

## PCFM

| Condition                            | Comment  |
|--------------------------------------|--|
| <b>General introductory comments</b> | <p>The following comments on the PCFM relate to the GT2 Price Control Financial Model (Statcon) published on 17 December 2020 as part of the statutory consultation. We draw this distinction as Ofgem has since recirculated the PCFM to licensees on 15 January 2021.</p> <p><u>Combining the Revenue RRP and RFPR with the Price Control Financial Model (PCFM)</u></p> <p>In the reasons and effects documents published as part of the statutory consultation, Ofgem set out their intent to consolidate the various financial instruments and reporting templates into the PCFM (paragraph 2.1). The Regulatory Financial Performance Reporting (RFPR) sections and reporting elements of the PCFM are yet to be published.</p> <p>This impacts and limits our review of the licence as follows:</p> <ul style="list-style-type: none"> <li>• The Return Adjustment (RTNA) term is reliant on operational performance values and average RAV with the licence formula referencing the PCFM as the source for this data. The RFPR section of the PCFM which we assume would include these values has yet to be developed.</li> <li>• The Tax Reconciliation template has not yet been published. This template requires networks to identify and categories differences between the regulatory tax allowances and corporation tax liability attributable to the licensee. This omission is of particular concern as the reconciliation forms the basis of a Board Assurance Statement and is the trigger for Ofgem to instigate a tax review and potential reopener direction.</li> </ul> <p><u>Transparency of calculations</u></p> <p>The calculations used to derive incentive values should be presented in the PCFM to provide appropriate governance and transparency that the licence algebra has been correctly applied in translating incentive performance to revenue impact. Although the Licence contains the algebra, due to its complex nature, we consider it to be in stakeholders' best interests to include the calculations, in the same way as they were included in the RIIO-1 Revenue RRP, to provide a clear linkage between performance and revenue. The absence of the calculations from the RIIO-2 PCFM will lead licensees to having offline separate models to calculate such values, undermining the objective of Ofgem streamlining the Revenue RRP into the PCFM. Including the calculations in the PCFM will ensure that all parties are interpreting and applying revenue calculations correctly and consistently.</p> |
| <b>RPI/CPIH</b>                      | <ul style="list-style-type: none"> <li>• Ofgem's stated intent, which we supported, through the RIIO-2 process was that the transition from RPI to CPIH indexation would result in consumers and investors being neither better nor worse off in net present value terms.</li> </ul> <p>However, the inflation indexation framework currently applied does not achieve value neutrality due to significant errors in the methodology used. This is most evident in the indexation of the RAV which, by use of annual Regulatory Year average inflation values, does not allow the full entitlement to RPI indexation of the RAV up to 31 March 2021, followed by CPIH indexation thereafter. Application of an annual average inflation values also causes potential issues with other elements of Allowed Revenue which are not derived directly from the RAV; these elements will require further</p>  |

consideration on a line by line basis. We also refer Ofgem to the paper submitted via the ENA on this issue; "RPI to CPIH Transition", First Economics, January 2021.

Correction of this error will likely result in a significant change to Allowed Revenue. However, we recognise the complex nature of the correction and that this will require further discussions between Ofgem and the licensees to resolve. We therefore request that Ofgem acknowledges and sets out their commitment to resolving this error prior to the publication of the licence modification in February 2021 although we recognise that a solution is likely to be implemented after this date. We believe this is an error of mathematics rather than disagreement on policy and are willing to work with Ofgem to develop the most appropriate solution.

- RPI requires rounding to 3 decimal places in the PCFM as per the Price Control Financial Handbook (PCFH), paragraph 2.14. The rounding should be applied within the formulae used to calculate the financial year average inflation values in rows 23 and 29 on the Annual Inflation tab.
- CPIH requires rounding to 3 decimal places in the PCFM as per the PCFH, paragraph 2.14. The rounding should be applied within the formulae used to calculate the financial year average inflation values in rows 26 and 29 on the Annual Inflation tab.
- The RPI and CPIH inflation indices for November 2020 do not align with the ONS data as per the PCFH data sources referenced in Footnotes 3 and 4. We propose that the PCFM values are updated to align with the source data:

|                 | ONS   | PCFM  |
|-----------------|-------|-------|
| CPIH – Nov 2020 | 109.1 | 109.3 |
| RPI – Nov 2020  | 293.5 | 294.6 |

## Calculation of Allowed Revenue

### Calculated Revenue (R and SOR)

- The SOR value (as calculated on the SystemOperator tab) includes a SORTNA term. This is labelled as Return Adjustment. However, the licence provides drafting for an RTNA term only (SpC 2.5), not SORTNA. As per our response to Chapter 2, the PCFM should be amended to enact the licence by removing the SORTNA term from the PCFM and including both Gas Transmission Owner and Gas System Operator relevant terms within the RTNA calculation.
- The Equity Issuance costs are calculated on a nominal basis before being converted to a 18/19 price base through which they then flow to Calculated Revenue. As a result, the opening RAV figure required to calculate Equity Issuance costs is converted from 18/19 price base to nominal. Currently in the PCFM the "Real to nominal prices conversion factor (financial year average)" used to convert the RAV uses the prior year conversion factor. The nominal Equity Issuance costs are then deflated using the current year inflation indexation factor. This results in Equity Issuance costs in 2022 being understated by £0.1m. We therefore requested to Ofgem that the PCFM was republished in early January 2021 to correct these values.

- The Revenue calculation in the PCFM is inconsistent with the licence. The revenue in the PCFM includes BPI while formula for  $R_t$  in SpC 2.1.7 of the licence omits the BPI term. The licence formula requires updating; this amendment is proposed in our response to chapter 2.

### AR / ADJ

- The PCFM does not correctly replicate Part B of SpC 8.2 which states that the Authority will publish the ADJR and AR, SOADJR and SOAR terms. The AR (TO) and AR (SO) tabs within the PCFM correctly state that the AR term is as published but then incorrectly apply the “as published” wording to the ADJ and SOADJ terms which are not published under SpC 8.2 Part B. The “as published” wording is omitted from the ADJR and SOADJR terms. The following cells in the PCFM should therefore be amended as follows to maintain consistency with the licence drafting:

AR (TO) tab : cell E11 : AIP adjustment term

AR (TO) tab : cell E12 : Adjusted revenue (as published)

AR (SO) tab : cell E11 : AIP adjustment term

AR (SO) tab : cell E12 : Adjusted revenue (as published)

### K correction and penalty terms

- The licence states that the penal rate adjustment will be applied if  $RR_t/AR_t \geq 1.06$  or if  $RR_t/AR_t \leq 0.94$ . However, the PCFM applies  $PRA_t$  when  $RR_t/AR_t > 1.06$  or if  $RR_t/AR_t < 0.94$ . This is inconsistent with the licence for the  $PRA_t$  term in SpC 2.1.14 and the  $SOPRA_t$  term in SpC 2.3.12. The PCFM should be updated to reflect the licence formulae.

## Uncertainty Mechanism

### Reopeners

- The totex variant allowances allocation percentages are not completed for a number of allowance categories. When the allowance Variable Values are populated through the Annual Iteration Process (AIP) or PCFM republication process, the omission of the allocation percentages results in the allowances being excluded from the Totex Incentive Mechanism (TIM) and capitalisation mechanisms resulting in incorrect revenues. As the allocation percentages are not themselves Variable Values, they cannot be populated through the AIP but would instead have to be modified through the PCFM Working Group. We therefore propose that the allocation percentages are populated in their entirety in the PCFM published prior to the start of the RIIO-2 period.

### PCD

- There are inputs within the blue box variable input table which reference the same licence term. This creates ambiguity in the population of the PCFM variable values and will result in incorrect inputs or even duplicate allowances if the values are populated by reference to the licence term only. We propose that Ofgem amend the PCD licence drafting and align the PCFM references with the revised drafting and

refer Ofgem to our proposals as set out at the start of our response to Chapter 3. This applies to the following terms:

- CRITt (NGGT TO & NGGT SO)
  - CROTt (NGGT TO & NGGT SO)
  - PSUPt (NGGT TO)
  - PCFt (NGGT TO)
  - BTRt (NGGT TO)
  - KLSSt (NGGT TO)
  - CEPt (NGGT TO)
- The FIOct term is also duplicated within the blue box variable input table on the NGGT TO tab. In this case, there is no baseline PCD allowance for the FIOct term and both allowances directed through the re-opener process and any subsequent adjustments will flow through the UM input. Therefore, the FIOC PCD input (row 26) is not required and should be removed from the input table. Table 3.1 of the PCFM Handbook similarly requires removal of the FIOct PCD input.

### UIOLI

- The Net Zero And Re-opener Development Fund use it or lose it allowance (NGGT TO tab, row 29) does not include the licence term RDFt. We recommend that cell H29 on the NGGT TO tab is updated to state RDFt.
- There are conflicting messages as to where RDF should sit in the licence. The Final Determinations core document states that this UIOLI allowance will be associated to Licence condition 5.4, this intent is not reflected in the licence with the RDFt term being treated as a totex allowance rather than included in other revenue. We propose that Ofgem enact the policy set out in Final Determinations, which requires the RDFt term to be moved from chapter 3 to chapter 5 with the RDFt term being added to the formula defining ORAt. The PCFM also requires amendment to move the RDFt from the Totex Allowance Variable Value inputs (NGGT TO tab, row 29) to the Other Revenue Allowance Variable Value inputs (NGGT TO tab, row 94). Table 3.1 in PCFH will then also require aligning with the approach adopted in the PCFM by moving the RDFt from the Variant Totex Allowances category to the Other Revenue Allowances category.
- The CROTt terms do not have the correct functionality applied within the PCFM to enact the UIOLI mechanism. Within the PCFM, the allowances and expenditure flow through totex and into the TIM tab. This results in the Totex Incentive Mechanism being applied to any difference where expenditure is in excess of allowance. We propose that, in order to enact the UIOLI as described in Final Determinations, the CROTt UIOLI terms should form part of the total totex allowance but a new tab should be created for Non-TIM totex to clearly separate out this new category of totex. The Non-TIM totex tab should enable application of the appropriate capitalisation rate but would not apply any sharing factor to spend in excess of allowance (it is assumed that in the case of lower expenditure compared with the initial allowance, the allowance would be reduced to equal spend).

### Opex Escalator (OEt)

- There is currently no calculative methodology for OEt included in the PCFM, and instead this appears to be a hard-keyed value in the “blue box” section. We support integration of this methodology inside in the PCFM as opposed to having separate standalone calculation sheets. This reduces the number of data and process hand-offs, and reduces the risk for transposition errors in a situation where information is transferred between different spreadsheets.
- We observe that OEt is fully allocated to the indirect totex category. This is not fully correct, as the licence algebra comprises the Network Operating Cost escalator as well as the CAI mechanism. An element of OEt should therefore be allocated to the NOC totex category. This can be formularised within the PCFM based on the licence algebra, and in the calculative methodology for the OEt term within the PCFM.
- We observe that the OEt is assigned to Capitalisation Rate 2, which aligns to the treatment of UMs otherwise.
- In practice, thought needs to be given as to how direct and indirect UM costs are differentiated for the purposes of re-opener submissions, particularly where certain UM categories are outside the scope of the Opex Escalator, but could legitimately attract indirect cost allocations.

### RPEs

- At present, we observe that the PCFM contains rules as to whether different classes of variant totex would attract RPEs. However, these do not currently appear to have any calculative effect within the PCFM, and the underpinning rationale for these rules is unclear. It is therefore important that the PCFH clearly and consistently documents the intended policy as a point of record.
- Section 5.2 of the PCFH states that “The totex allowances to which the variable value RPEt applies are identified in the PCFM and the calculation of the allowance for real price effects is done within the PCFM”. On examination of the draft PCFM, we cannot see any calculative methodology for the RPE allowances, and instead these appear to be hard keyed inputs in the “Variant Allowances” section of the licensee input tabs. We support full integration of the calculative methodology for RPEs within the PCFM, although this does not currently appear to have been incorporated in the draft PCFMs.
- At time of writing there is no detailed end to end calculative methodology for RPE allowances available for us to appraise against the algebra quoted in section 5.4 of the PCFH.
- We observe that the PCFM includes allocation rules of RPE allowances to totex allowance types (column BD of licensee input tabs). The basis of these is unclear and appears to exclude allocations for totex allowance types that would attract RPE allowances. This requires further clarification, and reconciliation to finalised FD totex models.
- The PCFM currently allocates RPE allowances to the “Capitalisation Rate 2” totex category. This does not make logical sense, as the RPE allowances will be based on baseline totex allowances in the first instance. This is probably better implemented as a dynamic allocation rule based on the prevailing RPE allowance calculation, with RPE allowances on baseline allowances allocation to Capitalisation Rate 1, and RPE allowances on UMs being allocated to Capitalisation Rate 2.

## Innovation / Other Allowed Revenue

### Carry Over NIC

- The PCFM is inconsistent with the licence with respect to carry over NIC (NICF<sub>t</sub>). The PCFM includes the NICF term within the ORA<sub>t</sub> section (tab NGGT TO, row 93) and also includes NIC within the legacy section (tab NGGT TO, row 106), thus meaning there is duplication of inputs. The Carry over NICF term is included in Chapter 7 of the licence in SpC 7.7. Therefore, the PCFM should be amended to replicate the licence drafting by removing the reference to NIC from row 93 of the ORA<sub>t</sub> section.

### NICF

- The value associated with the 2020/21 NICF determination has not been included within the blue box inputs. This is of significant value to NGGT at £27.17m as per the decision document issued by Ofgem on 30 November 2020. We therefore requested to Ofgem that the PCFM was republished in early January 2021 to include this value.

### Other Revenue

- The GTO Other Revenue components included in the PCFM (NGGT TO tab, Other revenue allowances, rows 88-97) are inconsistent with the licence. In the PCFM Other Revenue includes The Strategic Innovation Fund but this is not included in section 5.1.3 of the licence. We consider that the PCFM is correct and the licence requires updating as detailed in our response to chapter 5.
- The Total Other Revenue term on the SystemOperator tab (row 74) is referred to as ORA<sub>t</sub>. This term should be labelled SOORAT<sub>t</sub> consistent with the terminology used in SpC 5.4.

## Legacy

### Legacy MOD and RIIO-1 Close out revenue adjustment

- We recognise that there are LMOD terms required to close out the RIIO-1 PCFM, however decisions on items non mechanistic close out items are outstanding and subject to consultation. At the moment the only route for these agreements to flow through are the LMOD terms. There are two key issues with this approach.

#### i) Status of LMOD values

Firstly, there is the issue around timing and at which point the LMODs become fixed. Close out methodologies and values may not be agreed by the time the LMOD2 (2022/23) is updated for RRP21 actuals and based on the following information taken from the regulatory instruments that once the MOD is set, there should be no retrospective changes.

Footnote 51 of the Price Control Financial Handbook (PCFH) states that 'LMOD2021/22 will not change in the RIIO2 PCFM after it has been set for the regulatory year 2020/21' and paragraph 8.19 in the PCFH states 'As with the RIIO-1 process, a new MOD<sub>t</sub> (eg MOD2021/22 and MOD2022/23) will be calculated and directed at each AIP, reflecting any changes related to the RIIO-1 variable values or from the closeout process'.

Whilst we expect updates to the forecast LMOD2022/23 following the submission of RRP21, it is still not clear whether LMOD2021/22 is fixed given there wasn't a formal

publication of the AIP in November 2020 and the MOD2021/22 (LMOD1) was not formally directed, which adds further to the confusion of the status.

Also, paragraph 8.23 of the PCFH states 'The value for LMOD2021/22 relating to Regulatory Year 2019/20 is derived from outturn data submitted by licensees by 31 July 2020 in accordance with the Regulatory Instructions & Guidance (RIGs). Values of LMODt will not change in any subsequent AIP.

We welcome clarification from Ofgem on the status of the legacy MOD values.

#### ii) Risks to cashflow and financeability

Secondly, the use of LMODs for revenue adjustments relating to all close out items poses a risk to the cashflows and financeability of the licensee through applying the adjustment to a single regulatory year. As raised previously through our response to the licence drafting informal consultation in September 2020 and through the Licence Drafting Working Groups, we consider that RIIO-1 close out adjustments should be spread over the same number of years in which they arose, in order to mitigate such risks. There is precedent for this in RIIO-1 whereby a legacy revenue term was included within the PCFM. We support maintaining this approach for RIIO-2. We propose that an 'LREV' term is reflected in the licence and incorporated into the PCFM which results in the ability to phase the total close out adjustment across the years of at least the RIIO-2 price control period. This is in line with the methodology used within the RIIO-1 framework. This means that the close out direction would result in the network and Ofgem determining on the items that go into the legacy revenue term but would avoid trying to create a mechanism at the same time and potentially having to make changes to the licence and PCFM.

#### Legacy RAV

- The labelling within the PCFM needs to reflect 'LRAVt' in Row 108 of the NGGT TO tab and Row 68 of the NGGT SO tab.
- We also note in our response to the PCFH that the timebound nature of the updates to LRAV, as set out in Chapter 8 of the PCFM, which limit updates to the November 2021 iteration process should be removed.

|                 |   |
|-----------------|---|
| <b>Tax</b>      | <ul style="list-style-type: none"> <li>We note that the allowance rate for Deferred revenue expenditure assumes an asset life of 45 years. In practice, the licensee may claim this balance over a different time period in its CT600 so this rate may need to be updated as RIIO-2 progresses. We note that the Deferred revenue expenditure capital allowance rate is designated as an Ofgem input in the NGGT TO tab, row 150 and NGGT SO, row 101. We would therefore welcome clarification as to how this cell would be updated if required</li> <li>In calculating the tax allowances for the Gas System Operator the tax base is calculated by adding back the Pre-RIIO-1 pension true up (SystemOperator tab, row 456). This is inconsistent with the Gas Transmission Owner tax base calculation (Finance&amp;Tax tab, rows 212-219) which does not add in the GTO equivalent Pre-RIIO-1 pension true-up. We request that Ofgem provide clarification on this difference in the tax base calculation.</li> <li>There are no rows for the "Special Rate" and "Deferred Revenue" tax pools on the NGGT SO tab (rows 91-94). However, there is a calculation for the capital allowances of these two pools (rows 337-357 on the SystemOperator tab). The PCFM requires updating to include the "Special Rate" and "Deferred Revenue" tax pool to tax allocations on the NGGT SO tab and SystemOperator tab to allow for allowances to be allocated to the "Special Rate" and "Deferred Revenue" tax pools if required.</li> <li>At the informal licence drafting consultation we raised the issue of the inflation applied to calculate the interest deduction term within the Profits attributable to corporation tax. This item is included in the issues log published by Ofgem but we do not consider this has been addressed in the current drafting PCFM. We therefore restate our comment.</li> </ul> <p>The Tax allowance calculation is impacted by the value of fixed and index-linked interest deducted in calculating the Profits attributable to corporation tax. The fixed interest value is calculated by inflating the real cost of debt value by the Forecast Debt inflation (CPIH long term assumption), row 183 of the Inputs tab. However, the values included with the Forecast Debt inflation (CPIH long term assumption) are set equal to the RPI-CPIH inflation (simple average year to March) for 2025/26 in row 178 of the Inputs tab. The value in 2025/26 does not equate to the OBR 5-year forecast value for the duration of the price control period. In order to maintain a long-term assumption for CPIH across the period, this value will need to be updated for the forthcoming and subsequent Regulatory Years at each Annual Iteration Process. As such long-term CPIH assumption should be included as a Variable Value input on the NGET tab and the process for completion detailed within the PCFH.</p> |
| <b>DRS</b>      | <ul style="list-style-type: none"> <li>The Identified directly remunerated services costs (NGGT TO tab, row 115) of £13.9m per annum, as submitted in our December 2019 business plan, have not been included within the blue box inputs. We therefore requested to Ofgem that the PCFM was republished in early January 2021 to include these values.</li> </ul>   |
| <b>Net debt</b> | <ul style="list-style-type: none"> <li>In the calculation of net debt (Finance&amp;Tax tab), the SO other revenue costs are currently being added in the calculation rather than deducted. On the Finance&amp;Tax row 29, a negative sign needs to be added into the beginning of the formula for each year.</li> </ul>   |

**Financial  
framework**

- The RIIO-1 vanilla allowed return on capital values (NGGT TO tab row 171 and NGGT SO tab row 122) for 2020/21 do not align with those in the latest RIIO-1 PCFM agreed with Ofgem for the November 2020 AIP, as shown in the table below:

| 2021    | GT    |
|---------|-------|
| T1 PCFM | 3.23% |
| T2 PCFM | 3.26% |

We request that Ofgem clarify the reason for this difference.

- The Risk free rate input is required to be rounded to 2 decimal places in the PCFM as set out in paragraph 4.26 of the PCFH. Currently, an unrounded input is included in NGGT TO, row 120 and NGGT SO tab, row 73. These inputs require rounding to 2 decimal places.
- The NGGT TO SO tab requires an SORFR input. However, the PCFH only includes a calculation for the RFR term. Although the RFR term is expected to follow the same calculation and produce the same value for SORFR, this would require explicit statement in the PCFH. We suggest that the simplest solution is to amend the term in the NGGT SO tab, cell H73 to RFR.
- The IBTA<sub>t</sub> input is required to be rounded to 2 decimal places in the PCFM as set out in paragraph 4.12 of the PCFH. Currently, an unrounded input is included in NGGT TO, row 119 and NGGT SO tab, row 72. These inputs require rounding to 2 decimal places.
- As raised in our response to the PCFH, the uplift values applied in the calculation of CDE are not specified in the PCFH and we request Ofgem provides further clarification on these values.