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| ET2 Price Control Financial Handbook | | | |
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| **Effective date** | [Insert date] | **Tel:** | 020 7901 7000 |
| **Version** | [WIP][[1]](#endnote-2)[[2]](#footnote-2) | **Email:** | RegFinance@ofgem.gov.uk |

This is the ET2 Price Control Financial Handbook which forms part of Special Condition 8.1 (Governance of the ET2 Price Control Financial Instruments) of the Electricity Transmission Licence held by Electricity transmission network operators.

This document consists of:

* + - * 1. a description of the ET2 Price Control Financial Model (PCFM) and the Annual Iteration Process (AIP) for it, used to calculate licensee’s Allowed Revenue during the course of the RIIO-ET2 Price Control Period
        2. an overview of the ET2 Variable Values used in the PCFM during the AIP, in accordance with the Special Conditions of the Licence
        3. details of how certain ET2 Variable Values are revised or calculated.

The procedures relating to modification of this handbook and the PCFM are contained in Special Condition 8.1 and up to date versions of both can be accessed on the Ofgem website.

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1. Introduction
   1. Under RIIO-ET2, Special Condition 2.1 (Revenue Restriction) determines the annual allowed revenue a licensee can recover in respect of its network business through charges. The calculation of annual allowed revenue is performed using the ET2 Price Control Financial Model (PCFM).
   2. Each year, certain inputs to the PCFM (the Variable Values) are updated through the Annual Iteration Process (AIP), resulting in updates to allowed revenue within the RIIO-2 price control period. These inputs reflect a range of factors including past and forecast performance and activity levels, and changes in the cost of capital.
   3. We have chosen to have a PCFM with an AIP because it:
2. incorporates ‘real time’ adjustments to financial allowances
3. uses a financial model for the purpose of computing interactions between financial adjustments where the relevant algebra would be excessively complicated to set out on the face of Special Conditions
4. provides transparency on adjustments to allowed revenues, since the Licence, this handbook, the PCFM and Variable Values are published
5. allows stakeholders to keep abreast of allowed revenue levels and to carry out business sensitivity analysis.
   1. This document is the Price Control Financial Handbook (PCFH, or handbook) and, along with the PCFM, is an ET2 Price Control Financial Instrument, which forms part of Special Condition 8.1. The PCFH and PCFM are subject to a formal change control process set out in Special Condition 8.1.
   2. This handbook supports the annual determination of allowed revenue by providing:
6. a description of the ET2 PCFM and the AIP
7. an overview of the ET2 Variable Values used in the PCFM during the AIP
8. details of how certain ET2 Variable Values are revised or calculated.

## Related documents

* 1. This handbook is one of several documents relevant to the calculation of allowed revenue. Other key documents include:

1. Final Determinations
2. Special Licence Conditions
3. PCFM
4. PCFM Guidance
5. Associated Documents (see Table 3.1).
   1. In any case of conflict of meaning between these documents, the following order of precedence applies:
6. the relevant licence condition(s)
7. the handbook
8. the PCFM
9. Associated Documents
10. Final Determinations.

## Document structure

* 1. The remainder of this handbook is structured as follows:

1. Section 2 provides an overview of the PCFM and details of the AIP
2. Section 3 lists the ET2 Variable Values used in the PCFM and updated through the AIP
3. subsequent sections provide details of how certain Variable Values are revised or calculated (along with further details on the PCFM).
4. The PCFM and the Annual Iteration Process
   1. This section provides an overview of the PCFM, the terms of reference for the PCFM Working Group (which reviews issues arising with respect to the form or usage of the PCFM), and details on the AIP through which the Variable Values and allowed revenue are updated annually.

## The Price Control Financial Model

* 1. The PCFM calculates the licensee’s allowed revenue for each Regulatory Year.
  2. The PCFM contains both fixed values and a Variable Values Table input area for the licensee. The allowed revenue figure for the licensee for each Regulatory Year of the Price Control Period is calculated using the fixed values, the Variable Values, and the formulae and functions embedded in the PCFM.
  3. At the outset of the Price Control Period, allowed revenue is calculated by the PCFM, using the Variable Values subsisting at that time. However, each year, through the AIP, the Variable Values must be updated, resulting in updated allowed revenue. To understand the factors that can change allowed revenue, it is helpful to distinguish between two variables that the PCFM calculates: Calculated Revenue (R) Special Condition 2.1 Part C; and Allowed Revenue (AR) Special Condition 2.1, Part B.

### Calculated Revenue

* 1. Calculated Revenue (R) is a ‘live’ calculation of real revenue allowances (in 2018/19 price terms) in accordance with Part C (Formula for calculating the Calculated Revenue term (Rt)) of Special Condition 2.1. It is a ‘live’ calculation in that Calculated Revenue for a given Regulatory Year will be different at different points in time if the inputs are changed.
  2. Chapter 3 details the Variable Values that can change through the Annual Iteration Process, including those that result in updates to Calculated Revenue.

### Allowed Revenue

* 1. Allowed Revenue (AR) is a calculation of nominal revenue allowances in accordance with Part B (Formula for calculating the Allowed Revenue term (ARt)) of Special Condition 2.1. Allowed Revenue for a given Regulatory Year depends on:

1. Calculated Revenue for the given Regulatory Year
2. inflation
3. an adjustment to reflect any revision of historical inputs from the previous AIP to the current AIP
4. a correction factor for historical deviations between Recovered Revenue and Calculated Revenue.

### Price base

* 1. When ascertaining Calculated Revenue, the PCFM works in a constant 2018/19 price base, except in respect of some tax calculations internal to the PCFM that use nominal prices. The use of nominal prices in the PCFM tax calculations is meant to more accurately reflect the licensee’s tax expenses profile in revenue allowance calculations.
  2. Where Variable Values need to be deflated from a nominal price base to the 2018-19 price base used in the PCFM, the following formula will be used:

Where:

value2018/19 prices means the deflated/restated value in 2018/19 prices

valuenominal means the value in a nominal price base or in prices of a Regulatory Year other than 2018/19

Where:

RPI means the arithmetic average of the Retail Prices Index (all items) (series: CHAW) published by the Office for National Statistics (ONS) (or any other public body taking on its functions) for each calendar month, for the period April to March in a Regulatory Year, rounded to three decimal places.[[3]](#footnote-3)

CPIH means the arithmetic average of the “Consumer Price inflation including owner-occupiers’ housing costs” (series L522) for each calendar month published by the ONS (or any other public body taking on its functions) for each calendar month, for the period April to March in a Regulatory Year, rounded to three decimal places.[[4]](#footnote-4)

### Temporal convention

* 1. The following conventions apply throughout this handbook:

1. *Relative references*: The AR term is licensee’s Allowed Revenue for each Regulatory Year t during the Price Control Period. References in this handbook to Regulatory Years are made relative to that usage. For example, in the context of ARt for Regulatory Year 2022/23, a reference in the same context to Regulatory Year t-1 would mean 2021/22 and so on
2. *Absolute references*: A reference to, for example, ‘the EDE value for 2022/23’ means the EDE value in the 2022/23 column of the Variable Values Table for the licensee contained in the PCFM.

### Forecast Variable Values

* 1. In calculating Allowed Revenue for Regulatory Year t, the PCFM uses some forecast Variable Values both for Regulatory Year t and preceding Regulatory Years. For example, in the case of expenditure, there is a two year lag before outturn values can be reflected in Allowed Revenue, and so forecasts are used.
  2. The licensee must submit updates to forecast Variable Values annually, through the AIP, in accordance with the requirements of the PCFM Guidance. These updates can apply to all Regulatory Years.

### Time value of money

* 1. The PCFM uses a ‘time value of money’ adjustment to incorporate the financial impact of the timing of cash flows, eg from switching revenues between years as a result of changes to prior year allowed revenue. This time value of money adjustment (expressed as a nominal rate) uses the annual arithmetic averages (from 01 April to 31 March, inclusive, for each year) of the daily overnight SONIA (the Sterling Overnight Index Average, published by the Bank of England (series IUDSOIA)) rate plus a 110bp margin.[[5]](#footnote-5)
  2. For future years, forecasts of SONIA will be used and updated at subsequent AIPs when out-turn data are available. SONIA will be forecast using a Bank of England instantaneous forward curve as published on the Bank of England website and will be updated during the AIP with outturn values.

### State of the PCFM

* 1. The PCFM exists as a constituent part of Special Condition 8.1 and will be maintained by Ofgem in its official records. The state of the PCFM remains constant unless and until changed by either:

1. an Annual Iteration Process - which will change the Variable Values and recalculated values which are directly or indirectly dependent upon them; or
2. a modification of the PCFM under the procedures set out in Special Condition 8.1 (Governance of ET2 Price Control Financial Instruments) or section 23 of the Act.
   1. A copy of the PCFM in its latest state will be maintained on the Ofgem website, and Ofgem will upload an updated copy by 30 November each year (after each AIP). This will allow the licensee and other stakeholders to make copies of the PCFM so that they can:
3. use their own forecasts of Variable Value revisions to forecast allowed revenue and conduct sensitivity analysis
4. reproduce the calculation of allowed revenues.
   1. Ofgem will keep a log of modifications to the PCFM and publish this log on its website.

### Error in the functionality of the PCFM

* 1. In the event that an error of functionality is discovered in the PCFM, the following procedure will be followed:

1. the issue will be considered at the earliest opportunity by the PCFM Working Group (see next section) and a corrective modification will be proposed by Ofgem
2. if the functional error has distorted the calculation of a previously published value of allowed revenue, the determined modification will include any time value of money adjustments necessary to correct for that distortion in the next calculation of allowed revenue
3. the procedure in Special Condition 8.1 for modifications to the PCFM will be followed.

## The ET2 Price Control Financial Model Working Group

* 1. 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 PCFM Working Group (‘the working group’) are set out below.

### Terms of reference

Purposes of the working group

* 1. The purposes of the working group are:

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

Composition

* 1. The composition of the group will be:

1. Ofgem (chair)
2. Ofgem (secretary)
3. one representative per ETO
4. Energy Networks Association representative (optional).

Timing and duration of the group’s work

* 1. The working group’s incumbency will run from 01 April 2021 to 31 March 2026.
  2. The group will meet at least once between 01 January and 01 April during each calendar year, but may meet more frequently if required, in particular in relation to the provision of views on the impact of proposed PCFM modifications (see paragraph 2.20 b)).
  3. In convening any meeting of the working group, Ofgem will give at least 10 working days’ notice of the proposed meeting date to the licensee.
  4. Representatives may attend meetings in person or through video or telephone conferencing facilities.
  5. A meeting of the working group will be quorate, for the purpose of expressing a view or recommendation in respect of the PCFM, when at least one representative from Ofgem, and at least one representative from every different ETO ownership group are present (in person or virtually).

Resources

* 1. 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. A copy of the record of each meeting will be provided to the licensee and to representatives who attended the meeting, and Ofgem will take account of any comments received in finalising the record.

## The Annual Iteration Process (AIP)

* 1. The AIP is the process carried out by the licensee and Authority each year[[6]](#footnote-6) in order to calculate allowed revenue (ARt for Regulatory Year t) by updating the Variable Value inputs to the PCFM.
  2. The AIP will be completed by 30 November prior to each Regulatory Year t, or as soon as is reasonably practicable thereafter. The deadline of 30 November reflects the need for the licensee to have confirmation of its allowed revenue in time to calculate and issue its use of system charges.
  3. The steps of the AIP are specified in Special Condition 8.2, Part A and the process around them is described below.

### Submission of ET2 PCFM

* 1. By 31 July prior to each Regulatory Year, the licensee must submit to the Authority the ET2 PCFM, with a completed Variable Values Table (covering activity in the prior Regulatory Year and changes to forecast activity[[7]](#footnote-7)), which has been run to calculate ARt. The licensee must publish a version of this ET2 PCFM on their website in accordance with the requirements of the PCFM Guidance.
  2. This submitted version of the GD2 PCFM may contain provisional values for Variable Values that are unknown at the time of submission. Examples of Variable Values which will not be known by 31 July are the risk free rate [XXX] (which is dependent on data published by the Bank of England in November) or a re-opener term which is subject to an outstanding decision by the Authority.
  3. Where a Variable Value is unknown at the time of submission, the licensee must calculate a provisional value using the approach specified within this handbook or within the PCFM Guidance, as applicable, and otherwise provide its best estimate with the information available at the time.
  4. Ofgem will review the submitted ET2 PCFM and confirm or amend any Variable Values, as appropriate and taking into account any decisions it has made in relation to those values.

### Dry Runs process

* 1. This process of confirming and amending values will normally take place over a number of months from 31 July to November and will be iterative to account for updates to the Variable Values as they become known.
  2. There will be one or more dry runs of the PCFM between the licensee’s initial submission of the ET2 PCFM and the final run in early November. The number of dry runs needed will depend on the number and timing of Variable Value updates required for the licensee in any particular Regulatory Year.
  3. Where the Authority amends a Variable Value from an earlier licensee submission, either due to a licensee error or to reflect updates to a provisional value, it will notify the licensee and request a resubmission of the PCFM. Any resubmissions following updates to Variable Values should be re-run to reflect the impact of the updated values on ARt.
  4. Where a licensee has not complied with Step 1 of Special Condition 8.2, Part A and has failed to submit a populated PCFM by 31 July, Ofgem will complete the Variable Values Table and run the model to calculate ARt.
  5. In order to facilitate publication of ARt by 30 November, Ofgem will normally expect to apply the following annual cut-off dates:

1. 01 May in respect of functional changes to the PCFM
2. 31 October in respect of information submitted by the licensee.[[8]](#footnote-8)

### Final Run

* 1. The final run of the ET2 PCFM will take place in early November and will be performed by Ofgem. This will take into account the Variable Values in the latest submission from the licensee, as confirmed by Ofgem and will also reflect the updated cost of debt CDE and risk free rate [YY] Variable Values, the latter of which is dependent on government bond yield data published by the Bank of England in the first week of November.
  2. Having determined any revisions to Variable Values for the licensee, Ofgem will run the ET2 PCFM as follows:

1. revised Variable Values will be entered in the appropriate Regulatory Year columns of the Variable Values Table for the licensee
2. the PCFM calculation functions will be rerun
3. all calculated values within the PCFM will be updated, including:
   1. the calculated revenue figure for the licensee for each Regulatory Year of the Price Control Period, and
   2. the modelled Regulatory Asset Value (RAV) balance for the licensee
4. the PCFM will output the value of ARt for Regulatory Year t for the licensee.
   1. The Authority will give the licensee at least 14 days’ notice of the value ARt, and a copy of the ET2 PCFM used to calculate it (including the licensee’s Variable Values, which may have been revised through the AIP), in accordance with requirements in the licence, to allow for any representations.
   2. The Authority will then (by 30 November in Regulatory Year t-1, or as soon as is reasonably practicable thereafter) publish the value of ARt and a copy of the ET2 PCFM used to calculate ARt. The value of ARt in the publication will be stated in £ millions to one decimal place.
   3. Where certain information is considered to be commercially sensitive, the licensee may request that this information be redacted before the ET2 PCFM is published. The Authority will consider the request and will share the version of the ET2 PCFM for publication including any redactions as considered necessary with the licensee in advance of the publication.
   4. Part C of Special Condition 8.2 specifies what will happen if the Authority does not publish a value for ARt by 30 November in Regulatory Year t-1.[[9]](#footnote-9)
   5. Table 2.1 below summarises the timings for the AIP during the Price Control Period.

# Table 2.1 - Summary of timings for the Annual Iteration Process

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **AIP Year** | **Licensee submits populated PCFM** | **PCFM functional change cut-off** | **Regulatory reporting information cut-off** | **Notice of proposed Variable Value revisions by** | **AIP completed and ARt published by** | **Regulatory Year t in which ARt applies** |
| Nov-2021 | 31 Jul 21 | 01 May 21 | 31 Oct 21 | 15 Nov 21 | 30 Nov 21 | 2022/23 |
| Nov-2022 | 31 Jul 22 | 01 May 22 | 31 Oct 22 | 15 Nov 22 | 30 Nov 22 | 2023/24 |
| Nov-2023 | 31 Jul 23 | 01 May 23 | 31 Oct 23 | 15 Nov 23 | 30 Nov 23 | 2024/25 |
| Nov-2024 | 31 Jul 24 | 01 May 24 | 31 Oct 24 | 15 Nov 24 | 30 Nov 24 | 2025/26 |

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

1. The ET2 Price Control Financial Model Variable Values
   1. This section lists all the ET2 Variable Values (including the relevant Special Condition and Associated Documents, where relevant, for each).

## PCFM Variable Values

The Variable Values that can be revised during AIPs are set out in Table 3.1 below.

* 1. For each Variable Value, the table provides a description, cross-references to the relevant Special Condition(s) (where appropriate), and details of Associated Documents (where relevant). It also identifies the Variable Values for which further details are provided in subsequent sections of this handbook. This includes the approaches to Variable Values calculated by Ofgem (eg cost of debt and real price effects) and details for some Variable Values in addition to that provided in Special Conditions (SpC) and other Associated Documents (eg taxation and pensions).

### Processing of different types of Variable Values

* 1. Table 3.1 presents the Variable Values according to the different types, which reflect the components of revenue to which they relate, as follows:

Cost of capital - percentage

* 1. This type of Variable Value affects the allowance provided to the licensee for financing their capital needs and contributes to Calculated Revenue indirectly.

Actual expenditure and totex allowances

* 1. The following types of Variable Values contribute to the calculation of the totex allowance through the Totex Incentive Mechanism:

1. actual expenditure
2. adjustments to totex allowances
   1. These types of Variable Values are used in the Totex Incentive Mechanism to determine the amounts that should, subject to the Totex Capitalisation Rate for the licensee, be processed as:
3. Fast Money – flowing directly into the Calculated Revenue (R) figure for the Regulatory Year to which the amount relates
4. Slow Money – addition to the licensee’s RAV in the Regulatory Year to which the amount relates, contributing indirectly to Calculated Revenue through the return on RAV and depreciation over multiple Regulatory Years.

Pass-through expenditure

* 1. This type of Variable Value is allowed expenditure that flows directly into Calculated Revenue (ie it is not used in the Totex Incentive Mechanism and there is no slow money component).

Innovation

* 1. This type of Variable Value is revenue that flows directly into Calculated Revenue.

Output Delivery Incentives

* 1. This type of Variable Value penalises or rewards licensees for incentive performance and flows directly into Calculated Revenue.

Tax allowance

* 1. This type of Variable Value relates to taxation of the licensee and contributes indirectly to Calculated Revenue or, in the case of TAXAt, flows directly into Calculated Revenue.

Legacy

* 1. This type of Variable Value relates to adjustments for previous price controls and comprises:

1. *Legacy Revenue adjustments (LAR)*: These type of adjustments flow directly into Calculated Revenue
2. *Legacy RAV Additions Adjustment (LRAV)*: These Variable Values contribute indirectly to Calculated Revenue.

Allowed revenue setting

* 1. This type of Variable Value is used in the calculation of Allowed Revenue (see paragraph 2.7) and comprises inflation indices, SONIA and Recovered Revenue.

Table 3.1 - ET2 Variable Values (VV)[[10]](#footnote-10)

| **VV** | **Description** | **SpC** | **Cross-reference/ Associated Document** |
| --- | --- | --- | --- |
| **Cost of Capital** | | | |
|  | Risk-free rate |  | PCFH section 4, PCFM Guidance |
| CDEt | Allowed percentage cost of debt (NGET and SPT) |  | PCFH section 4, PCFM Guidance |
| [CDEt] | Allowed percentage cost of debt (SHET) |  | PCFH section 4, PCFM Guidance |
| **Actual Totex Expenditure** | | | |
| ALCt | Actual load related capex |  | PCFM Guidance |
| ARCt | Actual asset replacement capex |  | PCFM Guidance |
| AOCt | Actual other capex |  | PCFM Guidance |
| ACOt | Actual network operating costs (opex) |  | PCFM Guidance |
| - | Actual indirects (opex) |  | PCFM Guidance |
| ANCt | Actual non-operational capex |  | PCFM Guidance |
| **Totex Allowance Adjustments** | | | |
|  | NARM funding adjustment and penalty mechanism | SpC 3.1 | PCFM Guidance |
|  | Resilience Re-opener |  | PCFM Guidance, [Re-opener Guidance and Application Requirements] |
|  | Resilience (UIOLI) Re-opener |  | PCFM Guidance, [Re-opener Guidance and Application Requirements] |
|  | Resilience (TIM) |  | PCFM Guidance, [PCD Reporting Requirements and Methodology] |
|  | Resilience (UIOLI) |  | PCFM Guidance, [PCD Reporting Requirements and Methodology] |
| NOITt | Non-operational IT and Telecoms Capex REOPENER ELEMENT ONLY | SpC 3.5 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| NZt | Net Zero Re-opener | SpC 3.6 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| CAMt | Coordinated Adjustment Mechanism Re-opener | SpC 3.7 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| GRIt | Generation PCD BASELINE | SpC 3.8 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| WWt | Wider Works | SpC 3.10 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| DSIt | Demand PCD | SpC 3.11 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| BPt | Bespoke PCD | SpC 3.12 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| VIMEt | Mitigating the impact of Pre-existing Transmission Infrastructure on the Visual Amenity of Designated Areas | SpC 3.13 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| OTCt | Reducing carbon emissions from operational transport | SpC 3.15 | PCFM Guidance, PCD Reporting Requirements and Methodology |
| NZFt | Net Zero Fund (UIOLI) | SpC 3.16 | PCFM Guidance |
| NZ3Ct | Net Zero carbon capital construction | SpC 3.17 | PCFM Guidance |
| GCEt | Generation Connection Outputs - Generation Connections volume driver component ONLY | SpC 3.18 | PCFM Guidance |
| LOTIt | LOTI Re-Opener | SpC 3.20 | PCFM Guidance, Guidance for Large Onshore Transmission Investments (LOTI), Re-opener Guidance and Application Requirements |
| MSIPt | Medium Sized Investment Projects re-opener | SpC 3.21 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| PCFt | Pre-Construction Funding re-opener | SpC 3.22 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| SCRt | Subsea Cable Repair re-opener | SpC 3.23 | PCFM Guidance, Re-opener Guidance and Application Requirements |
| DRIt | Demand Related Infrastructure Outputs - Allowed Expenditure volume driver component ONLY | SpC 3.19 | PCFM Guidance |
| UNLRt | Uncertain non-load projects re-opener | SpC 3.24 | PCFM Guidance, Re-opener Guidance and Application Requirements, PCD Reporting Requirements and Methodology |
|  | [Recovery (placeholder name)] |  | PCFM Guidance |
|  | [Shunt Reactor Volume Driver] |  | PCFM Guidance |
|  | [Opex Escalator indexation re-opener] |  | PCFM Guidance, Re-opener Guidance and Application Requirements |
|  | RPE Indexation |  | [PCFH section 5], PCFM Guidance |
| **Pass-through Expenditure** | | | |
| RBt | Business rates | SpC 6.1, Part B | PCFM Guidance |
| EDEt | Pension scheme established deficit | SpC 6.1, Part A | PCFH section 7 |
|  | Other Pass-through |  | PCFM Guidance |
| **Output Delivery Incentives** | | | |
| ENSIt | Common ODI - Energy Not Supplied | SpC 4.2 | PCFM Guidance |
| IIGIt | Common ODI - SF6 and other Insulation and Interruption gases (IIGs) Leakage | SpC 4.3 | PCFM Guidance |
| CONADJt | Common ODI - Timely connections | SpC 4.4 | PCFM Guidance |
| ESIt | Bespoke 1 - NGET Only (Environmental Scorecard) | SpC 4.5 | PCFM Guidance |
|  | [Common ODI - Quality of Connections Survey] |  |  |
| **Innovation** | | | |
| NIAt | The RIIO-2 Network Innovation Allowance | SpC 5.2 | PCFM Guidance, RIIO-2 Network Innovation Allowance Governance Document |
| **Tax** | | | |
|  | Adjusted net debt |  | PCFM Guidance |
|  | Tax deductible net interest cost |  | PCFM Guidance |
| TAXAt | Tax allowance adjustment | SpC 2.4 | PCFH section 6, PCFM Guidance |
| TTEt | Tax liability allowance adjustments - driven by tax trigger events |  | PCFH section 6, PCFM Guidance |
|  | General pool capital allowance opening balance brought forward |  | PCFM Guidance |
|  | Special Rate capital allowance opening balance brought forward |  | PCFM Guidance |
|  | Structures and buildings capital allowance opening balance brought forward |  | PCFM Guidance |
|  | Deferred revenue expenditure opening balance brought forward |  | PCFM Guidance |
|  | Deferred revenue pool additions (RIIO1) plus opening balance at start of RIIO1 |  | PCFM Guidance |
|  | Tax loss brought forward |  | PCFM Guidance |
|  | Allocation to "General" tax pool |  | PCFM Guidance |
|  | Allocation to "Special Rate" tax pool |  | PCFM Guidance |
|  | Allocation to "Structures and Buildings" tax pool |  | PCFM Guidance |
|  | Allocation to "Deferred Revenue" tax pool |  | PCFM Guidance |
|  | Allocation to "Revenue" tax pool |  | PCFM Guidance |
|  | Allocation to "Non Qualifying" tax pool |  | PCFM Guidance |
|  | Corporation tax rate |  | PCFM Guidance |
|  | General pool capital allowance rate |  | PCFM Guidance |
|  | Special Rates capital allowance rate |  | PCFM Guidance |
|  | Structures and buildings capital allowance rate |  | PCFM Guidance |
|  | Deferred Revenue Expenditure capital allowance rate |  | PCFM Guidance |
| **Legacy Adjustments** | | | |
| [LMOD1] | [LMOD-1] | SpC 7.3 | [PCFH section 8], PCFM Guidance |
| [LMOD2] | [LMOD-2] | SpC 7.3 | [PCFH section 8], PCFM Guidance |
| LARt | RIIO-2 legacy price control adjustments to allowed revenue | SpC 7.1 | [PCFH section 8], PCFM Guidance |
| LRAVt | RIIO-2 legacy price control adjustments to RAV |  | [PCFH section 8], PCFM Guidance |
|  | RIIO-1 net RAV additions (after disposals) |  | [PCFH section 8], PCFM Guidance |
| **Allowed Revenue Setting** | | | |
| RPIi | Forecast RPI (simple average year to March) | SpC 2.1 Part D | PCFH section 2, PCFM Guidance |
| CPIHt | Forecast CPIH (simple average year to March) | SpC 2.1 Part D | PCFH section 2, PCFM Guidance |
| Ij | Sterling Overnight Index Average (SONIA) | SpC 2.2 Part A | PCFH section 2, PCFM Guidance |
| RRi | Recovered revenue | SpC 2.3, Part A | PCFM Guidance |

1. Cost of debt and cost of equity indexation[[11]](#footnote-11)
   1. The licensee’s Calculated Revenue includes amounts to cover the efficient cost of raising finance for the transmission business from external sources, commonly referred to as the ‘cost of capital’. These amounts are calculated as a percentage return on the licensee’s RAV. The percentage is Ofgem’s estimate of the transmission businesses’ weighted average cost of capital (WACC) determined using a pre-tax cost of corporate debt percentage, a post-tax real cost of equity percentage (adjusted for expected outperformance) and a notional gearing percentage weighting.
   2. Under the RIIO-ET2 price control, the notional gearing percentage is fixed for the Price Control Period. However, the corporate debt percentages (CDE and [XXX])[[12]](#footnote-12) and the cost of equity percentage (through changes to the real (CPIH) risk-free rate ([YYY])) are updated by Ofgem on an annual basis. The updates are effected through the AIP and the approaches to determining the updated Variable Values are described below.

## Cost of debt

* 1. The ET2 PCFM in its state as at 01 April 2021 includes opening cost of corporate debt percentages CDE for the licensee for every Regulatory Year of the Price Control Period.
  2. Revised CDE values will be determined by Ofgem in accordance with the approach[[13]](#footnote-13) set out below and published in respect of each AIP. In brief, revised CDE values will be determined using a trailing average of the pounds sterling indices of bonds issued by utilities that have a remaining maturity of 10 or more years contained in the Markit iBoxx® database of bond market data. The averaging periods for the index of debt costs, set via the AIP, commence with an eleven-year period[[14]](#footnote-14), and then extend by one year as each Regulatory Year of the Price Control Period elapses.
  3. The steps Ofgem will follow to determine revised CDE values are:

*Step 1 – establish trading days*

* 1. Establish the trading days period[[15]](#footnote-15) to be used in relation to the particular AIP:

# Table 4.1 – trading days

|  |  |  |
| --- | --- | --- |
| ***Annual Iteration Process taking place no later than:*** | ***Trading days period*** | ***Regulatory Year t from which revised CDE value applies*** |
| 30 November 2021 | 01 November 2010 to 31 October 2021 | 2022/23 |
| 30 November 2022 | 01 November 2010 to 31 October 2022 | 2023/24 |
| 30 November 2023 | 01 November 2010 to 31 October 2023 | 2024/25 |
| 30 November 2024 | 01 November 2010 to 31 October 2024 | 2025/26 |

*Step 2 – obtain nominal bond yields for each trading day*

* 1. For each day in the trading days period ascertained under Step 1, obtain, from the Markit data service, the iBoxx Utilities 10yr+ index (ISIN reference DE0005996532).

*Step 3 – obtain inflation forecast*

* 1. For each day in the trading day period ascertained under Step 1, obtain an inflation value. For any given day in the trading day period, the inflation value is the latest Office for Budget Responsibility (OBR) 5yr forecast of CPI that was available on that given day, subject to the assumption that the OBR forecast is available from the first day of the month following the month of publication. For example, the inflation value for 01 November 2018, is the OBR 5yr forecast of CPI (to 2023) published in October 2018 and the inflation value for 31 October is the OBR 5yr forecast of CPI (to 2022) published in March 2018.
  2. Ofgem will source the inflation values from the data page of the OBR website.[[16]](#footnote-16)

*Step 4 – calculate real cost of debt for each trading day*

* 1. This step converts the nominal bond yields in the iBoxx data to a real cost of debt value, incorporating transaction and liquidity costs. For each day in the trading day period ascertained under Step 1, add [17] basis points (for transaction and liquidity costs) to the annual yield figures obtained under Step 2, deflate these using the inflation figure obtained under Step 3, using the following formula:

*CoD = ( 1 + iBoxx + [0.0017]) / (1 + Π ) - 1*

where:

CoD is the daily real average of the cost of debt;

iBoxx is the annual yield figures obtained under Step 2 expressed as a Decimal Percentage; and

*Π* is the inflation figure obtained under Step 3.

*Step 5 – calculate average cost of debt for trailing period*

* 1. Calculate the arithmetic average value of CoD across the trading days period ascertained under Step 1.
  2. This average, expressed as a percentage and stated to three decimal places, constitutes the revised Variable Value for the cost of corporate debt (CDE value) for each Regulatory Year.
  3. Ofgem will provide the licensee with a copy of the spreadsheet used to calculate revised CDE values at the same time as giving the notice (paragraph 2.42).
  4. The data and spreadsheet used to calculate revised CDE values will be published on the Ofgem Website (by 30 November in each Regulatory Year, or as soon as reasonably practicable thereafter (see para 2.43)).

**Variation of approach for SHE Transmission plc**

* 1. *SHETPLC’s cost of debt [XXX] is calculated by applying weights, based on changes to SHETPLC’s RAV during the RIIO-1 and RIIO-2 periods, to annual yield figures*SHE Transmission plc (SHETPLC) had a higher RAV growth in RIIO-1 than other networks and is expected to have a higher RAV growth in RIIO-2 (although the difference in RIIO-2 is not expected to be as large as in RIIO-1). A notional company with greater RAV growth than the average notional company could be expected to raise a greater proportion of its debt than the average network during that period of growth. Because of this, SHETPLC’s cost of debt is calculated differently from other networks.
  2. SHETPLC’s cost of debt [XXX] is calculated by applying weights, based on changes to SHETPLC’s RAV during the RIIO-1 and RIIO-2 periods, to annual yield figures, as follows:

where:

SHETPLC IVt means the revised [XXX] value for SHETPLC for Regulatory Year t.

IVt means the cost of debt index Variable Value for all other licensees determined under Steps 1 to 5 above

RAV means the Regulatory Asset Value for SHETPLC (inclusive of ‘shadow’ RAV[[17]](#footnote-17)) for the specified Relevant Years, expressed in nominal prices.

For this purpose, RAV values expressed in nominal prices will be obtained using the following procedure:

* + after 31 October in Relevant Year t-1, Ofgem will take a copy of the PCFM in its state following the last completed Annual Iteration Process, but including any subsequent functional modifications under Special Condition 8.1;
  + Ofgem will apply to that copy, all of the prospective revised variable Values which it has by that time determined for use in the Annual Iteration Process that is required to take place by 30 November in that same Regulatory Year t-1[[18]](#footnote-18).
  + Ofgem will run trial calculations using those values and extract the nominal RAV values which are generated within the copy model as a result.

**CoD** means a real cost of debt determined in accordance with the formula at step 4 above, but in respect of the periods specified in this formula.

* 1. It should be noted that the RAV values for SHETPLC, recorded in the PCFM, and used in calculating values of the term SHETPLC IV may subsequently be changed by other aspects of Annual Iteration Processes. In those instances, revised [XXX] values for SHETPLC will be calculated and directed for any affected Relevant Years.

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

* 1. If, for any reason, the iBoxx, or OBR series identified above cease to be published, or if Ofgem believes there is a material change in their basis, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements. If the consultation is not completed in time to determine revised Variable Values for the cost of debt for any AIP, Ofgem may use an interim approach to ensure timely completion of an AIP.[[19]](#footnote-19)  Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP.
  2. If, for reasons other than stated in paragraph 4.18, iBoxx data (paragraph 4.7) are unavailable for an entire trading days period in time to determine revised Variable Values for the cost of corporate debt for any AIP then, for that AIP 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 Variable Values for the affected Regulatory Years will be determined and published.

## Cost of equity – risk-free rate

* 1. The ET2 PCFM in its state as at 01 April 2021 includes opening real (CPIH) risk-free rates ([YYY]) for the licensee for every Regulatory Year of the Price Control Period. Changes in [YYY] result in changes to the cost of equity percentage value used in determining the allowed cost of capital (determined in the PCFM).
  2. Revised [YYY] values will be calculated by Ofgem in accordance with the approach set out below and published in respect of each AIP. In brief, revised [YYY] values will be calculated using yields on government securities (20-year real zero coupon) and applying an adjustment for the difference between RPI and CPIH inflation expectations.
  3. The steps Ofgem will follow to calculate the revised risk-free rate [YYY] value for Regulatory Year t are:

*Step 1 – obtain real government bond yields*

* 1. For each business day from 1 October to 31 October for Regulatory Year t-1, obtain the yield for British government securities, 20-year real zero coupon (series reference IUDLRZC) from the statistics page of the Bank of England’s website.[[20]](#footnote-20)

*Step 2 – obtain RPI and CPI inflation forecasts*

* 1. For each business day from 01 October to 31 October for Regulatory Year t-1, obtain inflation forecasts of CPI and RPI. For any given business day in this period, the inflation forecasts are the latest OBR 5yr forecast of CPI and 5yr forecast of RPI available on that given day, subject to the assumption that the OBR forecast is available from the first day of the month following the month of publication. For example, the inflation values for 01 November 2018, are the OBR 5yr forecasts of CPI and RPI (to 2023) published in October 2018 and the inflation values for 31 October 2018 are the OBR 5yr forecasts of CPI and RPI (to 2022) published in March 2018.
  2. Ofgem will source the inflation values from the data page of the OBR website.[[21]](#footnote-21)

*Step 3 – derive an RPI-CPIH inflation wedge*

* 1. For each business day from 01 October to 31 October for Regulatory Year t-1, calculate an RPI-CPIH wedge using inflation values from step 2 and applying the following formula:

*Step 4 – calculate real risk-free rate for each business day*

* 1. This step converts the real (RPI) 20 year gilt yields for each business day, from 1 October to 31 October, for Regulatory Year t-1 collected in Step 1 to a real (CPIH) risk-free rate by using the RPI-CPIH wedge calculated in Step 3 according to the following formula:

*Step 5 – calculate average real (CPIH) risk-free rate*

* 1. Calculate the arithmetic average value of the real (CPIH) risk-free rates from Step 4 across the business days in the period 01 October to 31 October in Regulatory Year t-1.
  2. This average, expressed as a percentage and stated to three decimal places, constitutes the revised Variable Value for the real risk-free rate ([YYY] value) for Regulatory Year t.
  3. Ofgem will provide the licensee with a copy of the spreadsheet used to calculate revised [YYY] values at the same time as giving the notice (paragraph 2.42).
  4. The data and spreadsheet used to calculate revised [YYY] values will be published on the Ofgem Website (by 30 November in each Regulatory Year, or as soon as reasonably practicable thereafter (see para 2.43)).

### Non-availability or changes to basis of data for cost of equity – risk-free rate

* 1. If, for any reason, the Bank of England, or OBR series identified above cease to be published, or if Ofgem believes there is a material change in their basis, Ofgem will consult on alternatives, as well as on any reconciliation that may need to be undertaken between the above series and any replacements. If the consultation is not completed in time to determine revised Variable Values for the risk-free rate for any AIP, Ofgem may use an interim approach to ensure timely completion of an AIP. [[22]](#footnote-22)  Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP.

1. Real Price Effects
   1. [To be done… ]
2. Tax liability allowances
   1. The PCFM calculates a licensee’s tax liability allowance on a notional basis (ie as a stand-alone entity) using, among other inputs, corporation tax rates and capital allowance writing down rates. Where rate changes are announced, these can be reflected in the PCFM by updating the Variable Values for these rates [XX etc.] at each AIP.
   2. The PCFM also calculates a tax clawback. Where a licensee’s gearing (calculated from the Variable Values [XX and YY]) is greater than notional gearing, any tax benefit from higher tax-deductible interest costs is clawed-back for network users through the tax liability allowance.
   3. Tax liability allowances are also dependent on other Variable Values including:
3. Tax trigger events TTE - a licensee’s notional tax liability[[23]](#footnote-23) is subject to existing legislation, case law, accounting standards and HM Revenue & Customs (HMRC) policy. Changes to these can trigger a change to tax liability allowances
4. Tax review adjustment mechanism TAXAt – this mechanism enables Ofgem to direct an adjustment to the notional tax allowance subject to a tax review and consultation with the licensee.
5. Capital allowances: Opening pool balances (legacy) – opening balances of capital allowance pools can be updated, through Variable Values [XXX].
   1. Further below, the approach to determining or revising the Variable Values in paragraph 6.3 and/or the calculation in the PCFM are described.
   2. It should be noted that underlying tax liability allowances for the licensee within the PCFM may also change under the AIP as a consequence of other Variable Values, such as changes in allowed totex. However, these changes are distinct from the specific adjustments to tax liability allowances in this chapter.
   3. Any recalculation of the licensee’s tax liability allowances necessarily includes an iterative modelling aspect: an increased allowance gives rise to an increased liability which requires an increased allowance and so on. The effect can be either positive or negative. This ‘tax allowance on tax allowance’ issue is dealt with by the functionality within the PCFM and is factored into Calculated Revenue via the AIP.

*Regulatory tax losses*

* 1. In some instances, the approach to calculating tax liability allowances could imply that the licensee could receive a negative allowance. In such cases, the price control treatment is to model a zero allowance and to record the tax loss arising as a ‘regulatory tax loss’ balance, to be deducted from the total taxable profits before the tax is calculated for any tax liability allowances that would otherwise be allocated to the year concerned or later years. The regulatory tax loss balance attributable to each Regulatory Year (together with a running total) is held within the PCFM.
  2. For the avoidance of doubt, regulatory tax losses are not carried back and offset against tax liability allowances for Regulatory Years earlier than the Regulatory Year to which the regulatory tax loss concerned is attributable.
  3. Any surrender by a licensee of losses to a group company will not be reflected within the regulatory loss balance and similarly for consortium relief[[24]](#footnote-24).

*Group tax arrangements*

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

1. the claim or surrender of group tax relief (including consortium relief);
2. interest payments (including any coupons on debt instruments or preference share dividends) and receipts that are not tax deductible or chargeable under HMRC rules for the purposes of computing the licensee’s taxable profits, including but not limited to adjustments for transfer pricing and the ‘Corporate Interest Restriction Rules’; and
3. any other adjustments required in appendix 1 of Ofgem’s open letter dated 31 July 2009 (Claw-back of tax benefit due to excess gearing).[[25]](#footnote-25)
   1. For the purposes of the approach set out in the tax clawback section of this chapter, levels of debt, interest and gearing are considered at licensee level, as opposed to any other level with respect to the corporate or ownership group of which the licensee is a member.

*Accounting framework*

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

1. EU-*IFRS, if adopted for use by the licensee[[26]](#footnote-26);*
2. *Financial Reporting Standard 101, EU adopted IFRS with reduced disclosures; or*
3. *UK* GAAP under Financial Reporting Standard 102.

## Tax trigger events

* 1. The PCFM allows for changes to a licensee’s tax liability allowance, through TTE, for factors exogenous to the licensee, its owners or controllers that cause a change in its notional tax liabilities[[27]](#footnote-27) for one or more Regulatory Years. These factors exclude changes to the corporation tax rate and writing down allowance rates, which are accounted for with the Variable Values [XXX etc.], but include:

1. changes to applicable legislation;
2. the setting of legal precedents through case law;
3. changes to HMRC interpretation of legislation; and
4. changes in accounting standards.

*Notification of Tax Trigger Events*

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

1. a description of the event;
2. the changes in tax liability allowances that the event is considered to have caused and the Regulatory Years to which they relate;
3. the calculations (including all relevant parameters and values) that the licensee used to arrive at the amounts referred to in subparagraph (b) – in performing these calculations the licensee should include a ‘tax allowance on tax allowance’ factor as explained in paragraph 6.6 but should ignore the tax trigger deadband;
4. any relevant information provided by HMRC in relation to the event;
5. evidence of mitigating measures that the licensee has taken to minimise any additional liabilities arising from the event; and
6. comments by the licensee on:
   1. the relevance of the event to its tax position,
   2. whether grounds exist to contest the applicability of the event to the licensee, and
   3. the reporting treatment the licensee expects to apply in its tax submissions to HMRC and in its Regulatory Accounts.
   4. The licensee’s notification should also state whether it considers that the materiality threshold (see paragraph 6.24) has been exceeded for the Regulatory Year(s) concerned, taking into account the total net amount of tax liability changes (upward and downward) included in the current notification and any previous notifications.
   5. Ofgem will review any notifications given to it by the licensee under paragraph 6.14 and may ask the licensee:
7. for additional information in respect of one or more of the notified events; and/or
8. to submit the results of agreed upon audit procedures specified by Ofgem and carried out by the licensee’s Appropriate Auditor, to assist in confirming the appropriateness and accuracy of the licensee’s calculations.
   1. Ofgem will inform the licensee by 31 October in the same Regulatory Year t-1 whether, in respect of each tax trigger event:
9. it has agreed (on a provisional or confirmed basis) the change in tax liabilities figure calculated by the licensee;
10. it has determined (on a provisional or confirmed basis) a different change in tax liabilities figure from that calculated by the licensee; or
11. it has decided that consideration of any change in tax liabilities should be deferred until further/better information is available.
    1. In deciding which of the actions set out in paragraph 6.18 should be taken, Ofgem will, without limitation, take account of whether the licensee has conclusively agreed its tax liabilities for the Regulatory Year concerned with HMRC. Where there has been a provisional agreement/determination or a deferral of consideration, the TTE values concerned will be subject to further revision for the purposes of a later AIP.
    2. Where Ofgem decides to use 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 will consider.
    3. Ofgem will also notify the licensee by 31 October in each Regulatory Year t-1 of any tax trigger events that it proposes to take into account that have not been included in a notification sent to Ofgem by the licensee. The licensee has the right to reply setting out its objections, which Ofgem will consider.
    4. If Ofgem has not finished considering any matters raised by the licensee under paragraph 6.20 or paragraph 6.21 before notifying the licensee of tax trigger events that it proposed to take into account, the Authority will through business correspondence, apprise the licensee of any provisionality it has applied in determining the revised TTE values that it proposes to apply, that might entail a further revision to those values for use in the next AIP.
    5. Where a tax trigger event changes the allocation of allowable expenditure into different statutory capital allowance pools, the applicable allocation and allowance rates will be adjusted to take into account the new expected allocation basis from the effective date of the new requirement. Ofgem will work with licensees to agree the financial effect of revised tax pool allocation requirements where these are not straightforward.

*Materiality threshold and ‘deadband’*

* 1. A materiality threshold is applied to tax trigger events during the Price Control Period and a £m threshold amount for each Regulatory Year is included among the fixed values on the Tax Trigger sheet for the licensee in the PCFM.
  2. A change to the licensee’s notional tax liability allowance for a particular Regulatory Year is only applied where one or more trigger events would result in a tax liability allowance change for that year whose absolute value is greater than the threshold amount. Furthermore, any change to the tax liability allowance (upward or downward) is limited to the amount that is in excess of the threshold amount for the Regulatory Year concerned. Additionally, tax trigger events will only be taken into account for the purposes of increasing the licensee’s tax liability allowances where the licensee has demonstrably used its reasonable endeavours to minimise any increase in its tax liabilities.
  3. Where the change to the licensee’s tax liability allowance for a particular Regulatory Year is below the threshold, subsequent tax trigger events, relating back to that Regulatory Year, could cause the threshold amount to be exceeded. In that case, a change to the licensee’s tax liability allowance for the Regulatory Year concerned (a revised TTE value) would be determined once the threshold had been exceeded.
  4. For the avoidance of doubt, a regulatory tax loss figure attributable to a particular Regulatory Year is not taken into account for the purposes of deciding whether the threshold amount has been exceeded for that year.

*Logging of trigger events*

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

1. a description of the event;
2. the name of the party who notified the event (Ofgem or licensee);
3. the date of notification;
4. the amount of any change in the licensee’s tax liabilities that has been determined; and
5. details of any events for which a determination is in abeyance and a description of the outstanding actions to be taken.

## Tax review

* 1. Special Condition 2.4 (Tax Review Adjustment) sets out that the Authority will direct the value of TAXAt after a Tax Review.
  2. At the outset of the Price Control Period on 01 April 2021, the value of TAXAt is set at zero for the duration of the price control. Under Special Condition 2.4, Part A the licensee’s tax liability allowance can be updated following a Tax Review. The Authority may consider initiating a Tax Review if one or more of the events described below occurs.

*Potential Trigger events*

* 1. There are a number of scenarios in which the Authority may consider triggering a tax review; these are as follows:

1. if there are material, unexplained differences between the notional tax allowance and actual tax liability, which have not been adequately addressed in the supporting commentary to the reconciliation[[28]](#footnote-28);
2. if Ofgem is notified in writing of a valid concern, whether by the licensee itself or another stakeholder; or
3. if a licensee undergoes a change in ownership or a material change in circumstances that is likely to affect its tax liability.

*Materiality*

* 1. Under paragraph 6.31, an unexplained difference between the notional tax allowance and actual tax liability will be subject to the same materiality threshold that is applied to Tax Trigger Events during the Price Control Period as described in paragraph 6.25 of this handbook. For the avoidance of doubt, an unexplained difference is considered material if it exceeds the threshold described.
  2. Where the aggregate remaining variance in the submitted Tax Reconciliation is greater than the threshold amount, Ofgem would expect the licensee to provide supporting explanation(s) in the commentary to the Tax Reconciliation.

*Notifying the Authority*

* 1. A notification by the licensee under paragraph 6.31 must be made in writing to the Authority on or before [31 July] in respect of the preceding Regulatory Year and include statements setting out:

1. the reason for the notification including a description of the specific event(s) that the licensee considers will have an impact on their actual corporation tax liability;
2. the impact of the specific event(s) on the licensee's actual corporation tax liability and whether it is considered material;
3. the Regulatory Year(s) that the licensee considers will be affected by the event;
4. a calculation and the basis of the calculation for any proposed adjustments to the value of the TAXAt term; and
5. supporting evidence including any relevant information or correspondence received from HMRC and any other information that the licensee considers is relevant.
   1. Where Ofgem receives a notification of a valid concern from a stakeholder after [31 July] in any Regulatory Year, the adjustments will be made in the subsequent year at the following AIP. In such a case, the functionality of the PCFM means that a Time Value of Money Adjustment would be applied.
   2. If an adjustment is made to the TAXAt term for a period prior to the Regulatory Year in which the Tax Review is triggered, any resultant changes to Allowed Revenue will, subject to a Time Value of Money Adjustment, be brought forward. For the avoidance of doubt such an adjustment will not have any retrospective effect on a previously published value of Allowed Revenue.

*Preliminary assessment*

* 1. Where one or more of the events under paragraph 6.31 occur, Ofgem will perform a preliminary assessment before deciding whether to undertake the review.
  2. This preliminary assessment may involve requesting further information from the affected licensee(s) and explaining the Authority is considering undertaking a Tax Review.

*Review process*

* 1. If the preliminary information requested does not suitably address the concerns raised, Ofgem may undertake a formal Tax Review, which will require the affected licensee to procure, at its own expense, a review by an Appropriately Qualified Independent Examiner[[29]](#footnote-29).
  2. Ofgem will notify the licensee in accordance with Part A of Special Condition 2.4 (Tax Review Adjustment) in order to commence the review.

*After the review*

* 1. Following the review, the Authority will consider the findings of the examiner’s report and publish a decision on whether or not an adjustment is needed to the tax allowance through the Variable Value TAXAt in accordance with Part B of Special Condition 2.4 (Tax Review Adjustment).
  2. Before making a decision, the Authority will consult on the proposed adjustment to the TAXAt for no less than 28 days.
  3. Where the examiner’s report contains information that is considered confidential or market sensitive, the licensee may request that this information be redacted from any publication. Information agreed in writing as being confidential by the Authority will be excluded from any publications.
  4. The adjusted value will be reflected in the ET2 PCFM and will be published on the Ofgem Website by 30 November in each Regulatory Year.

## Capital allowances

*Opening pool balances (legacy)*

* 1. Tax liability allowance calculations under the AIP make use of regulatory tax pool balance figures held within the PCFM. The opening balances (as at 01 April 2021) for these tax pools may be subject to legacy price control adjustments through revisions to [XXX] Variable Values.

1. Pensions

## Financial Adjustments - Pensions

* 1. The PCFM contains a Variable Value (EDE) allowance[[30]](#footnote-30) for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period. Opening values for EDE are based on the outcome of a pension reasonableness review concluded in November 2020. EDE (or the pensions allowance value) will be updated during the Price Control Period, through the AIP, according to the provisions of this chapter.

### Expected timing of pensions allowance revisions

* 1. The intention is that pensions allowance values will only be revised periodically in light of triennial actuarial valuations of the relevant pension schemes. Two pension scheme valuations are expected in the RIIO-ET2 price control period, as set out in Table 7.1 with only the first of these expected to result in publication of revised allowances within the period.

# Table 7.1 – Expected timetable for pensions scheme valuations

|  |  |  |
| --- | --- | --- |
| **Pension scheme valuation date** | **Completion of Reasonableness Review** | **Publication of revised pension allowance value** |
| 31 March 2022 | 31 October 2023 (rr = 2023/24) | 30 November 2023 |
| 31 March 2025 | 31 October 2026 (rr = 2026/27) | 30 November 2026 |

* 1. Although the intention is to revise pensions allowance values according to the timetable in Table 7.1 it may be necessary to revise them at different times if, for example, a scheme valuation or completion of a Reasonableness Review (see from paragraph 7.30) is delayed. In those circumstances, pensions allowance values would still be determined in a way that is consistent with the procedures set out in this chapter. The revision of Pensions Allowance values at a different time because of the delayed completion of a Reasonableness Review will not affect the timetable for subsequent reviews of Pensions Allowance referred to in Table 7.1.
  2. Licensees whose scheme triennial valuation dates differ to those shown in the first column of Table 7.1 will be required to provide either a full valuation or an updated valuation on these dates. The approach that should be used by the licensee to produce an updated valuation is set out in the Authority’s Pension Deficit Allocation Methodology, published in the Triennial Pension Reporting Pack as part of the Regulatory Instructions Guidance.
  3. The remainder of this chapter sets out:

1. general provisions – in section 1
2. the timetable and process for revising pension allowance values, including details of the Reasonableness Review – in section 2
3. the calculation of revised pensions allowance values – in section 3.

## Section 1 – General provisions

### Price control pension principles

* 1. The Authority’s price control pension principles are set out in Ofgem’s guidance note on price control pension principles under RIIO issued as Appendix 3 to the decision letter, ‘Decision on the Authority's policy for funding Pension Scheme Established Deficits’ dated 7 April 2017.[[31]](#footnote-31)

### Pension Scheme Established Deficit

* 1. For the purposes of this chapter:

1. the term cut-off date refers to the date of 31 March 2012
2. the term Pension Scheme Established Deficit (PSED), or “established deficit”, means an amount derived as the value of the liabilities within a defined benefit pension scheme (or schemes) sponsored (or co-sponsored, eg if part of a group scheme) by the licensee expressed as a positive number, less the corresponding assets, where those assets and liabilities are:
   1. attributable to the licensee’s transmission business, and
   2. attributable to pensionable service up to and including the cut-off date.[[32]](#footnote-32)
   3. The licensee’s PSED will be calculated using:
3. the triennial actuarial valuation of the pension scheme or schemes that contain the PSED described in paragraph 7.7 b)
4. the allocation of assets and liabilities in the scheme(s) referred to in subparagraph a) to the PSED using the Pension Deficit Allocation Methodology;
5. the effective date for revised allocations at each triennial actuarial valuation that take effect in the year rr (see Table 7.1), and
6. the Reasonableness Review with respect to the price control pension principles which could, exceptionally, result in adjustments to the PSED figure on account of errors in methodology or data.
   1. While the Price Control Period ends on 31 March 2026, Pensions Allowance values will be determined having regard to further PSED repair periods determined under the methodology set out in this chapter (and the associated Price Control Financial Instrument licence condition).

### Established surpluses

* 1. The existence of an established surplus indicates that consumers have funded the relevant pension scheme more than it would now appear was necessary. One of the objectives behind our policy is to protect the consumer interest by encouraging strategies that ensure any over-funding can be returned to consumers, where appropriate, and that minimise the risk of a surplus being unrecoverable for consumers or being used, for example to de-risk the scheme, in a way that would not otherwise be in the consumer interest. Strategies may include careful management of deficit funding, the use of asset backed funding arrangements as described from paragraph 7.14, and the use of pension contribution holidays, especially when a scheme still has a significant number of active members.
  2. In the event that an established surplus arises, it may be appropriate for a licensee and the pension scheme trustees to agree a programme of pension contributions below the level that would otherwise be necessary to fund the accruals of benefits for active members and any deficit relating to post cut-off service. These reduced contributions can be called a contribution holiday. It is important that a pension contribution holiday, to the extent that it is attributable to an established surplus, is returned to consumers.
  3. As part of the Reasonableness Review (see paragraph 7.30) we will conduct an initial review of any established surplus to identify whether a more detailed review is required. This more detailed review would occur as part of the close out of RIIO-2, using the latest information available at that time. The review would take into account the mitigating actions a company has put in place to manage an unnecessary surplus, prevailing and forecast market conditions, the impact of any pension payment holidays (including the timing of those holidays) and the materiality of the surplus. If the review concludes an adjustment is required, it would be applied as part of RIIO-2 close-out.

### Pension costs outside the scope of this chapter

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

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

### Asset-backed funding arrangements

* 1. The licensee may choose to enter into asset-backed funding arrangements with pension scheme trustees, either directly or indirectly through related parties. Such arrangements might include a range of alternative funding arrangements, for example, mechanisms involving contingent assets or loan notes benefitting relevant pension schemes.
  2. Any asset-backed funding arrangements must be fully compliant with all conditions, for example relating to the ring fence, in the licensee’s licence (except where appropriate consent has been granted under the terms of a condition).
  3. Notwithstanding that an arrangement may be fully compliant with licence conditions, the licensee is encouraged to provide information on any such mechanism or prospective mechanism to the Authority at the earliest opportunity. In general, the Authority would encourage asset-backed funding arrangements that would facilitate the return of funds to consumers in the event that a pension scheme deficit turns out to be smaller than anticipated.
  4. Asset-backed funding arrangements would in general be disregarded in the determination of revised Pensions Allowance values because allowances are provided for PSED repair and not for ancillary arrangements (such as asset-backed funding) per se. However, such arrangements would be relevant in any proposal by the licensee for Pensions Allowance values under the methodology set out in this chapter.

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

### Reasons for updating pensions allowance values

* 1. The licensee’s pensions allowance values may be revised during the Price Control Period to reflect:

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

### Process steps in a year in which a reasonableness review is being conducted[[33]](#footnote-33)

*Step 1: by 31 July*

* 1. The Authority will be in receipt of price control review information from the licensee for Regulatory Years up to and including the last complete Regulatory Year.
  2. The Authority will obtain the licensee’s Scheme Valuation Data Set for the relevant valuation of the licensee’s defined-benefit pension schemes by 31 July and commence a Reasonableness Review.
  3. The Scheme Valuation Data Set should comprise:

1. the actuarial valuation of each defined-benefit scheme in respect of which the licensee is a sponsoring employer, being either a full valuation or an update of the last preceding full triennial valuation, with the asset and liability values projected forward to the full valuation date on the basis set out in the Pension Deficit Allocation Methodology[[34]](#footnote-34)
2. each scheme’s statement of funding principles
3. each scheme’s statement of investment principles, and
4. any other information reasonably required.

*Step 2: by 31 August*

* 1. The licensee will submit:

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

*Step 3: by 14 September*

* 1. The licensee will submit:

1. its proposals with supporting explanation for
2. Base Annual PSED Allowances (PBAPAy), under paragraph 7.46
3. payment history allowances (PPHy), under paragraph 7.52
4. any proposed prospective discounting basis for payment history variances, reflected in PhDRy, under paragraph 7.52.
5. explanation of how it has engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED.
   1. In its explanations under paragraphs 7.24 b), the licensee should set out why it considers its proposals appropriately protect the interests of consumers. The licensee’s explanations should, in each case where appropriate, refer to the prevailing level of Base Annual PSED Allowances, the profile of repair payments that can be agreed with the scheme trustees, how it has sought to maintain confidence of scheme trustees in the covenant with the licensee in support of such agreement, how it has sought to minimise the risk of stranded surplus, how it has sought to balance the interests of existing and future consumers, how it has sought to manage the volatility of revenues and financial ratios and any asset-backed arrangements that are intended to protect the consumer interest. The licensee’s explanations should, where appropriate, refer to or be consistent with information it submitted in accordance with paragraph 7.22.

*Step 4: by 30 September*

* 1. The Authority will provisionally decide whether:

1. any change should be made to the licensee’s proposals for Base Annual PSED Allowances and payment history allowances for reasons anticipated in paragraph 7.32 a) and b), and 7.33
2. to apply an existing adjustment factor, introduce a new adjustment factor or extend the scope or effect of an existing adjustment factor for reasons anticipated in paragraph 7.34. Adjustment factor can be either upwards or downwards
3. to set out any recommendation to the licensee to adopt good practice before the next reasonableness review under paragraph 7.38.
   1. The Authority will give notice of any such provisional decisions to the licensee, allowing 14 days for representations to be made.

*Step 5: by 31 October*

* 1. The Authority will complete its Reasonableness Review:

1. determine the values BAPAy, representing the Base Annual PSED Allowances, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.46
2. determine the values PHy, representing the payment history allowances, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.52
3. determine the values AFy, representing any adjustment factors, for each of the three years following the Reasonableness Review
4. calculate the Pensions Allowance values for each of the three years following the Reasonableness Review, such that:
5. set out any recommendation to the licensee to adopt good practice before the next Reasonableness Review
6. determine the discount rates for payment history allowances, hDRy, or an unambiguous basis for determining them, for each of the three years following the Reasonableness Review, giving reasons for any departure from those proposed in paragraph 7.52
7. confirm whether a more detailed review of any established surplus is required (see paragraph 7.12).

*Step 6: by 30 November*

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

### Reasonableness Reviews and adjustment factors

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

1. formulated and justified its proposals for Base Annual PSED Allowances and Payment History Allowances
2. engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED, recognising the responsibilities of trustees and the regulatory framework they are subject to, recognising the uncertainties that exist in the PSED valuation and recognising the strength of the employer’s covenant
3. responded to any recommendations set out by the Authority in preceding Reasonableness Reviews
4. otherwise followed good practice, informed by practice in the regulated and broader private sectors, taking into account statutory and regulatory factors affecting the relevant pension schemes and the specific circumstances of each scheme, in promoting consumer interests with respect to the PSED.
   1. The review referred to in paragraph 7.30 is termed the Reasonableness Review for the purposes of this methodology.
   2. Having completed the review, the Authority will consider whether there is any case for:
5. making corrections to the licensee’s calculations in respect of its proposals for Base Annual PSED Allowances and Payment History Allowances due to data or methodological errors
6. determining Base Annual PSED Allowances and Payment History Allowances with different profiles (while maintaining the same overall prospective values) compared with those proposed by the licensee under paragraphs 7.46 and 7.52
7. continuing to apply, modifying the scope or modifying the effect of any existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review
8. applying any new adjustment factor under paragraph 7.34, and
9. conducting a more detailed review of any established surplus (see paragraph 7.12).
   1. The Authority will only make a determination in respect of paragraph 7.32b) if it considers the licensee’s proposals under paragraphs 7.46 and 7.52 do not appropriately protect the interests of consumers, taking into account statutory and regulatory factors affecting the relevant pension schemes, which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED.
   2. Consistent with its price control pensions Principle 3,[[35]](#footnote-35) the Authority will only apply adjustment factors referred to in paragraph 7.32 c) and 7.32 d) to the extent necessary to disallow any excess costs arising from a material failure in the licensee’s responsibility for taking good care of entrusted pension scheme resources on behalf of consumers. New adjustment factors will only arise in the following limited circumstances:
10. where the Authority has established the licensee’s recklessness, negligence, fraud or breach of fiduciary duty towards consumers, such as failures in its participation in the governance of a pension scheme to correct for poor governance or management of the scheme’s resources, including any undue risk of a stranded surplus
11. inequitable charges for consumers arising from using the time value of money in paragraphs 2.13 and 2.14 in ascertaining the cumulative payment history variance under paragraph 7.49 for any materially accelerated PSED payments that would otherwise have been determined with reference to the discount rate specified in the licensee’s Scheme Valuation Data Set
12. the licensee’s failure to respond adequately to any recommendations set out by the Authority in preceding Reasonableness Reviews.
    1. Any modification to the effect of existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review will be made after taking equitable account of the time value of money involved, in general with reference to hDRy.
    2. Before deciding to make determinations referred to in paragraphs 7.32 b), 7.32 c) and 7.32 d), the Authority will consult with the licensee (see paragraph 7.27), giving its reasons with reference to paragraphs 7.33 and 7.34 and to the Pensions Principles referred to in paragraph 7.6.
    3. After, considering any representations made by the licensee, the Authority will:
13. notify the licensee of its decision
14. set out the matters, referred to in paragraphs 7.33 and 7.34, that have led to its decision, and
15. Set out the basis on which it considers any adjustment factors referred to in 7.32 c) or 7.32 d) might be discontinued at the next Reasonableness Review.
    1. Where, after consulting with the licensee (paragraph 7.27) and giving due weight to the licensee’s representations, the Authority considers the licensee is not following good practice which would have the effect of promoting consumer interests with respect to the PSED, the Authority will set out recommendations to the licensee for it to adopt before the next reasonableness review where:
16. the Authority considers that adopting the recommendations would not conflict with statutory and regulatory factors affecting the relevant pension schemes
17. the Authority has taken into account the relative duties of the licensee and the pension scheme trustees and the extent to which the licensee is only able to influence trustee decisions
18. the Authority considers that adopting the recommendations would be in the interests of consumers and would not disproportionately impact the licensee
19. the Authority considers it is practical for the licensee to adopt the recommendations.

## Section 3 – Proposals for revised pensions allowance values

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

1. Base Annual PSED Allowances
2. payment history allowances.

### Base Annual PSED Allowances

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

1. the indicative further PSED repair period, see from paragraph 7.42
2. the indicative base annual PSED allowance, see from paragraph 7.44 and
3. its proposal for Base Annual PSED Allowances, see from paragraph 7.46.

*Indicative further PSED repair period*

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

1. the value irp, where irp is calculated using the following formula:

where:

PSED is defined in paragraph 7.7 b), expressed in 2018/19 price terms

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

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

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

and

1. 15.

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

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

1. 11.14, calculated under the formula at paragraph 7.42a), and
2. 15.

*Indicative Base Annual PSED Allowance*

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

where:

irp is the indicative further PSED repair period ascertained under paragraph 7.42.

* 1. For example, if the PSED was £1m in 2012/13 prices, the Indicative further PSED repair period was 11.14 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be £100k. IBAPA will equal EBAPA unless irp is limited to 15.

*Proposal for Base Annual PSED Allowances*

* 1. Subject to its consideration of the factors set out in subparagraphs (a) to (d) below, the licensee may propose allowances in line with the Indicative Base Annual PSED Allowance calculated under paragraph 7.44. The licensee may propose, with its supporting rationale, an alternative profile of Base Annual PSED Allowances over a repair period that may be shorter or longer than the period determined by paragraph 7.42 if it considers that the indicative Base Annual PSED Allowance calculated by paragraph 7.44 above either:

1. does not fairly represent a profile of repair payments that can be agreed with the scheme trustees,
2. following consultation with the Authority, does not appropriately protect the interests of consumers,
3. derives from an indicative further PSED repair period ascertained under paragraph 7.42 which is less than 5 years, or
4. is otherwise inappropriate or inequitable.
   1. The alternative proposal under paragraph 7.46 must represent a profile of Base Annual PSED Allowances, PBAPAy for each year y subsequent to the valuation date specified in Table 7.1 such that

where:

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

ABV means the value of assets as at the PSED valuation date held under asset-backed arrangements that is fairly attributable to funding by the licensee out of negative cumulative payment history variances (see paragraph 7.49) up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 7.52) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 7.52.

PBAPAy for years rr-1 and rr are the Base Annual PSED Allowances determined by the Authority for those years, and

“·” is a symbol for multiply (the mathematical operation of multiplication)

### Payment history allowances

* 1. The determination of revisions to Pensions Allowance values for the licensee will include payment history allowances, which may be positive or negative, relating to the cumulative variance between the licensee’s PSED repair payments and its historical allowances for PSED repair prior to the PSED valuation date. The payment history prior to a triennial valuation will affect that valuation, and thus the Base Annual PSED Allowances needed to fund it as described in paragraph 7.40. Payment history allowances ensure that customers are properly compensated if the licensee has, prior to the triennial valuation, paid less in funding the PSED than it has received from consumers, and that companies do not lose out if they have paid more.
  2. The cumulative pre-valuation payment history variance value at the end of the Reasonableness Review year, Vrr, is ascertained using a method permitted by paragraph 7.51 or using the following formula:

where:

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

pco1 means the first regulatory year subsequent to the cut-off date

rr is the regulatory year specified in Table 7.1 for the relevant Reasonableness Review

Dy means the net sum of the following, which may be positive or negative, expressed in 2018/19 price terms:

* amounts received by the relevant pension scheme(s) in respect of PSED repair during the course of year y, including amounts received in respect of an obligation accounted for in the LO term in paragraph 7.47
* less any amounts directly or indirectly returned to the licensee or a related undertaking by the relevant pension scheme(s) during the course of year y under an arrangement agreed between the licensee and the scheme(s),
* less the amount by which ongoing pension contributions (for active members) have been reduced on account of an established surplus as described in paragraph 7.11.
* plus any amounts determined by the Authority as advisory fees or other costs relating to the development or implementation of a pensions initiative, eg a contingent asset arrangement, following a review of evidence submitted by the licensee.

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

Ey means the licensee’s Base Annual PSED Allowances plus payment history allowances, PHy (which may be positive or negative), included in revenue allowances for the year y expressed in constant price terms in accordance with paragraph 7.48. Ey excludes any adjustment factor value AF but includes any prior period history allowances included in revenue allowances in the period since pco1 relating to any true-up value in LTU and any other relevant allowances, including contingent asset allowances. With the written agreement of the Authority, the licensee may adjust prior period history allowances to exclude those attributable to legacy true-up values excluded from the LTU term in accordance with paragraph 7.50.

CTy means the actual or, in the case of CTrr+1, prospective rate of Corporation Tax applicable to the licensee in year y

for example:

hDRy means the discount rate values under any alternative discounting basis determined by the Authority in the relevant reasonableness review for year y (see 7.28 e)) or, where no alternative discounting basis has been specified, the time value of money as described in paragraphs 2.13 and 2.14.

* 1. Where relevant,

1. Subject to subparagraph (b), the legacy true-up value, LTU, represents the present value as at the end of the Reasonableness Review year of any arrangement or arrangements previously agreed or determined by the Authority for the post cut-off true-up of the licensee’s pension deficit payment history or true-up of other pension-related costs prior to the cut-off date.
2. With the Authority’s written agreement, the licensee may attribute payment history allowances to legacy true up values identified in subparagraph (a) on a present value neutral basis and exclude both attributable payment history allowances from the calculation of Ey in paragraph 7.49 and the attributable LTU value from the LTU term applied in paragraph 7.49.
   1. The licensee may choose to present a truncated calculation of the term Vrr specified in paragraph 7.49, on a basis that is demonstrably consistent with the formula specified in paragraph 7.49. Such a truncated calculation would include cumulative pre-valuation payment history variance values calculated for a previous reasonableness review and rolled forward for payment history variances arising since the valuation date relevant to that earlier review, discount rates and, where relevant, changes in corporation tax rates.
   2. The licensee should propose payment history allowances for future years y, PPHy, such that:

PhDRy means the discount rate for payment history allowances for year y proposed by the licensee, or the rate forecast for year y according to the licensee’s proposed basis of determining discount rates, in either case framed in accordance with paragraph 7.25. Such a proposal may relate PhDRy to the value of DR, the time value of money or rates of return on asset-backed arrangements. In the absence of any proposal, PhDRy is the time value of money in period rr+1 calculated in accordance with paragraphs 2.13 and 2.14.

ABC means the deemed present value as at the end of the Reasonableness Review year of the cumulative funding of asset-backed arrangements through negative cumulative payment history variances up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV (see paragraph 7.47) and ABC agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, ABC should be set at the present value of ABV specified in paragraph 7.47 as at the end of the reasonableness review year, after applying appropriate discount rates (generally hDRy).

1. Legacy
   1. [to be done … ]

# Appendices

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Appendix 1 - Glossary

[to be done… ]

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Alphabet A1

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Alphabet A2

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B

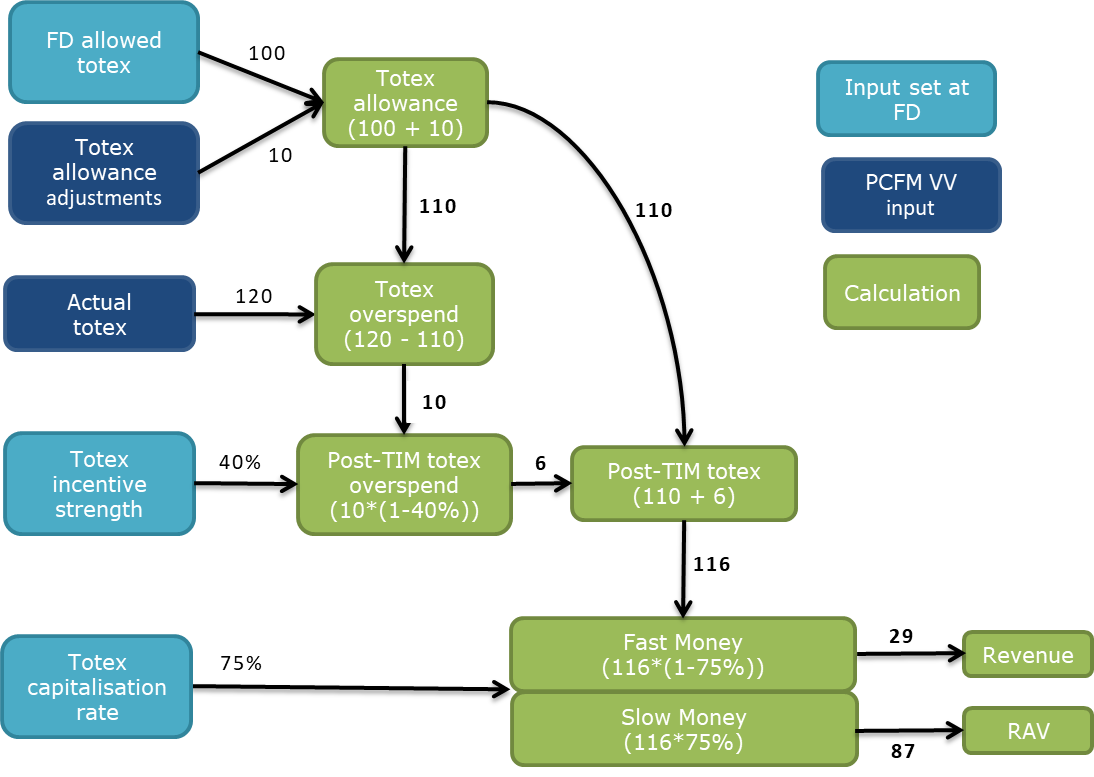
Alphabet B1

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Appendix 2 – Totex Incentive Mechanism

1. The Totex Incentive Mechanism (TIM) enables licensees to retain a specified portion of underspending against totex allowances (with network users benefiting from the reciprocal portion) or to bear a specified portion of overspending (with network users funding the reciprocal portion).
2. The TIM adjusts totex allowances for (forecast or outturn) over or underspend against those allowances. The adjustment depends on the amount of under or overspend and the Totex Incentive Strength (TIS) for the licensee. The TIS is the post-tax percentage the licensee bears of an overspend, or retains of an underspend, against allowances. The adjustment that is made to the totex figures is the Funding Adjustment Rate (often called the ‘sharing factor’) which is calculated as (1 – TIS) and is a fixed input value for the licensee in the PCFM. Applying the Funding Adjustment Rate to the over (or under) spend gives the amount that is added to (or subtracted from) the totex allowances, giving a post-TIM totex.
3. The PCFM apportions post-TIM totex using the Totex Capitalisation Rate for the licensee as either fast money or slow money (see paragraph 3.6). The Totex Capitalisation Rate for the licensee for the relevant Regulatory Year is a fixed input value for the licensee in the PCFM. Under the AIP, the effects of this modelling treatment (including any ancillary effects such as the impact on tax allowances) are reflected in the value of the term Rt.
4. A schematic of the TIM, with illustrative numbers showing an overspend, is provided in the chart below.

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



1. [↑](#endnote-ref-2)
2. [Note: This handbook is a work in progress (WIP) and the content is subject to decisions at Final Determinations.  Square brackets [] are used to provide notes to the reader or to indicate items that cannot yet be added or are otherwise provisional.] [↑](#footnote-ref-2)
3. <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/chaw/mm23> [↑](#footnote-ref-3)
4. <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l522/mm23> [↑](#footnote-ref-4)
5. <https://www.bankofengland.co.uk/> [↑](#footnote-ref-5)
6. Except for 2025/26, when there will be no AIP (see Special Condition 8.2.15). [↑](#footnote-ref-6)
7. Variable Values for Regulatory Years later than Regulatory Year t do not feed into the calculation of the term ARt. Therefore, calculated values in the PCFM for Regulatory Years later than Regulatory Year t represent only a forecast. This is without prejudice to the status of the Variable Values concerned, which may have been decided and/or directed under licence conditions and which may or may not be subject to subsequent revision. [↑](#footnote-ref-7)
8. In applying this cut-off date, Ofgem will, through business correspondence, apprise the licensee of any provisionality it has attached to information submissions, that might involve a restatement of the information by the licensee for the purpose of making a further revision to the Variable Value(s) concerned for use in a subsequent Annual Iteration Process. [↑](#footnote-ref-8)
9. Except for 2025/26, when there will be no AIP (see Special Condition 8.2.15). [↑](#footnote-ref-9)
10. [Note: this table is a draft. The final version will comprise a list of VVs contained within the PCFM at Final Determinations and be consistent with the terms in the licence.] [↑](#footnote-ref-10)
11. [Note: chapter to be amended to clarify that cost of debt and risk-free rate are to be updated for all Regulatory Years at each AIP, with forecasts based on the approach in the WACC Allowance model.] [↑](#footnote-ref-11)
12. The ET2 PCFM uses two variable values for [‘Allowed percentage Cost of Debt (CoD)’] as reflected in Table 2, one applies to *“National Grid Electricity (NGET) and Scottish Power Transmission (SPT)”* and the other applies to *`SHE Transmission Plc (SHETPLC)’.* SHETPLC uses a different cost of debt approach, as explained in paragraphs 4.15 - 4.17. The ET2 PCFM needs both CoD values to be updated each year. [↑](#footnote-ref-12)
13. PCFM uses a different approach for cost of debt calculation for SHET Transmission Plc (SHETPLC) as described in paragraphs 4.15 - 4.17. [↑](#footnote-ref-13)
14. A ten year period having been used to set opening CDE values at the outset of the Price Control Period. [↑](#footnote-ref-14)
15. Trading days as published in the Markit iBoxx® database [↑](#footnote-ref-15)
16. <https://obr.uk> [↑](#footnote-ref-16)
17. See Glossary [↑](#footnote-ref-17)
18. For the purpose of the Annual Iteration Process itself these prospective values remain contingent upon the notification and direction processes specified in relevant Special Conditions [↑](#footnote-ref-18)
19. This interim approach is not restricted to using the value from the most recent publication that did contain the value (as required of the licensee under Special Condition 8.2.9 (b)). [↑](#footnote-ref-19)
20. <https://www.bankofengland.co.uk/> [↑](#footnote-ref-20)
21. https://obr.uk [↑](#footnote-ref-21)
22. This interim approach is not restricted to using the value from the most recent publication that did contain the value (as required of the licensee under Special Condition 8.2.9 (b)). [↑](#footnote-ref-22)
23. The tax liability which would be modelled if the event was taken into account. [↑](#footnote-ref-23)
24. <https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm80530> [↑](#footnote-ref-24)
25. <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=49&refer=Networks> and as amended for the treatment of hybrid financial instruments [↑](#footnote-ref-25)
26. Including the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) where applicable. [↑](#footnote-ref-26)
27. The tax liability, which would be modelled if the event were taken into account. [↑](#footnote-ref-27)
28. The reconciliation referred to is the Tax Reconciliation template reconciling the notional tax allowance per the PCFM and actual tax liability per their latest CT600 forms. This template forms part of the licensee’s annual RIGs submissions. [↑](#footnote-ref-28)
29. The examiner would be a qualified tax accountant from a reputable firm regulated by a relevant professional body. The examiner chosen by the licensee should be agreed to by Ofgem. If appropriate, the examiner used may be the licensee’s Appropriate auditors as defined in Standard Condition B1 of the Electricity Transmission Licence. [↑](#footnote-ref-29)
30. In the context of PSED repair expenditure we refer to ‘allowances’ rather than ‘allowed expenditure’ because EDE is included in full in calculated revenue in the PCFM, ie it is not subject to the TIM. [↑](#footnote-ref-30)
31. <https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_pseds.pdf> [↑](#footnote-ref-31)
32. This definition applies even if the value derived is a negative amount (a surplus position) and may be described as an “established surplus”. [↑](#footnote-ref-32)
33. Although the intention is to conduct the steps of the reasonableness review according to the dates specified in this section, it may be necessary to change these dates (eg as occurred with the review in 2020, when dates were changed as a consequence of the impacts Covid-19) whilst following the same steps. [↑](#footnote-ref-33)
34. [https://ofgem.gov.uk/publications-and-updates/notice-modify-regulatory-instructions-and-guidance-held-network-operators](https://authors.ofgem.gov.uk/publications-and-updates/notice-modify-regulatory-instructions-and-guidance-held-network-operators) [↑](#footnote-ref-34)
35. See Appendix 3, of <https://www.ofgem.gov.uk/system/files/docs/2017/04/decision_on_policy_for_funding_pseds.pdf> [↑](#footnote-ref-35)