special Condition GDC 27 and this chapter, Pension Scheme Administration means the range of activities that pension scheme trustees are required by legislation including to undertake or commission in running the pension scheme. It includes, without limitation, the keeping of scheme records, scheme management and administration, scheme policy and strategy, the provision of information to scheme members, the calculation and payment of benefits and liaison with tax and regulatory authorities, and the preparation of valuations. It does not include investment management fees which are remunerated by deduction from investment returns; or any activities which are the responsibility of the licensee, such as advisors to the licensee on managing or advising it on any and all aspects of its relationship with the trustees including recovery plans.

3.10. Pension Scheme Administration expenditure refers to payments made by the licensee to cover the proportion of scheme administration costs attributable to its transmission business. It does not refer to investment or asset management costs; which are netted into the pension fund's investment returns.

3.11. The Pension Protection Fund charges an annual levy on eligible pension schemes. PPF levy expenditure refers to payments made by the licensee to cover the proportion of this levy attributable to its transportation business.

3.12.

Costs and adjustments outside the scope of this chapter

Pension costs for service after 31 March 2013

3.13. Pension costs attributable to the licensee, but which relate to pensionable service on or after 1 April 2013 will be considered as a constituent part of labour costs for price control purposes. This includes costs relating to any incremental deficit which accrues in relation to such service, ascertained in accordance with the pension deficit allocation methodology. These costs therefore fall outside the scope of Special Condition GDC 27 and this chapter.

True-up for pension payments by the licensee in the GDPCR price control period

3.14. For the price control period preceding RIIO-GD1 (the GDPCR price control), a true-up applied to the difference between the level of pension costs included in the licensee's allowed revenues, and the actual payments made by the licensee to the pension scheme trustees. Any true-up amount not included in RIIO-GD1 opening base revenue allowances ('PU' values) will be dealt with in accordance with Special

Condition GDC 64 Legacy (price control adjustments) and chapter 10 of this handbook. Such adjustments therefore fall outside the scope of Special Condition GDC 27 and this chapter. It should be noted however, that the level of payments made by the licensee in the GDPCR price control period will have fed through to the licensee's Established Deficit position as at 1 April 2013.

Temporal conventions

3.15. For the purposes of Special Condition GDC 27 and this chapter, "Formula Year t" means the Formula Year in which a value for the term MOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's base Distribution Network Transportation Activity Revenue[12]. References to Formula t-1 etc should be construed accordingly.

3.16. A reference to, for example, *the EDE value for 2015-16* means the EDE value in the 2015-16 column of the PCFM variable Values Table for the licensee contained in the GD1 Price Control Financial Model.

Part 2 - Updating allowances through the Annual Iteration Process

3.17. The licensee's allowances for Pension Scheme Established Deficit repair and Pension Scheme Administration/PPF levy costs will be updated during the RIIO-GD1 price control period to reflect:

- Established Deficit level information contained in pension scheme valuation reports provided by the licensee to Ofgem; and
- scheme administration and PPF costs information contained in the licensee's price control review information submitted to Ofgem.

3.18. It is anticipated that EDE and APFE values will be revised on two occasions during the RIIO-GD1 price control period, driven by the triennial scheme valuation cycle indicated in the timetable below.

Table 3.1 - Expected timetable for EDE and APFE value revisions

Actuarial defined benefit pension scheme valuation as at	Expected receipt by Ofgem	Reasonableness of costs review completed	Revised EDE and APFE values directed for Annual Iteration Process no later than:	EDE values revised for Formula Year	APFE values revised for Formula Year

[12] See Special Condition GDC 20 (Restriction of revenue in respect of the Distribution Network Transportation Activity).

31 March 2013	June 2014	30 September 2014	30 November 2014	2015-16 onwards	2013-14
31 March 2016	June 2017	30 September 2017	30 November 2017	2018-19 onwards	2014-15 to 2016-17
31 March 2019	June 2020	30 September 2020	n/a	n/a	n/a

3.19. For licensee's whose scheme triennial valuation dates are different from those shown in the first column of Table 3.1, reference will be made to deficit information provided in their most recent preceding scheme full triennial valuation. Asset and liabilities amounts will be rolled forwarded on a basis consistent with the actuarial methodology used for the valuation, Ofgem's pension deficit allocation methodology and the particular scheme's statement of funding principles.

3.20. Ofgem will direct revised values for EDE and APFE values at other times, if that is necessary to reflect any revised timetable of information availability or process completion. However, in those circumstances, EDE and APFE values would still be determined in accordance with the procedures set out in this chapter.

3.21. As set out in paragraph 3.4, revised EDE and APFE values feed directly into the recalculated base revenue figures in the PCFM for applicable Formula Years through the annual iteration process. Incremental changes to recalculated base revenue figures for years earlier than Formula Year t will, subject to a time value of money adjustment, be brought forward and reflected in the calculation of the term MOD to be directed for Formula Year t. For the avoidance of doubt, such a revision will not have any retrospective effect on a previously directed value of the term MOD.

Reasonableness review

3.22. After receiving each data set, or substantially all of each data set, of scheme valuations, Ofgem will commission an independent review of the reasonableness of the Established Deficit position for each tranche of scheme valuations. The expected completion times for the reasonableness reviews due to take place during the RIIO-GD1 price control period are shown in Table 3.1. The data set comprises:

- the actuarial valuation of the licensee's pension scheme(s), either a full triennial valuation as at the date specified or an updated valuation of the last preceding full triennial valuation with the asset and liability values rolled forward as defined in the pensions deficit allocation methodology document;
- the schemes statement of funding principles;
- the schemes statement of investment principles; and
- the completed deficit allocation methodology tables and other pension data tables and supporting documents specified in the price control review cost information regulatory instructions and guidance (RIGs) document

3.23.

Part 3 – Established Deficit repair allowances

Determination and direction of revised EDE values by 30 November 2014

3.24. Subject to paragraph 3.2X, revised EDE values will be determined by 30 November 2014 for each Formula Year from 2015-16 to 2020-21 using the methodology set out in Table 3.2 below.

Table 3.2 - Process for determining revised EDE values to be directed by 30 November 2014

Row	Timing	Event	Value
1	By 30 June 2014	Ofgem obtains the actuarial scheme valuation for the licensee's defined benefit pension scheme as at 31 March 2013 and commences a reasonableness review.	"A"
2	By 31 July 2014	Ofgem receives price control review information from licensee covering Formula Year 2013-14.	
3	By 30 September 2014	Licensee submits deficit allocation information and indicative Established Deficit figure.	
4	By 31 October 2014	Ofgem carries out reasonableness review of information submitted by licensee and determines Cut-Off Date Established Deficit position as at 31 March 2013.	
5		Cut-Off Date Established Deficit amount deflated to 2009-10 prices using actual RPI data [insert basis of deflation from nominal prices] determined in accordance with paragraph 1.7.	"B"
6	By 31 October 2014	Remaining deficit repair period established as 13 years (2027-28 minus 2014-15)	
7		Annual Established Deficit repair allowance in 2009-10 prices computed as: = "B" / ((1-(1+DR)^ -13) / LN(1+DR)) Where: DR is the discount rate determined by Ofgem through a benchmarking process against median pre-retirement	"C"

<table>
<tr><td></td><td></td><td>discount rates for occupational pension schemes in Great Britain; and
LN returns the natural logarithm of the subject value.
If there is a surplus shown by the valuation, B and C are set to zero and paragraph 3.26 below applies.</td><td></td></tr>
<tr><td colspan="3">Adjustment relating to licensee payment history in RIIO-GD1 period</td><td></td></tr>
<tr><td>8</td><td rowspan="4">By 31 October 2014</td><td>Obtain relevant portion (i.e. the portion attributable to the licensee's distribution business) of actual deficit repair payment made by licensee in 2013-14 and, subject to any adjustments arising from Ofgem's reasonableness review, deflate to 2009-10 prices using actual RPI data [insert basis of deflation from nominal prices determined in accordance with paragraph 1.7.</td><td>"D"</td></tr>
<tr><td>9</td><td>Deduct the pre-existing EDE value for Formula Year 2013-14 from "D" to give the difference between pre-existing allowance and actual payment.</td><td>"E"</td></tr>
<tr><td>10</td><td>Annual adjustment amount in 2009-10 price computed as:

=value "E" / ((1-(1+DR)^ -13 / LN(1+DR))

where
DR is the discount rate determined by Ofgem through a benchmarking process against median pre-retirement discount rates for occupational pension schemes in Great Britain; and
LN returns the natural logarithm of the subject value.
The value "F" may be either positive (if actual payments at "D" are greater than the pre-existing allowance), or negative (if actual payments at "D" are less than the pre-existing allowances).</td><td>"F"</td></tr>
<tr><td>11</td><td>Revised EDE value for each Formula Year from 2015-16 to 2020-21 determined as "C" + "F".
Note 2015-16 will remain the first Relevant Year in the event that the adjustment is delayed by one or more years.</td><td></td></tr>
</table>

3.25. The adjustment contained in Row 10 of Table 3.2 deals with a situation where the licensee has previously paid across more, or less, than the allowance (EDE value) it was given for a particular Formula Year.

Scheme surplus

3.26. If the difference between the assets and corresponding liabilities referred to in paragraph 3.6 represents a surplus position as at as at 31 March 2013, then EDE values for Formula Years from 2015-16 onwards will be revised to zero pending the next review process set out in Table 3.3. The policy position with regard to pension scheme surpluses is set out in the March 2011 Strategy document ~~[published policy]~~ and, as applicable, the relevant Final Proposals.

Determination and direction of revised EDE values by 30 November 2017

3.27. Subject to paragraph 3.29, revised EDE values will be determined by 30 November 2017 for each Formula Year from 2018-19 to 2020-21 using the methodology set out in Table 3.3 below.

Table 3.3 - Process for determining revised EDE values to be directed by 30 November 2017

Row	Timing	Event	Value
1	By 30 June 2017	Ofgem obtains the actuarial scheme valuation for the licensee's defined benefit pension scheme(s as at 31 March 2016 and commences a reasonableness review.	"A"
2	By 31 July 2017	Ofgem in receipt of price control review information from licensee covering Formula Years 2014-15; 2015-16 and 2016-17.	
3	By 30 September 2017	Licensee submits deficit allocation information and indicative Established Deficit figure.	
4	By 31 October	Ofgem carries out reasonableness review of information submitted by licensee and determines Established Deficit position as at 31 March 2016.	
5		Established Deficit amount deflated to 2009-10 prices using actual RPI data determined in accordance with paragraph 1.7.	"B"
6		Remaining deficit repair period established as 10 years (2027-28 minus 2017-18)	

7	2017	Annual Established Deficit repair allowance in 2009-10 prices computed as: = “B” / ((1-(1+DR)^ -10) / LN(1+DR)) Where: DR is the discount rate determined by Ofgem derived through a benchmarking process against energy network operators pre-retirement discount rates as applied in their valuations at “A” and moderated against similar rates reported by occupational pension schemes in Great Britain; and LN returns the natural logarithm of the subject value. If there is a surplus shown by the valuation B and C are set to zero and paragraph 3.29 below applies.	“C”
Adjustment relating to licensee payment history in RIIO-GD1 period			
8	By 31 October 2017	Obtain relevant portion (i.e. the portion attributable to the licensee’s transmission business) of actual deficit repair payments made by licensee during 2014-15; 2015-16 and 2016-17 and, subject to any adjustments arising from Ofgem’s reasonableness review, deflate to 2009-10 prices using actual RPI data determined in accordance with paragraph 1.7.	“D”
9		Deduct the total of pre-existing EDE values for Formula Years 2014-15; 2015-16 and 2016-17 from “D” to give the difference between pre-existing allowances and actual payments.	“E”
10		Annual adjustment amount in 2009-10 price computed as: =value “E” / ((1-(1+DR)^ -10 / LN(1+DR)) where DR is the discount rate determined by Ofgem derived through a benchmarking process against energy network operators pre-retirement discount rates as applied in their valuations at “A” and moderated against similar rates reported by occupational pension schemes in Great Britain; and LN returns the natural logarithm of the subject value. The value “F” may be either positive (if actual payments at “D” are greater than the pre-existing allowance), or negative (if actual payments at “D” are less than the pre-existing allowances).	“F”
11		Revised EDE value for each Formula Year from	

		2018-19 to 2020-21 determined as "C" + "F"	

3.28. The adjustment contained in Row 10 of Table 3.3 deals with a situation where the licensee has previously paid across more, or less, than the allowance (EDE value) it was given for a particular Formula Year.

Scheme surplus

3.29. If the difference between the assets and corresponding liabilities referred to in paragraph 3.6 represents a surplus position as at as at 31 March 2016, then EDE values for Formula Years from 2018-19 onwards will be revised to zero pending the next triennial determination. The policy position with regard to pension scheme surpluses is set out in Ofgem's pension principles in the March 2011 Strategy document and, as applicable, the relevant Final Proposal.

Determination and direction of revised EDE value by 30 November 2020

3.30. Subject to paragraph 3.32, revised EDE value will be determined by 30 November 2020 for each Relevant Year from 2021-22 to 2023-24 using the methodology set out in Table 3.4 below.

Table 3.4 - Process for determining revised EDE values to be directed by 30 November 2020

Row	Timing	Event	Value
1	By 30 June 2020	Ofgem obtains the actuarial scheme valuation for the licensee's defined benefit pension scheme(s) as at 31 March 2019 and commences a reasonableness review.	"A"
2	By 31 July 2020	Ofgem in receipt of price control review information from licensee covering Relevant Years 2017-18; 2018-19 and 2019-20.	
3	By 30 September 2020	Licensee submits deficit allocation information and indicative Established Deficit figure.	
4	By 31 October 2020	Ofgem carries out reasonableness review of information submitted by licensee and determines the Established Deficit position as at 31 March 2019.	
5		Established Deficit amount deflated to 2009-10 prices using actual RPI data determined in accordance with paragraph 1.7.	"B"
6		Remaining deficit repair period established as 6 years (2026-27 minus 2020-21)	

7		Annual Established Deficit repair allowance in 2009-10 prices computed as: = “B” / ((1-(1+DR)^ - 6) / LN(1+DR)) Where: DR is the discount rate determined by Ofgem through a benchmarking process against moderated median pre-retirement discount rates for occupational pension schemes in Great Britain; and LN returns the natural logarithm of the subject value If there is a surplus shown by the valuation B and C are set to zero and paragraph 3.33 below applies.	“C”
Adjustment relating to licensee payment history in RIIO-ET1 period			
8	By 31 October 2020	Obtain relevant portion (ie the portion attributable to the licensee’s transmission business[13]) of actual deficit repair payments made by licensee during 2017-18; 2018-19 and 2019-20 and, subject to any adjustments arising from Ofgem’s reasonableness review, deflate to 2009 prices using actual RPI data determined in accordance with paragraph 1.7.	“D”
9		Deduct the total of pre-existing EDE/SOEDE values for Relevant Years 2017-18; 2018-19 and 2019-20 from “D” to give the difference between pre-existing allowances and actual payments.	“E”
10		Annual adjustment amount in 2009-10 price computed as: =value “E” / ((1-(1+DR)^ -6 / LN(1+DR)) where DR is the discount rate determined by Ofgem through a benchmarking process against moderated median pre-retirement discount rates for occupational pension schemes in Great Britain; and LN returns the natural logarithm of the subject value. The value “F” may be either positive (if actual payments at “D” are greater than the pre-existing allowance), or negative (if actual payments at “D” are less than the pre-existing allowances).	“F”

[13] Split into TO and SO for NGET

11		Revised EDE/SOEDE value for each Relevant Year from 2021-22 to 2022-27 determined as "C" + "F"	

3.31. The adjustment contained in Row 10 of Table 3.4 deals with a situation where the licensee has previously paid across more, or less, than the allowance (EDE value) it was given for a particular Relevant Year.

Scheme surplus

3.32. If the difference between the assets and corresponding liabilities referred to in paragraph 3.5 represents a surplus position as at as at 31 March 2019, then EDE value for Relevant Years from 2021-22 onwards will be revised to zero pending the next triennial scheme valuation. The policy position with regard to pension scheme surpluses is set out in the March 2011 Strategy document and, as applicable, the relevant Final Proposals

Part 4 - Pension Scheme Administration and PPF levy allowances

3.33. The licensee's actual costs in respect of scheme administration costs and PPF levies will be reported under the annual Regulatory Reporting cycle in accordance with Standard Special Condition A40 (Price Control Review Information) of the licence.

3.34. Revised APFE values will be determined in accordance with the steps set out below by 30 November 2017 for years 2015-16 and 2016-17.

Values to be directed by 30 November 2017

(i). The actual aggregated Pension Scheme Administration and PPF levy expenditure reported by the licensee in its price control review information submissions for Formula Years 2014-15, 2015-16 and 2016-17 will be obtained.

(ii). The expenditure amounts in (i) will be deflated to 2009-10 prices using actual RPI data.

(iii). The actual deflated expenditure figure for any Formula Year in (ii) is added to the annual adjustment threshold amount of £1m.

(iv). The aggregate price control allowance for Pension Scheme Administration and PPF levy expenditure for that year set out in the relevant Final Proposals is obtained.

(v). If the amount referred to in step (iii) is exceeded in any specified Formula Year, the excess amount only will be added to the pre-existing amount allowance at the price control for that item.

(vi). If a the amount at (iii) is less than the pre-existing price control allowed value at (iv), then no revision to the price control value will be made.

(vii). The excess at (v) will be added to the pre-existing APFE and APFE values to determine the revised APFE and SOAPFE values for Formula Years 2014-15, 2015-16 and 2016-17.

(viii). Ofgem will review Pension Scheme Administration and PPF levy costs based on actual costs incurred in previous years and known changes to the PPF levies advised by the PPF and, subject to them being considered efficient, reset the existing constituent costs; and the combined existing APFE values for Formula Years 2017-18, 2018-19 and 2019-20.

Values to be directed by 30 November 2020

(i). The actual aggregated Pension Scheme Administration and PPF levy expenditure reported by the licensee in its price control review information submissions for Formula Years 2017-18, 2018-19 and 2019-20will be obtained.

(ii). The expenditure amounts in (i) will be deflated to 2009-10 prices using actual RPI data.

(iii). The actual deflated expenditure figure for any Formula Year in (ii) is added to the annual adjustment threshold amount of £1m.

(iv). The aggregate price control allowance for Pension Scheme Administration and PPF levy expenditure for that year set out in the relevant Final Proposals is obtained.

(v). If the amount referred to in step (iii) is exceeded in any specified Formula Year, the excess amount only will be added to the pre-existing amount allowance at the price control for that item.

(vi). If a the amount at (iii) is less than the pre-existing price control allowed value at (iv), then no revision to the price control value will be made.

(vii). The excess at (v) will be added to the pre-existing APFE and APFE values to determine the revised APFE value for Formula Years 2017-18, 2018-19 and 2019-20.

(viii). Ofgem will review Pension Scheme Administration and PPF levy costs based on actual costs incurred in previous years and known changes to the PPF levies advised by the PPF and, subject to them being considered efficient, reset the existing constituent costs; and the combined existing APFE values for Formula Years 2020-21, 2021-22 and 2022-23.

Direction of revised APFE values

3.35. The Authority will direct revised APFE values no later than 30 November 2017 and 30 November 2020 in accordance with the procedure set out in Part D of Special Condition GDC 27.

Part 5 - Processing of revised EDE and APFE values under the Annual Iteration Process

3.36. EDE and APFE values, as revised are added in full to recalculated base revenue figures in the PCFM under the Annual Iteration Process and are treated as 100 per cent fast money. Revisions to EDE and APFE values will have ancillary effects on other calculations under the Annual Iteration Process which also feed into recalculated base revenue figures.

3.37. Incremental changes to recalculated base revenue figures for years earlier than Formula Year t will, subject to a time value of money adjustment, be brought forward and reflected in the calculation of the term MOD to be directed for Formula Year t. For the avoidance of doubt, such a revision will not have any retrospective effect on a previously directed value of the term MOD.

3.38. EDFE and APFE values are not added to RAV and are not subject to the Totex Incentive Mechanism.

4. Tax liability allowances - financial adjustment methodologies

Part 1 - Overview

4.1. The opening base revenue allowances ('PU' values) for the licensee set down in the table at Appendix 1 to Special Condition GDC 20 (Restriction of revenue in respect of the Distribution Network Transportation Activity) include tax liability allowances which are modelled at the outset of the price control period to take account of:

(c) existing and announced corporation tax rates and writing down allowance rates;

(d) existing legislation, case law, accounting standards and HM Revenue & Customs (HMRC) policy; and

(e) modelled levels of gearing and corporate debt interest payments.

4.2. Part B of Special Condition GDC 27 provides for adjustments to be made to the licensee's tax liability allowances[14] during the price control period through the Annual Iteration Process for the GD1 Price Control Financial Model. Changes to the factors referred to at sub-paragraphs 5.1(a) and (b) are referred to as 'tax trigger events' and the methodology for adjustments is set out in Part 2 of this chapter. Changes in respect of the factors referred to at sub-paragraph 5.1(c) are referred to as 'tax clawbacks' and the methodology for adjustments is set out in Part 3 of this chapter.

Temporal conventions

4.3. For the purposes of Special Condition GDC 27 and this chapter, "Formula Year t" means the Formula Year in which a value for the term MOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's base Distribution Network Transportation Activity Revenue[15].

Annual Iteration process

4.4. The updating of the licensee's tax liability allowances and regulatory tax losses balance is carried out through the Annual Iteration Process for the GD1 Price Control Financial Model. The Variable Values Table for the licensee contained in the GD1

[14] References in this chapter to tax liabilities are references to liabilities for corporation tax only and not to any other type of taxation.

[15] See Special Condition GDC 20 (Restriction of revenue in respect of the Distribution Network Transportation Activity).

PCFM contains rows for PCFM Variable Values for tax liability allowance adjustments driven by:

- tax trigger events ('TTE' values); and
- tax clawbacks ('TGIE values').

4.5. TTE and TGIE values represent £m amounts. As at 1 April 2013, the TTE and TGIE values for the licensee, for each Formula Year will be zero. Part B of Special Condition GDC 27 (Specified financial adjustments) provides for any revisions to TTE and TGIE values to be directed after determination under the methodologies in this chapter.

4.6. Revisions to TTE and TGIE values feed into the recalculated base revenue figures and/or the regulatory tax loss balances for applicable Formula Years in the GD1 PCFM, through the Annual Iteration Process. Incremental changes to recalculated base revenue figures for years earlier than Formula Year t are, subject to a time value of money adjustment, brought forward and reflected in the calculation of the term MOD to be directed for Formula Year t. For the avoidance of doubt, such changes will not have any retrospective effect on a previously directed value of the term MOD.

4.7. It should be noted that underlying tax liability allowances for the licensee within the GD1 PCFM might also be changed under the Annual Iteration Process as a consequence of other variable value changes, such as increases in allowed Totex expenditure. However, these changes are distinct from the specific adjustments to tax liability allowances under the methodologies in this chapter. . The allocation assumptions of the component elements of allowed Totex expenditure to capital allowance pools and revenue in the PCFM as set out in the Final Proposals will not be updated in the price control period.

Price bases for tax calculations

4.8. The GD1 PCFM works in constant 2009-10 prices, with all inputs and outputs in this price base. Where applicable, financial amounts which are expressed in later, nominal prices, will be deflated to 2009-10 prices on the basis of actual RPI data before being used to determine revised TTE and TGIE values.

4.9. The GD1 PCFM uses nominal prices for some internal tax calculation functions. For this purpose, the model refers to RPI forecast values set at the outset of the price control period and hard coded into the model.

Regulatory tax losses

4.10. In some instances, the approach to calculating tax liability allowances could imply that the licensee should receive a negative allowance. In such cases, the price control treatment is to model a zero allowance and to record what would have been the negative allowance as a 'regulatory tax loss' figure, to be deducted from any tax liability allowances which would otherwise be allocated to the year concerned or to later years. The regulatory tax loss balance attributable to each Formula Year (together with a running total) is held within the GD1 PCFM and regulatory tax losses are referred to where applicable in the methodologies in this chapter.

Group tax arrangements

4.11. For the purposes of the methodology set out in Part 2 of this chapter, tax liabilities, allowances and trigger events are considered on a notional 'licensee business' basis, and consequently the following are disregarded in the assessment of tax liabilities and allowances for price control purposes:

- the claim or surrender of group tax relief (including consortium relief);
- interest payments and receipts which are not tax deductible or chargeable under HMRC rules for the purposes of computing the licensee's taxable profits, including adjustments for transfer pricing and debt cap adjustments; and
- any other adjustments required in appendix 1 of the July 2009 decision letter.

4.12. For the purposes of the methodology set out in Part 3 of this chapter, levels of debt, interest and gearing are considered at licensee level or, for National Grid Gas each of its distribution networks level, as opposed to any other level with respect to the corporate or ownership group of which the licensee is a member.

Part 2 - Adjustments driven by tax trigger events - methodology

4.13. The methodology set out in this Part provides for the licensee's tax liability allowances to be updated (subject to a threshold described below) to take account of tax trigger events. This means that consumers will derive a benefit when tax liability costs fall materially, and the licensee and its shareholders will be appropriately reimbursed when they rise.

Tax trigger events

4.14. There are two types of tax trigger event for the purposes of tax liability allowance adjustments:

Type A

Type A events consist of:

- changes to corporation tax rates, applicable to one or more Formula Years; and
- changes to capital allowance rates applicable to one or more Formula Years.

<u>Type B</u>

Type B events consist of other factors (exogenous to the licensee, its owners or controllers) which cause a change to the licensee's notional tax liabilities for one or more Formula Years including:

- changes to applicable legislation;
- the setting of legal precedents through case law;
- changes to HMRC interpretation of legislation; and
- changes in accounting standards, including any deferral of the Accounting Standard Board's (ASB) implementation date for Financial Reporting Exposure Draft 48 (FRED48)[16].

4.15. Where a Type B event changes the allocation of allowable expenditure into different or introduces new capital allowance pools, the model will only be updated for the scale of the change driven by the policy and the applicable allowance rates will be adjusted to the new expected allocation basis from the introduction of a new capital allowance pool or pools. There is no adjustment of allocations to licensee's actual allocations for relevant years up to the date of the change,

4.16. Type B events will only be taken into account where the licensee has demonstrably used all reasonable endeavours to minimise any increase in its tax liabilities.

Materiality threshold and 'deadband'

4.17. A materiality threshold is applied to tax trigger events during the price control period and a £m threshold amount for each Formula Year is included amongst the fixed values on the Tax Trigger sheet for the licensee in the GD1 PCFM.

4.18. The materiality threshold for each Formula Year is fixed for the period of the price control. The threshold is determined as the greater of:

- 0,33 per cent of opening base revenue allowances ('PU' values) for the licensee set down in the table at Appendix 1 to Special Condition GDC 20 (Restriction of revenue in respect of the Distribution Network Transportation Activity); and
- the effect of a one per cent change in the rate of corporation tax,

on the opening values of the PU term for each Formula Year.

[16] FRED48 The Financial Reporting Standard applicable to UK and Republic of Ireland published by ASB January 2012, which is expected to become FRS102

4.19. A change to tax liability allowances for a particular Formula Year is only applied where one or more trigger events result in a change to the licensee's tax liabilities for that year (upward or downward) by an amount which is greater than the threshold amount. Furthermore, any change to the tax liability allowance (upward or downward) is limited to the amount which is in excess of the threshold amount for the year concerned.

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

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

Accounting standards

4.22. The licensee's tax liability calculations are subject to:

- specific legislative requirements;
- case law;
- HMRC interpretation of legislation; and
- changes in accounting standards, including any deferral of the Accounting Standard Board's (ASB) implementation date for Financial Reporting Exposure Draft 48 (FRED48)[17] requirements of the accounting framework applicable to preparation of the licensee's statutory accounts[18]

4.23. The accounting frameworks to be applied by the licensee for the purpose of computing tax liabilities are:

- UK GAAP in respect of Formula Years 2013-14 and 2014-15; and
- for each subsequent Formula Year either:
    - EU-IFRS, if adopted for use by the licensee; or
    - UK GAAP (under Financial Reporting Standard 102, as it should be known as on the implementation of FRED48).

Notification of tax trigger events

[17] FRED48 The Financial Reporting Standard applicable to UK and Republic of Ireland published by ASB January 2012, which is expected to become FRS102
[18] Section 385 of the Companies Act 2006 refers.

Type A trigger events

4.24. Ofgem will, by 30 September in each Formula Year t-1, notify the licensee of the Type A trigger events which it proposes to take into account in determining any revised TTE values for use in the Annual Iteration Process that is required to take place by 30 November in that same Formula Year t-1. It is, however, open to the licensee to contact Ofgem in advance of 30 September in each relevant year to discuss the current view of Type A events. If Ofgem does not notify the licensee by 30 September in any year, the adjustments will be made in the subsequent year.

4.25. The notification from Ofgem will specify the corporation tax rate change(s) or changes to rates of capital allowances concerned and the Formula Years to which they relate.

4.26. If, after receiving the notification referred to in paragraph 5.20, the licensee considers that a Type A trigger event has occurred, which has not been included in the notification, it should contact Ofgem within 14 days and provide details of the event concerned. If Ofgem agrees that a further Type A trigger event has occurred, it will notify the licensee by 31 October in the same Formula Year t-1.

4.27. If any Type A trigger event is left out of account when it ought to have been included in the determination of a revised TTE value (either because it was not included in a notice or otherwise) the position will be rectified in a subsequent revision of the TTE value(s) concerned. In such a case, the functionality of the PCFM means that a time value of money adjustment would be applied.

Type B trigger events

4.28. The licensee must notify Ofgem by 30 September in each Formula Year t-1 of all the Type B trigger events that it becomes aware of, except those which have been previously reported. This requirement applies equally to events which could be expected to increase or to reduce the licensee's tax liability allowances.

4.29. If the licensee fails to notify Ofgem of any events it becomes aware, or should be aware of, which potentially or actually increases in the licensee's tax liability it will not be made retrospective nor made PV neutral. If the failure relates to a reduction in the licensee's tax liability, then subject to the licensee demonstrating that it uses all reasonable endeavours to identify all Type B trigger events this may not be held a breach of the licence conditions. . We will deal with each event on its merits on a case-by-case basis.

4.30. The notification referred to in paragraph 4.28 should include, in respect of each Type B trigger event:

(a) a description of the event;

(b) the change in tax liabilities which the event is considered to cause and the Formula Years to which they relate;

(c) the calculations (including all relevant parameters and values) which the licensee used to arrive at the amounts referred to in sub-paragraph b);

(d) any relevant information provided by HMRC in relation to the event;

(e) evidence of mitigating measures which the licensee has taken to minimise any additional liabilities arising from the event; and

(f) whether licensee agrees or disagrees with HMRC, whether they may contend it; and how they intend to report it in the tax submissions.

4.31. The licensee’s notification should also state whether the licensee considers that the materiality threshold (see paragraph 4.17) has been exceeded for the Formula 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.

4.32. Ofgem will review any notifications given to it by the licensee under paragraph 4.28 and may ask the licensee:

- for additional information in respect of one or more of the notified events; and/or
- to submit the results of limited scope audit procedures, specified by Ofgem and carried out by the licensee’s appropriate auditors[19], to assist in confirming the appropriateness and accuracy of the licensee’s calculations.

4.33. Ofgem will inform the licensee by 31 October in the same Formula Year t-1 whether, in respect of each Type B trigger event:

- it has agreed the change in tax liabilities figure calculated by the licensee;
- it has determined a different change in tax liabilities figure from that calculated by the licensee; or
- it has decided that consideration of any change in tax liabilities should be deferred until further/better information is available.

4.34. Where Ofgem determines a different change in 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 must consider.

4.35. Ofgem will also notify the licensee by 31 October in each Formula Year t-1, of any Type B trigger events that it proposes to take into account but which have not

[19] As defined in Standard Special Condition A3 of the Gas Transporter Licence

been included in a notification sent to Ofgem by the licensee. The licensee has the right to reply setting out its objections, which Ofgem must consider.

4.36. The final quantification and adjustment for any type B trigger event will be deemed to have occurred when the licensee and HMRC conclude the agreement of the licensee's tax liabilities for the relevant Formula Year concerned. The adjustment to TTE values will be directed in accordance with paragraphs 4.41 and 4.42.

Logging of trigger events

4.37. Ofgem will keep a log of tax trigger events which have been subject to notifications by it or by licensees showing for each event:

- a description of the event and whether it was Type A or Type B;
- the name of the party who notified the event (Ofgem or licensee);
- the date of notification;
- the amount of any change in the licensee's tax liabilities which has been determined under the procedures set out below; and
- details of any events for which a determination is in abeyance and a description of the outstanding actions to be taken.

Determination and direction of revised TTE values

Determination of revised TTE values using the tax trigger calculation tool

4.38. The design of the GD1 PCFM includes additional functionality meaning that a copy of the GD1 PCFM (held on Ofgem's website) can be used as a tax trigger calculation tool, as an adjunct to the Annual Iteration Process.

4.39. After 31 October in each Formula Year t-1, Ofgem will generate a *duplicate copy* of the GD1 PCFM, in its state following the last completed Annual Iteration Process (but including any subsequent functional modifications under Special Condition GDC 57) for use as the tax trigger calculation tool. It will then take the following steps to determine TTE values for each licensee:

a) the 'Tax allowance before tax trigger' amount for the licensee for each Formula Year shown on the tax trigger worksheet will be noted;

b) the PCFM copy will be put into 'tax trigger tool mode' using the selector on the User Interface worksheet;

c) all of the other PCFM Variable Value revisions which have been determined for use in the prospective Annual Iteration Process (and which Ofgem expects to include in the notices of proposed Variable Value revisions to licensees) will be applied to the Variable Values Table;

d) all of the existing TTE values will be re-set to zero;

e) any existing values in the yellow input cells on the tax trigger worksheet will be cleared with the exception of the tax deadband values;

f) changes to corporation tax rates or writing down allowance rates (reflecting Type A trigger events) will be input into the yellow input cells in the appropriate rows and Formula Year columns on the tax trigger worksheet;

g) the tax trigger macro calculation programmed into the workbook will be run;

h) the aggregate changes to the licensee's tax liabilities determined in respect of all Type B trigger events (whether notified during Formula Year t-1 or on an earlier occasion) will be input into the yellow input cells on the 'Type B event values' row in the appropriate Formula Year columns on the tax trigger worksheet;

i) the tax trigger macro calculation will be re-run;

j) the new 'Tax allowance' amount for the licensee shown on the tax trigger worksheet will be noted – this is displayed net of the deadband amount which is also calculated under the macro calculation;

k) the difference between the 'Tax allowance before tax trigger' referred to at point (i) and the new 'Tax allowance' referred to at point (x) will be calculated as a £m amount, for the licensee for each Formula Year.

4.40. Subject to paragraph 4.41, the amounts calculated under step (xi) will then be determined to be the TTE values for the licensee for each Formula Year. Where these values differ from the TTE values shown on the Variable Values Table for the licensee in the GD1 PCFM (following the last completed Annual Iteration Process), Ofgem will direct that the TTE values concerned are to be changed in accordance with the process set out in Part B of Special Condition GDC 27 and referred to below.

4.41. The process set out in paragraph 4.39 will be re-performed, if any of the prospective PCFM Variable Values, referred to at step 'c)' are changed, to ensure that accurate TTE values are available for the annual iteration process.

Notes on the tax trigger calculation

- The two stage calculation process referred to in steps (vii) and (ix) allows the tax trigger calculation tool to take full account of the interrelationship between Type A and Type B events.
- The nullification of existing TTE values referred to in step (iv) together with the inclusion of all determined changes to the licensee's tax liabilities referred to in step (viii) ensures that the determination of TTE values under step (xi) is on a consistent basis and accurately applies the materiality threshold/ deadband applicable to each Formula Year.
- the inclusion of all available revisions to other PCFM Variable values under step (iii) ensures that the tax allowance calculation is as up to date as possible for each Formula Year.

Direction of revised TTE values

4.42. The Authority will direct any revisions to TTE values for the licensee by 30 November in each Formula Year t-1, having given the licensee at least 14 days notice of the values which it proposes to direct.

4.43. Revised TTE values can be directed in respect of a particular Annual Iteration Process for any Formula Year during the price control period, including for years later than year t.

4.44. The procedure for the Authority's direction of revised TTE values is set out in Part D of Special Condition GDC 27.

Part 3 - Adjustments driven by gearing levels and corporate debt interest costs ('tax clawback') - methodology

4.45. At the outset of the price control period, modelling assumptions are made about financing requirements, gearing levels and corporate debt costs for the licensee's business. These result in modelled levels of tax deductible interest costs and tax relief for the licensee.

4.46. If the licensee operates at a higher level of gearing than the modelled level, it stands to benefit from the tax value of higher levels of deductibility. We apply a mechanism which 'claws back' this benefit for consumers by updating the licensee's tax liability allowances using the methodology set out in this Part. It should be noted that there is no provision to give additional tax allowances to the licensee if it chooses to operate at a level of gearing lower than the modelled one.

Determination and direction of revised TGIE values

4.47. As a function of each Annual Iteration Process of the PCFM, for each year in the period 2013-14 to 2010-21 inclusive, updated figures for the expected amount of tax deductible interest payable by the licensee is calculated. These are shown as core and non-core elements in the Finance and Tax worksheet.

4.48. After 31 October in each Relevant Year, Ofgem will obtain the most recently modelled figure for tax deductible interest payable by the licensee in Formula Year t-2, and all prior years from a copy of the GD1 PCFM, in its state following the last completed Annual Iteration Process (but including any functional modifications under Special Condition GDC 57).

4.49. The licensee is required to submit its price control cost reporting pack by 31 July in each Formula Year t-1[20], in accordance with standard special condition A40 (Price Control Review Information) of the gas transporter's licence and the Price Control Cost Reporting Rules: Instructions & Guidance ('RIGs') issued under that condition.

4.50. Ofgem will obtain from the 'tax clawback data table' that submission:

(i). the licensee's view of adjusted net debt figure as at 31 March in Formula Year t-2 for the purposes of this calculation; and

(ii). the adjusted amount of tax deductible net interest payable by the licensee during Formula Year t-2, measured on an accruals basis.

4.51. The criteria, which the licensee must observe in reporting each of these adjusted items, are set out in the decision letter dated 31 July 2009 and Ofgem reviews the licensees reporting in this regard.

4.52. Ofgem will obtain from the PCFM the licensee's indicative RAV (including any Shadow RAV) balance as at 31 March in Formula Year t-2;

<u>Applicability tests</u>

4.53. Ofgem will use two tests – gearing level test and a positive tax benefit test - to see whether there is a revised TGIE value for the licensee in respect of Formula Year t-2.

Gearing level test

4.54. Ofgem will divide the licensee's net debt figure as at 31 March in Formula Year t-2 (see paragraph 4.48(i)) into the licensee's indicative PCFM RAV (including any Shadow RAV) balance as at 31 March in Formula Year t-2 (see paragraph 4.50) to obtain an actual calculated gearing ratio.

4.55. If the actual calculated gearing ratio established under paragraph 4.52, expressed as a percentage, is lower than the notional level of gearing then:

- if the existing TGIE value is zero, no revised TGIE value is determined; or
- if the existing TGIE value is not zero, it is revised to zero.

4.56. If the actual calculated gearing ratio established under paragraph 4.52, expressed as a percentage, is greater than the notional level of gearing then the positive benefit test will be performed.

[20] subject to any changes to Standard Special Condition A40 (Price Control Review Information)

Positive benefit test

4.57. Ofgem will subtract the aggregate of Core and non-Core modelled figures for tax deductible interest payable by the licensee in Formula Year t-2 (see paragraph 4.46) from the adjusted tax deductible interest payable reported by the licensee (see paragraph 4.48(ii)) for Formula Year t-2. If the resultant amount is positive then the clawback has been triggered.

4.58. If the clawback has been triggered, Ofgem will multiply the result in 4.55 by the actual corporation tax rate applicable for the relevant year to derive the licensee's benefit figure. The revised TGIE value for the licensee for Formula Year t-2 is determined as:

Revised TGIE value = benefit figure x -1

4.59. If the benefit figure is a negative value then:

- if the existing TGIE value is zero, no revised TGIE value is determined; or
- if the existing TGIE value is not zero, it is revised to zero.

<u>Interaction with unutilised regulatory tax losses</u>

4.60. If for any Formula Year the licensee has a clawback but no modelled profits subject to tax then the pre-tax value of TGIE (ie the amount in 4.55) is added to the cumulative unutilised regulatory tax losses. This will be relieved against future Core taxable profits.

Direction of revised TGIE values

4.61. Revised TGIE values will be directed in respect of Formula year t-2 and each prior Relevant Year in the RIIO-T1 price control period. This is because the figures used in determining them are obtained from the licensee's annual cost reporting return which, at the time of first submission, contains data relating to Formula Year t-2 and prior years.

4.62. If, for any reason, RAV, net debt or tax deductible interest figures submitted by the licensee are subject to amendment after they have been used in determining revised TGIE values, the following procedure will be followed for the next Annual Iteration Process:

- Ofgem will re-perform the calculation of a benefit figure and the applicability tests set out above to determine whether any revised TGIE value should be determined and directed in respect of the Formula Year to which the amended figures relate. For this purpose, Ofgem will use a copy of the PCFM in its latest state to obtain a modelled figure for tax deductible interest payable by the licensee.
- If a revised TGIE value is directed for a year earlier than Formula Year t-2, any resultant changes to recalculated base revenue figures for years earlier

than Formula Year t-2 calculated under an Annual Iteration Process will, subject to a time value of money adjustment, be brought forward and reflected in the calculation of the term MOD to be directed for Formula Year t. For the avoidance of doubt, such a revision will not have any retrospective effect on a previously directed value of the term MOD.

4.63. The Authority will direct any revisions to TGIE values for the licensee by 30 November in each Formula Year t-1, having given the licensee at least 14 days notice of the values which it proposes to direct.

4.64. The procedure for the Authority's direction of revised TGIE values is set out in Part D of Special Condition GDC 27.

Part 4 - Processing of revised TTE and TGIE values under the Annual Iteration Process

4.65. A positive incremental change in a TTE value will increase the 'recalculated base revenue figure' for the Formula Year concerned by the same amount. However, if there is any outstanding (unused) amount of regulatory tax loss for the licensee, attributable to that Formula Year or to an earlier Formula Year, the increase to the recalculated base revenue figure will be partially or fully abated by that amount, and the record of regulatory tax losses held within the GD1 PCFM will be updated accordingly.

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

4.67. Only negative incremental changes in TGIE value are possible (resulting from a positive tax saving multiplied by minus one - see paragraph 4.56).

4.68. A negative incremental change in a TTE value or TGIE value will decrease the 'recalculated base revenue figure' for the Formula Year concerned by the equivalent amount. However, if the modelled tax liability (in the GD1 PCFM under the Annual Iteration Process) for the Formula Year concerned is smaller (in absolute terms) than the aggregate change in the TTE and TGIE value for that year, then:

- a portion of the aggregate incremental change in the TTE and TGIE values equal to the modelled tax liability will be deducted from the recalculated base revenue figure for the Formula Year concerned; and

  the remaining amount will be added to the regulatory tax loss balance for the Formula Year concerned and carried forward.

5. Corporate debt allowed percentage cost - financial adjustment methodology

Overview

5.1. The allowed revenue totals for each licensee include amounts to cover the efficient cost of raising finance for the transportation business from external sources. This is commonly referred to as the 'cost of capital'. Cost of capital allowances are calculated as a percentage return on the licensee's Regulatory Asset Value (RAV). The percentage represents Ofgem's estimate of the weighted average cost of capital (WACC)[21] for the transportation business. The WACC is determined using a pre-tax cost of corporate debt percentage, a post-tax real cost of equity percentage and a weighting (notional gearing) percentage.

5.2. Under the RIIO-GD1 price control the cost of equity and notional gearing percentages are fixed for the whole of the price control period. However, the corporate debt cost percentage is updated on an annual basis with reference to a trailing average index of debt costs. The update is effected through the annual iteration of the GD1 Price Control Financial Model (PCFM).

5.3. The use of an indexed corporate debt percentage means that allowed revenues are appropriately updated to reflect debt market conditions. As a result, consumers will derive a benefit when debt costs fall whilst licensees and their investors are provided with assurance that higher, efficiently incurred debt costs will be funded.

5.4. The basis for updating the cost of debt index percentage value by revising PCFM Variable Values for the licensee's allowed percentage cost of corporate debt ('CDE' values) is established in Special Condition GDC 27 (Specified financial adjustments). GDC 27 requires revised CDE values to be determined in accordance with the methodology in this chapter.

Temporal conventions

5.5. For the purposes of Special Condition GDC 27 and this chapter:

- "Formula Year t" means the Formula Year in which a value for the term MOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's base revenue[22].

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[21] see Glossary

[22] See Special Condition [•] (Restriction of revenue in respect of the Distribution Network Transportation Activity).

Methodology for determining revised PCFM Variable Values for the cost of corporate debt

5.6. At the outset of the RIIO-GD1 price control period (1 April 2013), the CDE value for every Formula Year will be the pre-tax cost of debt percentage for the licensee set down in RIIO-GD1 Final Proposals.

5.7. Revised CDE values are to be derived using the pounds sterling indices of bonds issued by non-financial institutions which have a remaining maturity of 10 or more years contained in the Markit iBoxx® database of bond market data.

5.8. A revised CDE value will be determined in accordance with the methodology set out below and directed in respect of each Annual Iteration Process for Formula Year t and subsequent Formula Years. However, only the revised CDE value for Formula Year t will impact on the value of MOD for the same Formula Year t[23].

The following steps are to be followed:

Step 1

Establish the 'trading days period[24]' to be used in relation to the particular Annual Iteration Process:

Annual Iteration Process taking place not later than:	**Trading days period**
30 November 2013	1 November 2003 to 31 October 2013
30 November 2014	1 November 2004 to 31 October 2014
30 November 2015	1 November 2005 to 31 October 2015
Et seq…….	Et seq…….

[23] Subject to revision of an earlier value – see paragraph 6.11

[24] Trading days as published in the Markit iBoxx® database

Step 2

For each day in the trading day period ascertained under Step 1, calculate the average of the annual yield figures from the following two iBoxx Sterling Non-Financial Indices:

(i). A 10+ index Markit iBoxx series reference: DE000A0JY837; and

(ii). BBB 10+ index Markit iBoxx series reference: DE000A0JZAH1

The A 10+ index covers bonds rated "A+", "A", and "A-" according to Markit iBoxx's published methodology and the BBB 10+ index covers bonds rated "BBB+", "BBB", and "BBB-". Each index only produces one annual yield figure for each day. Therefore, the average for each day is calculated as:

$$\frac{\text{"A 10+ index" annual yield figure for day + "BBB 10+ index" annual yield figure for day}}{2}$$

Step 3

For each day in the trading day period ascertained under Step 1, obtain the Bank of England's 'breakeven inflation' figure for 10-year government-issued bonds by applying the following formula:

$$\pi = (1 + i)/(1 + r) - 1$$

where:

π is the Bank of England's breakeven inflation figure.

i is the Yield From British Government Securities, 10 Year Nominal Zero Coupon – series reference IUDMIZC; and

r is the Yield From British Government Securities, 10 Year Real Zero Coupon – series reference IUDMIZC.

In the event that the above data series do not include an entry that exactly matches the date from the Markit iBoxx series, the nearest older entry is to be used.

<u>Step 4</u>

For each day in the trading day period ascertained under Step 1, deflate the average of the annual yield figures obtained under Step 2 using the Bank of England's 'breakeven inflation' figure obtained under Step 3, using the following

$$CoD = (1 + iBoxx)/(1 + \pi) - 1$$

where:

CoD is the required deflated average of the annual yield figures;

$iBoxx$ is the average of the annual yield figures obtained under Step 2; and

π is the Bank of England's breakeven inflation figure obtained under Step 3.

This step converts the nominal bond yields in the iBoxx data to a real cost of debt value.

<u>Step 5</u>

Calculate the average value of CoD across the trading day period ascertained under Step 1.

This average, expressed as a percentage, constitutes the revised PCFM Variable Value for the cost of corporate debt which will be inputted into the PCFM in the following format: X.XXper cent.

Non-availability of iBoxx or Bank of England data

5.9. If, for any reason, iBoxx data or Bank of England data is unavailable for an entire trading days period in time to determine revised PCFM Variable Values for the cost of corporate debt for any Annual Iteration Process, then for that Annual Iteration Process only, the trading days period concerned shall be deemed to have ended on the last trading day for which data has been published. If the data concerned is subsequently published, revised PCFM Variable Values for the affected Formula Years will be directed.

5.10. If, for any reason, the iBoxx or Bank of England series identified above cease to be published, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements.

Use of revised PCFM Variable Values in the Annual Iteration Process

5.11. The Authority will direct revised CDE values by no later than 30 November in each Formula Year t-1 in accordance with Part D of Special Condition GDC 27. Notice of proposed revised values will be given to the licensee at least 14 days before the date of the direction.

5.12. PCFM Variable Values for the cost of corporate debt will be directed together with all other types of PCFM Variable Value. Further information on the process is given in chapter 2.

5.13. The data and spreadsheet used to calculate revised CDE values will be published on the Ofgem website.

6. Totex incentive mechanism – financial adjustment methodology

Description of the Totex Efficiency Incentive

6.1. At Final Proposals the base revenues are set on the basis that costs equal the allowances. Where the actual costs incurred vary from the allowances provided during the price control, the Totex incentive mechanism provides for the appropriate sharing of any difference between consumers and licensees. The PCFM contains assumptions for both actual costs and allowances (which are initially equal to each other). Both the actual costs and the allowances included in the PCFM may be varied during the annual iteration process. This chapter describes the process by which the actual costs may be varied.

6.2. Special condition GDC 47 (Determination of PCFM Variable Values for Totex Incentive Mechanism Adjustments), contains a mechanism for adjusting a licensee's PCFM actual expenditure levels in respect of transmission business requirements for the RIIO-T1 price control period.

6.3. Special condition GDC 47 specifies the mechanism by which adjustments to PCFM actual expenditure for relevant cost categories are determined by the Authority. In addition, it sets out the procedure for revised PCFM Variable Values to be directed for the purposes of the Annual Iteration Process for the GD1 Price Control Financial Model.

6.4. This special condition provides for the determination and direction of revisions to the PCFM Variable Values that relate to the licensee's actual Totex expenditure. PCFM Variable Values which relate to the licensee's allowed Totex expenditure are specified in other special conditions of the licence.

Description of the Totex Efficiency Incentive

6.5. The Totex incentive mechanism calculates changes to base revenues arising from any under-expenditure or over-expenditure against the Totex allowance using the relevant 'Incentive Strength' for each network operator. This uses the actual expenditure reported to Ofgem in July each year (subject to any revisions that may be required for reporting inaccuracies or for expenditure that is not regarded as efficient) and adjusts revenues in the following formula year via the MOD term. The incentive mechanism therefore operates with a two year lag.

6.6. There are a number of incentive schemes that provide for the update of Totex allowances and these are described in following chapters. These have their own review process as set out in their respective licence conditions. The annual iteration process implements all the adjustments to allowances approved during the year by adjusting the variable values in the financial model, following the issue of directions by the Authority, which will calculate changes to base revenue.

6.7. The Totex Incentive Mechanism ensures that the licensee bears an appropriate share of any over-spend, or retains an appropriate share of any under-spend, represented by a difference, in respect of a given [Relevant Year], between:

(a) the licensee's allowed Totex expenditure; and

(b) the licensee's actual Totex expenditure.

6.8. The 'appropriate share' referred to in paragraph 6.7 is represented by the efficiency incentive rate (set down against the licensee's name in the table at Appendix [1] of Special Condition [47]).

Total expenditure ("Totex")

6.9. A full definition of Totex is given in the RAV methodology in the Regulatory Instructions and Guidance document (RIGs) consistent with that appended to Final Proposals for RIIO-GD1[25]. In summary Totex consists of all the expenditure relating to a licensees regulated activities with the exception of:

- all costs relating to de minimis activities
- all costs relating to excluded services activities
- pension deficit repair payments relating to the established deficit and for the avoidance of doubt, all unfunded early retirement deficiency costs (ERDC) post 1 April 2004
- costs associated with specific incentive schemes (eg TIRG)
- all statutory or regulatory depreciation and amortisation
- profit margins from related parties (except where permitted)
- all additional costs relating to rebranding a company's assets or vehicles following a name or logo change
- fines and penalties incurred by the network company (including all tax penalties, fines and interest) except if exceptionally Traffic Management Act penalty costs can be shown to be efficient
- compensation payments made in relation to standards of performance
- bad debt costs and receipts (subject to an ex post adjustment to allowed revenues)
- costs related to the SF6 incentive
- reversing, where appropriate, any cost reporting which is not on a normal accruals basis
- costs in relation to pass-through items, including business rates (except for business rates on non-operational buildings). Pass through items include NTS exit charges and Ofgem licence fees
- interest, other financing and tax costs (except for business rates on non-operational buildings and stamp duty land tax).

6.10. In addition, the incentive payment/deduction given/taken under the Totex Incentive Mechanism (TIM) where licensees have spent less/more than their allowance is included in Totex.

[25] Insert link

6.11. Thus the total Totex in any one year reflects the actual allowed expenditure plus the incentive adjustment. This total spend each year is split (according to the licensee's Totex Capitalisation Rate) into 'fast money' (which is funded in the year of spend) and 'slow money' (which forms the addition to RAV).

6.12. It should also be noted that:

- pension deficit repair payments relating to the incremental deficit are treated as Totex; and
- contributions and other proceeds received (including from legal and insurance claims) relating to the licensees regulated business are treated as an offset to Totex unless specifically excluded or specifically applied directly to the RAV any asset revaluation amounts.

Determining PCFM Variable Value revisions for the Annual Iteration of the GD1 Price Control financial Model

Temporal conventions

6.13. For the purposes of Special Condition GDC 47 and this chapter:

- "relevant year t" means the relevant year in which a value for the term TOMOD, or as applicable SOMOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's base transmission revenue[26]/ internal costs revenue.

6.14. Each July (or as directed by the RIGs) licensees submit a regulatory reporting pack which summarises performance in the previous regulatory year to 31st March. This forms the basis for input of actual expenditure into the licence model. The pack is subject to any revisions that may be required for reporting inaccuracies or for expenditure that is not regarded as efficient.

6.15. Following review of the pack and any adjustments identified the following expenditure categories are used to update the model:

6.15.1. ALC Actual load related capex expenditure

6.15.2. ARC Actual asset replacement capex expenditure

6.15.3. AOC Actual other capex expenditure

6.15.4. ACO Actual controllable opex

6.15.5. SOACO Actual controllable opex (SO)

6.15.6. ANC Actual non-operational capex

6.15.7. SOANC Actual non-operational capex (SO)

[26] See Special Condition [•] (Restriction on Transmission Network Revenue).

6.15.8. ACC Contributions received

6.16. Definitions of the expenditure included in these categories is included as part of the Price Control Review Reporting Rules (RIGs).[27]

Notification of revised PCFM Variable Values

6.17. The PCFM exists as a constituent part of Special Condition GDC57 (Governance of GD1 Price Control Financial Instruments). It has an input area for each licensee containing both fixed values and a PCFM Variable Values table. The initial base revenue figure for each licensee for each relevant year of the price control period is calculated using the fixed values, the initial PCFM Variable Values, and the formulae and functions embedded in the PCFM.

6.18. By 30 November in each Relevant Year t-1[6], Ofgem will determine whether any PCFM variable values for the licensee should be revised in accordance with the special conditions and methodologies referred to in chapters 3 to 10 of this handbook.

6.19. As part of the annual iteration cycle the Authority will direct the input of actual expenditure to the model as it reported in each year. This direction will include the categories of costs set out in paragraph [6.7] above. The update to the model of these items will impact MOD in the following year.

6.20. The Authority will give the licensee at least 14 days notice of any revised PCFM Variable Values in accordance with requirements in the licence, to allow for any representations or objections. The Authority will then (by 30 November in Relevant Year t-1) specify any PCFM Variable Value revisions in a formal direction to the licensee. The Authority shall have due regard to any representations or objections duly received, and give reasons for its decisions in relation to them.

6.21. Ofgem will then carry out the Annual Iteration Process in accordance with Special Condition [GDC 47] (see Chapter 1).

[27] [Insert link??]

7. Uncertain costs allowed expenditure - financial adjustment methodology

Overview

7.1. Special condition GDC 28 (Arrangements for the recovery of uncertain costs) contain mechanisms for adjusting the licensee's allowed expenditure levels in respect of distribution business requirements whose costs were uncertain when the licensee's opening base revenues for the RIIO-GD1 price control period were set. These are collectively referred to as uncertain costs and are divided into 'relevant cost categories' which are specified in the licence and summarised in Table 7.1 below.

7.2. Special condition GDC 28 specifies the mechanisms by which adjustments to allowed expenditure levels for relevant cost categories ('relevant adjustments') can be proposed by the Authority or the licensee, and determined by the Authority. They also provide for revisions to associated PCFM Variable Values (necessary to give effect to allowed expenditure adjustments) to be determined under the methodologies set out in this chapter. In addition, they set out the procedure for revised PCFM Variable Values to be directed for the purposes of the Annual Iteration Process for the GD1 Price Control Financial Model.

Table 7.1 – Relevant cost categories

Uncertain cost	PCFM Variable Value name	See Part of this chapter
Specified street works	IAESW	1
Connection charging boundaries	IAECCB	2
Enhanced physical site security	IAEEPS	3
Smart metering roll out	IAESM	4
Large load connections	IAELLC	5
Fuel poor network extensions scheme	IAEFP	6
Central Agent	IAECA	7

7.3. The IAE term equals IAESW + IAECCB + IAEPSS + IAESM + IAELLC + IAEFP + IAECA.

7.4. At the commencement of the RIIO-GD1 price control period, all PCFM Variable Values relating to uncertain costs will have the value zero, since known expenditure requirements will have been incorporated into the licensee's opening base revenue allowances. All PCFM Variable Values relating to uncertain costs and revisions thereto are given in 2009-10 prices, consistent with the price base used in the GD1 Price Control Financial Model and with values for MOD term.

7.5. Revised PCFM Variable Values relating to levels of allowed expenditure are modelled, subject to the Totex Capitalisation Rate, as:

- fast money – flowing directly to the base revenue figure for the Relevant Year to which the allowed expenditure relates; and
- additions to the licensee's RAV in the Relevant Year to which the allowed expenditure relates, generating a slow money adjustment to allowed revenues through the cost of capital return, depreciation and Totex incentive mechanism.

7.6. The effects of this modelling treatment, including any ancillary effects in respect of, for example, tax allowances, will be reflected in the value of the term MOD_t output as a result of each Annual Iteration Process for the GD1 Price Control Financial Model.

Temporal conventions

7.7. For the purposes of Special Condition GDC 28 and this chapter, "Relevant Year t" means the Relevant Year in which a value for the term MOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's Base Distribution Revenue[28]. References to Relevant Year t-1 etc should be construed accordingly.

7.8. A reference to, for example, *the IAESW value for 2015-16* means the IAESW value in the 2015-16 column of the PCFM variable Values Table for the licensee contained in the GD1 Price Control Financial Model.

7.9. Where revisions to PCFM Variable Values are directed for Relevant Years earlier than Relevant Year t, the effect of using those revised values in the Annual Iteration Process for the GD1 Price Control Financial Model will, subject to a time value of money adjustment, be reflected in the calculation of the term MOD for Relevant Year t and, for the avoidance of doubt shall not have any retrospective effect on a previously directed value of the term MOD.

7.10. Revisions to PCFM Variable Values directed for Relevant Years later than Relevant Year t do not feed into the calculation of the term MOD_t but (subject to further determinations) have status as values determined under the provisions of Special Condition GDC 28.

[28] See Special Condition ETC 20 (Restriction of Distribution Network Revenue).

Part 1 – Specified street works – determination of revisions to PCFM Variable Values

7.11. During the RIIO-GD1 price control period the licensee may incur relevant costs as specified and defined in Part J of Special Condition in complying with obligations or requirements arising under any orders or regulations made pursuant to Part 3 of the Traffic Management Act 2004 (or, in Scotland, the Transport (Scotland) Act 2005) that impose a permit scheme, or under any wider street works legislation applicable to the licensee's Distribution System ("specified street works costs").

7.12. Part A of Special Condition GDC 28 sets out the stipulations and procedures governing the proposal and determination of 'relevant adjustments' to the licensee's allowed expenditure levels in respect of specified street works costs. In summary these are:

- Relevant adjustments can, by the giving of a notice, be proposed by the Authority or by the licensee in respect of any Relevant Year of the RIIO-GD1 price control period, but proposals can only be made during two 'application windows':
    - the first application window runs from 1 May 2015 to 31 May 2015, and
    - the second application window runs from 1 May 2018 to 31 May 2018.
- Relevant adjustments must relate to:
    - one of the uncertain cost categories specified in the licence and summarised in Table x.1 above;
    - a material amount, as defined in the licence;
    - costs incurred, or expected to be incurred after 1 April 2013; and
    - costs which would not otherwise be recoverable under the price control arrangements.
- Any proposal must set out:
    - the relevant cost category to which the proposal relates;
    - the changes which are proposed to allowed expenditure levels and the Relevant Years to which those changes relate; and
    - the basis on which the proposed changes to allowed expenditure have been calculated.
- The Authority has four months following the end of each application window to determine whether a relevant adjustment should be made in respect of any proposal which has been made. The Authority must:
    - consult with the licensee;
    - consider the purpose of Special Condition GDC 28; and
    - take account of any fortuitous savings made by the licensee in respect of the same relevant cost category, but not take account of the licensee's general level of financial performance under the price control arrangements.

- In making a determination the Authority may:
    - confirm the proposed changes to allowed expenditure levels;
    - reject the proposed changes to allowed expenditure levels; or
    - vary the proposed changes to allowed expenditure levels.
- The Authority must notify the licensee of any determination within 14 days of making it.
- If the Authority does not determine a proposal made by the licensee within 4 months following the end of the application window concerned, and the proposal is not withdrawn, then the relevant adjustment (the changes to allowed expenditure levels referred to in the proposal) is deemed have been made.

7.13. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAESW values

IAESW values

7.14. After 30 September 2015 (in respect of the first application window) and 30 September 2018 (in respect of the second application window), the Authority will:

(i). consider the terms of any determinations made under Part A of Special Condition in GDC 28 in relation to relevant adjustment proposals for specified street works costs;

(ii). consider the terms of any duly made proposals for relevant adjustments in relation to specified street works costs which have been deemed to have been made;

(iii). ascertain the total amount of additional allowed expenditure for the licensee, (in 2009-10 prices) for specified street works costs for each Relevant Year of the RIIO-GD1 price control period (see example below); and

(iv). determine the total amount of additional allowed expenditure referred to in sub-paragraph (iii) to be the revised IAESW value for the Relevant Year concerned.

Indicative Example

During the first application window, the licensee proposes that its allowed expenditure for specified street works costs should be increased by £0.5m (in nominal prices) to address the additional costs of complying with its obligations or specified requirements.

No other proposals for relevant adjustments in relation to specified street works costs are made during the first application window.

The Authority consults with the licensee by an exchange of correspondence.

During July 2015 the Authority determines that the changes to allowed expenditure set out in the licensee's proposal should be confirmed and, within 14 days, notifies that determination to the licensee.

Ofgem converts the nominal figure of £0.5m into 2009-10 prices giving a figure of, say, £0.4m.

The Authority determines that opening IAESW value of zero should be revised to £0.4m.

7.15. The Authority will, where necessary, direct a revised IAESW value by no later than:

- 30 November 2015 in respect of relevant adjustments determined following the first application window; and
- 30 November 2018 in respect of relevant adjustments determined following the second application window,

in accordance with the procedure set out in Part C of Special Condition GDC 28.

7.16. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 2 – Connections charging boundary changes – determination of revisions to PCFM Variable Values

7.17. During the RIIO-GD1 price control period the licensee could relevant costs as a consequence of any material change to the charging methodology, as required by standard licence condition 4B (Connection Charging Methodology) and approved under the licence by the Authority and in relation to Distributed Entry Connections by person s requiring such connections ("connections charging boundary changes") to the licensee's Distribution System.

7.18. Paragraph [7.12] summarises the stipulations and procedures governing the proposal and determination of 'relevant adjustments' to the licensee's allowed expenditure levels in respect of connections charging boundary changes. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAECCB values

IAECCB values

7.19. After 30 September 2015 (in respect of the first application window) and 30 September 2018 (in respect of the second application window), the Authority will:

(i). consider the terms of any determinations made under Part A of Special Condition in GDC 28 in relation to relevant adjustment proposals to the connections charging boundary change methodology;

(ii). consider the terms of any duly made proposals for relevant adjustments in relation to connections charging boundary change methodology which have been deemed to have been made;

(iii). ascertain the total amount of additional allowed expenditure for the licensee, (in 2009-10 prices) connections charging boundary changes methodology for each Relevant Year of the RIIO-GD1 price control period (see example below); and

(iv). determine the total amount of additional allowed expenditure referred to in sub-paragraph (iii) to be the revised IAECCB value for the Relevant Year concerned.

Indicative Example

During the first application window, the licensee proposes that its allowed expenditure to the connections charging boundary change methodology should be increased by £0.5m (in nominal prices) to address the additional costs of a requirement specified by the Secretary of State.

No other proposals for relevant adjustments in relation to the connections charging boundary change methodology are made during the first application window.

The Authority consults with the licensee by an exchange of correspondence.

During July 2015 the Authority determines that the changes to allowed expenditure set out in the licensee's proposal should be confirmed and, within 14 days, notifies that determination to the licensee.

Ofgem converts the nominal figure of £0.5m into 2009-10 prices giving a figure of, say, £0.4m.

The Authority determines that opening IAECCB value of zero should be revised to £0.4m.

7.20. The Authority will, where necessary, direct a revised IAECCB value by no later than:

- 30 November 2015 in respect of relevant adjustments determined following the first application window; and
- 30 November 2018 in respect of relevant adjustments determined following the second application window,

in accordance with the procedure set out in Part C of Special Condition GDC 28.

7.21. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 3 - Enhanced physical site security – determination of revisions to PCFM Variable Values

7.22. During the RIIO-GD1 price control period the licensee could be required to implement formal recommendations or requirements issued by the Secretary of State for Energy and Climate Change to enhance the physical security of sites associated with the licensee's Distribution System.

7.23. Paragraph [7.12] summarises the stipulations and procedures governing the proposal and determination of 'relevant adjustments' to the licensee's allowed expenditure levels in respect of enhanced physical site security. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAEEPS values

IAEEPS values

7.24. After 30 September 2015 (in respect of the first application window) and 30 September 2018 (in respect of the second application window), the Authority will:

(i). consider the terms of any determinations made under Part A of Special Condition in GDC 28 in relation to relevant adjustment proposals for enhanced physical site security requirements;

(ii). consider the terms of any duly made proposals for relevant adjustments in relation to enhanced physical site security requirements which have been deemed to have been made;

(iii). ascertain the total amount of additional allowed expenditure for the licensee, (in 2009-10 prices) for enhanced physical site security requirements for each Relevant Year of the RIIO-GD1 price control period (see example below); and

(iv). determine the total amount of additional allowed expenditure referred to in sub-paragraph (iii) to be the revised IAEEPS value for the Relevant Year concerned.

Indicative Example

During the first application window, the licensee proposes that its allowed expenditure for enhanced physical site security should be increased by £0.5m (in nominal prices) to address the additional costs of a requirement specified by the Secretary of State.

No other proposals for relevant adjustments in relation to enhanced physical site security are made during the first application window.

The Authority consults with the licensee by an exchange of correspondence.

During July 2015 the Authority determines that the changes to allowed expenditure set out in the licensee's proposal should be confirmed and, within 14 days, notifies that determination to the licensee.

Ofgem converts the nominal figure of £0.5m into 2009-10 prices giving a figure of, say, £0.4m.

The Authority determines that opening IAEEPS value of zero should be revised to £0.4m.

7.25. The Authority will, where necessary, direct revised IAEEPS values by no later than:

- 30 November 2015 in respect of relevant adjustments determined following the first application window; and
- 30 November 2018 in respect of relevant adjustments determined following the second application window,

in accordance with the procedure set out in Part C of Special Condition GDC 28.

7.26. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 4 – Smart metering roll out – determination of revisions to PCFM Variable Values

7.27. During the RIIO-GD1 price control period the licensee could be required to implement formal recommendations or requirements issued by the Secretary of State for Energy and Climate Change to enhance the smart metering roll out associated with the licensee's Distribution System.

7.28. Paragraph [7.12] summarises the stipulations and procedures governing the proposal and determination of 'relevant adjustments' to the licensee's allowed expenditure levels in respect of smart metering roll out. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAESM values

IAESM values

7.29. After 30 September 2015 (in respect of the first application window) and 30 September 2018 (in respect of the second application window), the Authority will:

(i). consider the terms of any determinations made under Part A of Special Condition in GDC 28 in relation to relevant [adjustment] proposals for smart metering roll out requirements;

(ii). consider the terms of any duly made proposals for relevant adjustments in relation to smart metering roll out requirements which have been deemed to have been made;

(iii). ascertain the total amount of additional allowed expenditure for the licensee, (in 2009-10 prices) for smart metering roll out costs for each Relevant Year of the RIIO-GD1 price control period (see example below); and

(iv). determine the total amount of additional allowed expenditure referred to in sub-paragraph (iii) to be the revised IAESM value for the Relevant Year concerned.

Indicative Example

During the first application window, the licensee proposes that its allowed expenditure for smart metering roll out should be £0.5m (in nominal prices) to address the additional costs from the roll out.

No other proposals for relevant adjustments in relation to smart metering roll out are made during the first application window.

The Authority consults with the licensee by an exchange of correspondence.

During July 2015 the Authority determines that the changes to allowed expenditure set out in the licensee's proposal should be confirmed and, within 14 days, notifies that determination to the licensee.

Ofgem converts the nominal figure of £0.5m into 2009-10 prices giving a figure of, say, £0.4m.

The Authority determines that opening IAESM value of zero should be revised to £0.4m.

7.30. The Authority will, where necessary, direct revised IAESM values by no later than:

- 30 November 2015 in respect of relevant adjustments determined following the first application window; and
- 30 November 2018 in respect of relevant adjustments determined following the second application window,

in accordance with the procedure set out in Part C of Special Condition GDC 28.

7.31. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 5 – Large load connections – determination of revisions to PCFM Variable Values

7.32. During the RIIO-GD1 price control period the licensee may have to incur costs for large load connections to the licensee's Distribution System for which there is no allowed expenditure in the price control.

7.33. Paragraph [7.12] summarises the stipulations and procedures governing the proposal and determination of 'relevant adjustments' to the licensee's allowed expenditure levels in respect of large load connections. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAELLC values

IAELLC values

7.34. After 30 September 2015 (in respect of the first application window) and 30 September 2018 (in respect of the second application window), the Authority will:

(i). consider the terms of any determinations made under Part A of Special Condition in GDC 28 in relation to relevant allowance proposals for large load connections;

(ii). consider the terms of any duly made proposals for relevant allowances or adjustments in relation to large load connections which have been deemed to have been made;

(iii). ascertain the total amount of additional allowed expenditure for the licensee, (in 2009-10 prices) for large load connections for each Relevant Year of the RIIO-GD1 price control period (see example below); and

(iv). determine the total amount of additional allowed expenditure referred to in sub-paragraph (iii) to be the revised IAELLC value for the Relevant Year concerned.

Indicative Example

During the first application window, the licensee proposes that its allowed expenditure for large load connections should be increased by £0.5m (in nominal prices) to address the efficient costs of a specified connection or connections.

No other proposals for relevant adjustments in relation to large load connections are made during the first application window.

The Authority consults with the licensee by an exchange of correspondence.

During July 2015 the Authority determines that the changes to allowed expenditure set out in the licensee's proposal should be confirmed and, within 14 days, notifies that determination to the licensee.

Ofgem converts the nominal figure of £0.5m into 2009-10 prices giving a figure of, say, £0.4m.

The Authority determines that opening IAELLC value of zero should be revised to £0.4m.

7.35. The Authority will, where necessary, direct revised IAELLC values by no later than:

- 30 November 2015 in respect of relevant adjustments determined following the first application window; and

- 30 November 2018 in respect of relevant adjustments determined following the second application window,

in accordance with the procedure set out in Part C of Special Condition GDC 28.

7.36. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 6 – Fuel poor network extensions scheme– determination of revisions to PCFM Variable Values

7.37. During the RIIO-GD1 price control period, in accordance with Part G of Special Condition GDC 28, the Authority may at any time after 1 April 2013 review the licensee's operation of the Fuel Poor Network Extensions scheme ("the scheme") with a view to ensuring that it remains efficient and cost-effective for its stated purpose.

7.38. Part G of Special Condition GDC 28 summarises the stipulations and procedures governing the conduct of such a review. Where the Authority decides that the scheme should be modified or should cease it may direct that an adjustment made to the input variable with effect from the beginning of the next Formula Year following the Formula Year in which the direction is given. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAEFP values

IAEFP values

7.39. After the Authority decides and publishes that decision, the Authority will:

(i). consider the terms of any direction(s) to be made under Part G of Special Condition in GDC 28 in relation to relevant adjustment proposals for the scheme;

(ii). ascertain the total amount of adjustments to allowed expenditure for the licensee, (in 2009-10 prices) for the scheme's costs for each Relevant Year of the RIIO-GD1 price control period (see example below);

(iii). determine the total amount of adjusted allowed expenditure referred to in sub-paragraph (ii) to be the revised IAEFP value for all Relevant Years concerned; and;

(iv). issue a direction no later than the 30 November prior to the next Formula Year following the Formula Year in which the direction is given.

Indicative Example

[to be drafted]

7.40. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

Part 7 – Central Agent costs – determination of revisions to PCFM Variable Values

7.41. During the RIIO-GD1 price control period, in accordance with Part H of Special Condition GDC 28, the Authority may at any time after 1 April 2013 review the costs ("the Central Agent costs") incurred by the licensee in fulfilling its obligations under Standard Special Condition A15 (Central Agent). The purpose of the review will be to establish the efficient level of Central Agent costs in the event that Standard Special Condition A15 is amended or deleted.

7.42. Part H of Special Condition GDC 28 summarises the stipulations and procedures governing the conduct of such a review. Where the Authority decides that the scheme should be modified it may direct that an adjustment made to the input variable with effect from the beginning of the next Formula Year following the Formula Year in which the direction is given. Reference should be made to Special Condition GDC 28 for the full and definitive procedures and requirements.

Determination and direction of revised IAECA values

IAECA values

7.43. After the Authority decides and publishes that decision, the Authority will:

(i). consider the terms of any direction(s) to be made under Part G of Special Condition in GDC 28 in relation to relevant adjustment proposals for the scheme;

(ii). ascertain the total amount of adjustments to allowed expenditure for the licensee, (in 2009-10 prices) for the scheme's costs for each Relevant Year of the RIIO-GD1 price control period (see example below);

(iii). determine the total amount of adjusted allowed expenditure referred to in sub-paragraph (ii) to be the revised IAEFP value for all Relevant Years concerned; and;

(iv). issue a direction no later than the 30 November prior to the next Formula Year following the Formula Year in which the direction is given.

Indicative Example

[to be drafted]

7.44. Any nominal price figures included in relevant adjustment proposals will be converted into 2009-10 prices using actual RPI data as far as possible and, where necessary, the forecast RPI index numbers embedded in the GD1 Price Control Financial Model.

8. Mains and services replacement allowed expenditure - financial adjustment methodology

Mains and Services Replacement – allowed expenditure

8.1. During the RIIO-GD1 price control period ('RIIO-GD1') each licensee is required to carry out mains replacement, services replacement and services transfer activity relating to mains and services which are categorised as being *Above Threshold Tier 2* ('ATT2'). This activity is collectively termed 'Repex'.

8.2. The opening base revenue allowances ('PU' values) for each licensee, set down in the table at Appendix 1 to Special Condition [GDC 20](Restriction of revenue in respect of the Distribution Network Transportation Activity) reflect allowed expenditure figures for forecast levels of ATT2 mains replacement.

8.3. The allowed expenditure figures referred to in paragraph 9.2 constitute the 'RE' values contained in the Variable Values Table of the GD1 Price Control Financial Model ('PCFM') as at 1 April 2013, the first day of RIIO-GD1.

8.4. It is necessary to revise RE values during the course of RIIO-GD1 so that they represent allowed expenditure levels driven by actual (outturn) levels of Repex reported by each licensee. This ensures that the value of the term MOD_t which is calculated through the Annual Iteration Process for the PCFM appropriately reflects updated allowed expenditure on Repex as a component of Totex in:

(i). fast and slow money allowed revenue calculations; and

(ii). allowed revenue adjustments under the Totex Incentive Mechanism (see chapter 6).

8.5. The provisions for determining revised RE values are contained in Special Condition [GDC 22](Mains and Services Replacement Expenditure). All RE values are stated in 2009/10 prices.

Temporal convention

8.6. Each special condition that provides for the determination and direction of revised PCFM Variable Values uses the following convention:

- 'Formula Year t' means the Formula Year in which the value for the term MOD_t calculated through a particular Annual Iteration Process, is used in the formula set out in Part [•] of Special Condition [GDC 20] and references to Formula Years t-1 and t-2 are construed accordingly;

Determination and direction of revised RE values

8.7. Part B of Special Condition [GDC 22] (Mains and Services Replacement Expenditure) contains a formula which specifies what the RE value is to be for each Formula Year t-2.

8.8. The first Formula Year of RIIO-GD1 is 2013-14 which ends on 31 March 2014. Each licensee will report the Repex activity values specified in Part B of Special Condition [GDC 22] for that year by no later than 31 July 2014.

Ofgem will determine revised RE values for Formula Year 2013/14 between 31 July 2014 and 30 November 2014 - the deadline for directing revised RE values to be used in the Annual Iteration Process which will take place by 30 November 2014 (see chapter 2).

8.9. This process will be repeated annually:

(i). Formula Year t-2 – activity and expenditure occurs;

(ii). by 31 July in Formula Year t-1 – licensee reports activity and actual expenditure levels to Ofgem ;

(iii). by 30 November in Formula Year t-1 – Authority directs a revised RE value for Formula Year t-2 (and any earlier years in accordance with paragraph 9 of Special Condition [GDC 22]);

(iv). by 30 November in Formula Year t-1 – Authority carries out Annual Iteration Process and directs value of MODt for Formula Year t.

8.10. The Authority's direction of revised RE value by no later than 30 November in each Formula Year t-1 will be made in accordance with Part C of Special Condition GDC 22.

Processing of RE values under the Annual Iteration Process

8.11. Under the Annual Iteration process, RE values, as revised, representing allowed Repex expenditure are allocated to:

- fast and slow money[29] totals in accordance with the Totex Capitalisation Rate (per cent) specified in the RIIO-GD1 Final Proposals; and
- the "Repex" (deferred revenue) tax pool,

within the PCFM.

[29] See Glossary

8.12. RE values, as revised, for all Formula Years up to and including Formula Year t are then used with other PCFM variable values under the Annual Iteration Process:

(i). in calculating the value of the term MOD_t for Formula Year t including:

- fast money components,
- amounts of return and depreciation on the licensee's RAV balance,
- tax allowance effects,
- Totex Incentive Mechanism adjustments, and

(ii). to update Totex related balances held within the PCFM including the licensee's RAV balance.

8.13. Under the Annual Iteration Process described in chapter 2 the effect of revised RE values directed for Formula Years earlier than Formula Year t-2 (see paragraph 9.9(iii) flows through to the determination of the value of MOD_t and will have no retrospective effect on previously directed values of MOD. This point is confirmed in paragraph 14 of Special Condition GDC 22.

8.14. RE values held in the PCFM for Formula Years later than year t in relation to a particular Annual Iteration Process do not feed into the calculation of the term MOD_t and remain at the forecast levels referred to in paragraphs 9.2 and 9.3 pending any subsequent revision. Accordingly, all calculated values in the PCFM for Formula Years later than Formula Year t have indicative status only.

9. Innovation role-out mechanism allowed expenditure – financial adjustment methodology

Main Heading

Innovation roll-out mechanism

9.1. The purpose of this chapter of the price control financial handbook is to set out the methodology to determine the values relating to Innovation Roll-out allowed expenditure ('IRM' values) and the regulatory years to which those revisions relate.

9.2. The provisions for determining revised IRM values are contained in Special Condition [GDC 9] (The Innovation Roll-out Mechanism). All IRM values are stated in 2009-10 prices.

9.3. The application of the methodologies set out in this chapter of the handbook will mean that as a consequence of the annual iteration process, the value of the term MOD as calculated for formula year t will result in an appropriate adjustment of the base revenue of the licensee so that it is the same as it would have been had the forecast values used in the model been the same as the actual out-turn values.

9.4. The opening base revenue allowances ('PU' values) for each licensee, set down in the table at Appendix 1 to Special Condition [GDC xx](Restriction of revenue in respect of the Distribution Activity) reflect allowed expenditure figures for forecast levels of innovation expenditure (and will be zero at the outset).

9.5. The allowed expenditure figures constitute the 'IRM' values contained in the Variable Values Table of the RIIO-GD1 Price Control Financial Model ('PCFM') as at 1 April 2013, the first day of RIIO-GD1.

9.6. It may be necessary to revise IRM values during the course of RIIO-GD1 so that they represent allowed expenditure levels driven by additional innovation funding. This ensures that the value of the term MODt which is calculated through the Annual Iteration Process for the PCFM appropriately reflects updated allowed expenditure on innovation as a component of Totex in:

(i). fast and slow money allowed revenue calculations; and

(ii). allowed revenue adjustments under the Totex Incentive Mechanism (see chapter 6).

Temporal convention

9.7. Each special condition that provides for the determination and direction of revised PCFM Variable Values uses the following convention:

• 'Formula Year t' means the Formula Year in which the value for the term MODt calculated through a particular Annual Iteration Process, is used in the formula set out in Part [•] of Special Condition [GDC 9] and references to Formula Years t-1 and t-2 are construed accordingly.

Determination and direction of revised IRM values

9.8. Part A of Special Condition [GDC 9] (The Innovation Roll-out Mechanism) specifies the Features that qualify a roll-out for additional funding.

9.9. Part B of Special Condition [GDC 9] (The Innovation Roll-out Mechanism) specifies the licensees' ability to propose a relevant adjustment to the IRM value.

9.10. Part C of Special Condition [GDC 9] (The Innovation Roll-out Mechanism) specifies two periods when these adjustments can be proposed:

(a) the first application window opens on 1 May 2015 and closes on 31 May 2015; and

(b) the second application window opens on 1 May 2018 and closes on 31 May 2018.

9.11. For the first application window Ofgem will determine revised IRM values for Formula Year 2016-17 (if necessary) between 31 July 2015 and 30 November 2015 - the deadline for directing revised IRM values to be used in the Annual Iteration Process which will take place by 30 November 2015 (see chapter 2)

9.12. For the second application window Ofgem will determine revised IRM values for Formula Year 2019-20 (if necessary) between 31 July 2018 and 30 November 2018 - the deadline for directing revised IRM values to be used in the Annual Iteration Process which will take place by 30 November 2018 (see chapter 2).

9.13. The Authority's direction of revised IRM value by no later than 30 November in each Formula Year t-1 will be made in accordance with Part D of Special Condition GDC 9.

Processing of IRM values under the Annual Iteration Process

9.14. Under the annual iteration process, IRM values, as revised, representing allowed innovation expenditure are allocated to:

- fast and slow money totals in accordance with the Totex Capitalisation Rate (per cent) specified in the RIIO-T1 Final Proposals; and
- the tax pools associated with innovation expenditure in accordance with the licensee specific tax allocation profile, within the PCFM.

9.15. IRM values, as revised, for all Formula Years up to and including Formula Year t are then used with other PCFM variable values under the Annual Iteration Process:

(i). in calculating the value of the term MODt for Formula Year t including:

- fast money components,
- amounts of return and depreciation on the licensee’s RAV balance,
- tax allowance effects,
- Totex Incentive Mechanism adjustments, and

(ii). to update Totex related balances held within the PCFM including the licensee’s RAV balance.

9.16. Under the Annual Iteration Process described in chapter 2 the effect of revised IRM values directed for Formula Years earlier than Formula Year t-2 flow through to the determination of the value of MODt and will have no retrospective effect on previously directed values of MOD. This point is confirmed in paragraph 14 of Special Condition GDC 9.

9.17. IRM values held in the PCFM for Formula Years later than year t in relation to a particular Annual Iteration Process do not feed into the calculation of the term MODt and remain at the forecast levels referred to in paragraph 12.4 pending any subsequent revision. Accordingly, all calculated values in the PCFM for Formula Years later than Formula Year t have indicative status only.

10. Legacy price control adjustments – financial methodologies

Overview

10.1. The purpose of this chapter of the Price Control Financial Handbook is to set out the methodologies that are to be used to determine values for each component term in the formulae for legacy price control financial adjustments contained in Special Condition GDC 64 (Legacy price control adjustments.

10.2. The formulae for legacy price control financial adjustments, set out in Special Condition GDC 64, are used to determine revisions to PCFM Variable Values for:

a) legacy price control revenue allowance adjustments (LAR values); and

b) legacy price control adjustments to RAV balance additions (LRAV values).

10.3. The component terms for Legacy price control financial adjustments relate to outturn values for the items shown in Table 15.1 below, in respect of Formula Years prior to 1 April 2013 (the legacy period).

Table 15.1 – Legacy price control financial adjustment categories

Category	Licence Condition	Applicable licensees	PCFM Variable Value name	Component in PCFM Variable Value	See Part of this chapter
Pension adjustments	GDC 64	All	PAR	LAR	1
Tax adjustments	GDC 64	All	TAR	LAR	2
Non Gas Fuel Poor Network Extension Scheme adjustments	GDC 64	All	FAR FRAV	LAR LRAV	3

Capex incentive scheme adjustments	GDC 64	All	CAR CRAV	LAR LRAV	4
Mains and services replacement expenditure adjustments	GDC 64	All	MAR MRAV	LAR LRAV	5

10.4. Special Condition GDC 64 specifies that the component term values used to derive revised LAR and LRAV values are to be determined in accordance with the methodologies contained in this chapter. It also provides for revisions to those PCFM Variable Values to be directed for use in the annual iteration process for the Price Control Financial Model (PCFM).

10.5. For every annual iteration process in the RIIO-GD1 price control period, the Authority will:

a) determine each component term in the formulae for legacy price control financial adjustments for every Formula Year in the RIIO-GD1 price control period; and

b) derive and direct LAR and LRAV values which have been revised, where appropriate, to reflect the term values calculated under sub-paragraph a).

10.6. The application of the methodologies set out in this chapter of the handbook will mean that as a consequence of the annual iteration process, the value of the term MOD, calculated for Formula Year t, will result in adjustments to the licensee's Base Distribution Network Transportation Activity Revenue so that it appropriately reflect outturn levels of

- activities carried out by the licensee;
- incentivised performance by the licensee; and/or
- expenditure incurred by the licensee,

in the legacy period.

10.7. Under the annual iteration process, revisions to PCFM Variable Values for Legacy price control financial adjustments also result in appropriate changes to RAV balance additions. For the avoidance of doubt, legacy price control adjustments are not subject to the Totex Incentive Mechanism.

10.8. At the commencement of the RIIO-GD1 price control period, all PCFM Variable Values relating to legacy price control adjustments will have the value zero, since forecast outturn values for the component terms will have been incorporated into the licensee's opening base revenue allowances.

10.9. All PCFM Variable Values relating to legacy items and revisions thereto are given in 2009-10 prices, consistent with the price base used in the GD1 Price Control Financial Model and with values for the term MOD.

Temporal conventions

10.10. For the purposes of Special Condition GDC 64 and this chapter, "Formula Year t" means the Formula Year in which a value for the term MOD, calculated through a particular Annual Iteration Process, is used in the formula for the licensee's Base Distribution Network Transportation Activity Revenue. References to Formula Year t-1 etc should be construed accordingly.

Associated documents

10.11. The associated documents (previously published by Ofgem) referred to in this chapter are:

Open letter dated 31 July 2009 regarding Clawback of tax benefit due to excess gearing
[Tax clawback open letter](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=49&refer=Networks)

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=49&refer=Networks

[Open letter dated [ ] in respect of [Fuel Poor].]

[..additional associated documents]

Section 1 - Pension adjustments relating to the legacy period

10.12. The purpose of this part is to set out the methodology to determine the revised PCFM Variable Components (PAR & PRAV) for the true-up of Pensions from the GDPCR1.

Description of the pension true-up

10.13. The previous price controls provided an allowance for funding past deficits as a pass-through.

10.14. In the March 2011 Strategy paper appendix 6 paragraph 1.11 we will subject the true up adjustment of deficit funding contributions to an efficiency review, in accordance with pension principle one and add the cash amount of the true up of the deficits payments on a NPV neutral basis to revenues in RIIO-GD1. Paragraph 1.12 also states we would true up where we used forecast expenditure for 2012-13 at the next reset of allowances in RIIO-T1 [to include further quotes and also re ongoing costs].

10.15. In an open letter dated [xx] September 2009 we set out true up amounts for the one year price control and said we would make these in the control following GDPCR1.

Pension true-up calculation

10.16. The pension true-up calculation will involve several stages because the figures are recorded in various price base years.

10.17. For the deficit allowance, the steps are as follows:

Step one is to list the deficit allowances for each of the five years. The deficit allowances for the five years of the GPPCR1 price control are in 2006-07 prices as set out in GDPCR1 final proposals main supplementary appendices Appendix 6 table A6.1.

Step two is to rebase deficit allowances to the price base year used to report deficit actual (and forecasts to 2012-13 in the RIIO-GD1 BPDT).

Step three is to collate the deficit actual that relates to the regulated entity from the RRPs for each year.

Step four is to deduct the allowance from the actual for each of the five years.

Step five is to rebase these differences to RIIO-GD1 price base year of 2009-10.

Step six is to calculate the historical tax impact of the deficit true-up by multiplying the gross deficit adjustment for each year by the actual Corporation Tax rate for that year.

Step seven is to deduct the tax impact from the gross adjustment figure to arrive at the net deficit adjustment true-up after tax.

For the Ongoing Costs Allowance, the steps are as follows:

Step one is to list the ongoing cost allowances for each of the six years. The allowances for the first year of the TPCR4 price control are in 2004-05 prices as reported in RRPs. The allowances for the remaining four years of the price TPCR4 price control and rollover are in 2009-10 prices as set out in the RIIO-T1 BPDT of the ET TOs

Step two is to collate the actual ongoing costs (relating to the regulated business only) from the RRPs for each year.

Step three is to deduct the ongoing allowance from actual ongoing regulated costs for each of the six years.

Step four is to rebase these differences to RIIO-T1 price base year of 2009-10.

Step five is to calculate the historical tax impact of the deficit true-up by multiplying the gross deficit for each year by the actual Corporation Tax rate for that year.

Step six is to deduct the tax impact from the gross figure to arrive at the net ongoing costs true-up after tax.

10.18. The sum of differences in deficit & ongoing costs relative to allowances net after tax true-up is the total pension true-up to be adjusted for the time value of money using the WACC. We do this on a year by year basis with expenditure from year 1 of TPCR4 uplifted by 6.5 years compounded return at the prevailing cost of capital for each year, year 2 uplifted by 5.5 years etc.

10.19. To avoid a spike in the use of systems charges, the RIIO model funds the pension forecast over the eight years of the price control. However, the pension true-up is adjusted in the first year of the RIIO T1 price control, 2013-14.

10.20. The pension true-up adjusted for the time value of money will form the PAR component in the LAR PCFM variable value for year 2013-14 of the price control.

10.21. The pension true-up PRAV component in the LRAV PCFM variable is nil.

Part 2 - Tax adjustments relating to the legacy period

10.22. The purpose of this part is to set out the methodology to determine the revised PCFM Variable Components (TAR and TRAV) for the tax clawback for the final year of GDPCR1 due to excess gearing.

Description of the tax clawback from GDPCR1

10.23. A decision letter dated 31 July 2009 sets out Ofgem's implementation of the ex post adjustment considered in GDPCR1 final proposals.

10.24. The adjustment claws back from licensees the revenue benefit they obtain from lower tax costs as a result of a higher level of gearing than assumed in the Price Control Final Proposals.

10.25. The tax clawback adjustment is triggered when in any year actual gearing exceeds notional gearing and actual interest costs exceed those modelled at the price control. When both of these conditions are satisfied, Ofgem will clawback the tax benefit which results from the difference between actual and modelled interest costs in that year.

Methodology for calculating the tax clawback

10.26. The methodology for implementing the tax clawback is set out in Appendix 1 of the 31 July 2009 open letter. This sets out the adjustments to reported net debt and actual interest shown in the licensee's price control information.

10.27. The clawback calculation takes the following steps, and is that consistently applied for each year of GDPCR1, as follows:

Step 1: Compare actual gearing to notional gearing. For this purpose, we define actual gearing as adjusted year-end net debt/year-end RAV (in nominal year end prices). If actual gearing is lower or equal, then no clawback applies. If it is higher, then proceed to step 2.

Step 2: Compare actual adjusted interest (in accordance with 10.17) to modelled interest for the year. If actual adjusted interest tax relief is lower or equal, then no clawback applies. If it is higher, then proceed to step 3.

Step 3: The excess relief is calculated as actual interest less modelled interest. This is multiplied by the corporation tax rate applicable for that year (e.g. 30 per cent up to 31 March 2008; 28 per cent from 1 April 2008 and until revised by legislation) to determine the clawback adjustment.

Step 4: If the clawback adjustment is lower than the tax allowed in the financial model for that year, then the adjustment is present valued using the applicable cost of capital, and *deducted from revenue allowances in the subsequent price control*. To the extent that it exceeds the tax allowed, then the excess is instead added to the assumed regulatory tax loss for the year and carried forward. This will ultimately impact the licensee's tax allowance at the point at which we model them as having to pay corporation tax.

10.28. The adjustment will be the difference between the calculated forecast clawback for 2012-13 and the actual amounts as determined above once the outturn amounts for 2012-13 have been agreed.

10.29. The terms used in this methodology are defined in Appendix 1 of the 31 July 2009 open letter.

10.30. If the company has a tax charge for 2012-13, the tax clawback amount from step 4 to be "deducted from revenue allowances in the subsequent price control" will form the TAR component in the LAR PCFM variable value for 2013-14. If a licensee has no tax charge and has regulatory tax losses then the pre-tax value of the clawback is added to the opening regulatory tax losses at 1 April 2013.

10.31. The [TRAV] component in the [LRAV] PCFM variable is nil.

Part 3 - Non Gas Fuel Poor Network Extension Scheme adjustments relating to the legacy period

10.32. The purpose of this part is to set out the methodology to determine the revised PCFM Variable components (FAR & FRAV) for the GDPCR1 capex and repex roller scheme.

Process to update the Fuel Poor costs

10.33. As part of the GD1 Final Proposals we have calculated provisional amounts to be included for the logging up of Fuel Poor Expenditure in accordance with the methodology detailed in the letter dated [ ]. These will include forecasts for the amounts in relations to 2012-13. [set out overview of the calculation]

10.34. As part of the Annual Iteration process this calculation will be re-performed and any incremental adjustment on the final proposals calculation will comprise the FAR or FRAV terms. [set out details of calculation or cross refer to legacy workbook

Part 4 - Capex incentive scheme adjustments relating to the legacy period

10.35. The purpose of this part is to set out the methodology to determine the revised PCFM Variable components (CAR & CRAV) for the GDPCR1 capex and repex roller scheme.

Process to update the GDPCR1 capex roller

10.36. For the GDPCR1 allowed revenue, the term [ ] means the capital expenditure adjustment term calculated in special condition [ ]. [Does this apply in GD?]

10.37. As part of the GD1 Final Proposals we have calculated provisional amounts of the amount to be included under the GDPCR1 capex and repex roller mechanism. These will include forecasts for the amounts in relation to 2012-13. [set out overview of the calculation]

10.38. As part of the Annual Iteration process this calculation will be re-performed and any incremental adjustment on the final proposals calculation will comprise the CAR or CRAV terms. [set out details of calculation or cross refer to legacy workbook].

Part 5 – Mains and services replacement expenditure adjustments relating to the legacy period

10.39. [to be inserted]

Part 6 – Direction of LAR and LRAV values

10.40.

10.41. Part A of Special condition GDC 64 (insert name) sets out how LAR and LRAV are directed each year.

10.42. The LAR and LRAV values for all Formula Years are zero as at 1 April 2013.

10.43. The Authority shall, by 30 November in each Formula Year t-1:

(a) determine whether any LAR or LRAV values should be revised in relation to one or more of the schemes and mechanisms referred to in Parts A and B of the condition; and

(b) issue a direction in accordance with the provisions of Part C of the condition specifying any revised values that have been determined and the Formula Years to which they relate.

10.44. The first Formula Year in which the Authority will make a determination is Relevant Year 2013-14.

10.45. Revised LAR and LRAV values will normally relate to Formula Year 2013-14.

10.46. The revised LAR value for any Formula Year from 2013-14 onwards is determined in accordance with the following formula:

$$LAR = PAR + TAR + CAR + FAR$$

10.47. Where, in each case, for the same Formula Year t:

PAR means the revenue allowance adjustment in respect of true-ups for legacy period pension scheme expenditure, determined in accordance with Part B of the condition.

TAR means the revenue allowance adjustment driven by the licensee's gearing levels and corporate debt interest costs in the legacy period, determined in accordance with Part B of the condition.

CAR means the revenue allowance adjustment in respect of the close-out of the legacy period Capex rolling incentive, determined in accordance with Part B of the condition.

FAR means the revenue allowance adjustment in respect of fuel poor activity in the legacy period, determined in accordance with Part B of the condition.

10.48. The LRAV value for any Formula Year from 2013/14 onwards is determined in accordance with the following formula:

$$LRAV = CRAV + FRAV + RRAV$$

10.49. Where, in each case, for the same Relevant Year t:

CRAV means the adjustment to the licensee's RAV balance additions in respect of the close-out of the legacy period Capex rolling incentive, determined in accordance with Part B of the condition.

FRAV means the adjustment to the licensee's RAV balance additions in respect of transmission asset owner scheme activity in the legacy period, determined in accordance with Part B of the condition.

[RRAV means the adjustment to the licensee's RAV balance additions in respect of amounts over and above the Repex cap, determined in accordance with Part B of the condition – check this]

10.50. Where the Authority directs any revised LAR values or LRAV values for Relevant Years earlier than Formula Year t, the effect of using those revised values in the Annual Iteration Process for the GD1 Price Control Financial Model will, subject to a time value of money adjustment, be reflected in the calculation of the term MOD for Formula Year t and, for the avoidance of doubt shall not have any retrospective effect on a previously directed value of the term MOD.

Appendices

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Appendix 1 - Glossary

F

Fast money

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

Formula Year

[•]

G

GD1

Prefix/Suffix designating an item relevant to the RIIO-GD1 (electricity transmission) price control review which will be applicable for the eight years running from 1 April 2013.

GD1 Price Control Financial Model

The model referred to in Special Condition PCC 3 of the Electricity Transmission Licence. Derived from the Combined Model it has been developed to calculate appropriate changes to each licensee's base revenue through an annual iteration process - see chapter 2.

TPCR (Electricity Transmission)

The RPI-X type price control arrangements which applied to electricity transmission licensees from 1 April 1 April 2008 to 31 March 2013

M

MOD Term [TO and SO]

The term of that name included in the formula for Base Revenue set out in Special Condition X of the Electricity Transmission licence. It represents the incremental change to [base revenue] for the formula year concerned, ascertained in accordance with the methodologies set out in this Handbook. The value of the MOD term is calculated through the annual iteration of the GD1 Price Control Financial Model (see Chapter 2) and is specified in a direction given by the Authority by 30 November in each formula year.

O

Ofgem

The Office of the Gas and Electricity Markets Authority.

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 in its price control allowed revenues

RIIO

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

RIIO-GD1 (Electricity Transmission)

The price control arrangements which will apply to Electricity Transmission licensees from 1 April 2013 until 31 March 2021

S

Slow money

The proportion of Totex which is credited to the licensee’s RAV balance on which the licensee receives a revenue allowance to cover finance (vanilla WACC) and depreciation costs

Shadow 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.

SO

[•]

T

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, the multiplier is $(1+X)^{Y}$ where:

- X is the Vanilla WACC for the licensee applicable to the period of deferral; and

- Y is the number of years of deferral

TO

[•]

Totex

Total expenditure – a GDN's capital (capex), replacement (repex) and operational (opex) expenditure on its transportation business except for:

- costs relating to de minimis (non transportation business) activities;
- costs relating to excluded services;
- pension deficit repair payments relating to the established deficit and unfunded ERDC costs incurred after 1 April 2004;
- fines and penalties;
- compensation payments made in relation to standards of performance;
- bad debt costs;
- costs related to the SF6 incentive scheme;
- costs relating to pass-through items;
- finance and tax costs (except for some business rates and stamp duty land tax)
- other expenditure and accounting adjustments specifically excluded from Totex by the RIIO-GD1 Cost Reporting Regulatory Instructions and Guidance.

A set percentage of Totex is added to the RAV, and the price control approach is to remunerate this amount as 'slow money' with the remaining percentage remunerated as 'fast money' in the year it is expected to be incurred.

Totex Capitalisation Rate

The percentage of Totex which is added to RAV (slow money)

U

Unified Financial Model

The model used by Ofgem to ascertain opening base revenue values for all the network price controls and to allow financeability analysis of overall price control packages (compare to GD1 price Control Financial Model)

W

WACC

The Vanilla Weighted Average Cost of Capital is Ofgem's preferred way of expressing the rate of return allowed on the Regulatory Asset Values (RAV) of price controlled network companies. 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:

- the pre-tax cost of debt - i.e. the percentage charge levied by lenders, and
- the post tax cost of equity – i.e. the percentage return equity investors expect to actually receive,

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). This is because inflation isn't taken into account in the determination of the Real Vanilla WACC percentage since revenue allowances (which include the Vanilla WACC return) are separately RPI indexed.