

CROSS SECTOR	
REFERENCE NUMBER:	CATEGORY: Amendment
LICENCE CONDITION NUMBER: <i>(if relevant):</i>	SpC 8.1
TITLE:	GT2 & ET2 PCFH (DRAFT)
RELEVANT LICENCE CONSULTATION QUESTIONS <i>(if any):</i>	
RELEVANT ISSUES LOG:	
POLICY ISSUES	
	<p><u>Order of precedence</u></p> <ul style="list-style-type: none"> We note that, in NGET paragraph 1.7 and NGG para 1.8, Ofgem sets out an updated list of the order or precedence of documents which has added both Associated Documents and Final Determinations. Ofgem is proposing a number of Associated Documents which will be incorporated into the licence in particular licence conditions, albeit with different levels of obligations to comply. We do not object to the addition of Associated Documents to the order of precedence. In contrast, the Final Determinations do not form part of the licence and have legal effect only in so far as they are referenced specifically in the other documents which are listed. The Final Determinations should therefore not feature in the list of order of precedence. It may be helpful to include a sentence making clear that the Final Determinations do not form part of the licence unless expressly referenced. <p><u>Regulatory Processes</u></p> <ul style="list-style-type: none"> We note that, in Table 2.1, Ofgem refers to submission of a populated RIIO-2 PCFM on 31 July 2021. We would expect to complete the RIIO-1 regulatory reporting instruments i.e. the Cost & Outputs RRP, the Revenue RRP and the RFPR. The RIIO-1 PCFM is not submitted on 31 July by licensees under the RIIO-1 process. We would welcome discussions with Ofgem on the interaction of the RIIO-1 and RIIO-2 submissions and further consideration of the timelines given the regulatory reporting burden this may create. <p><u>Regulatory Instruments</u></p> <ul style="list-style-type: none"> Clarification of the purpose of the macros and the methodology they employ within the PCFH would be beneficial to users of the PCFM and therefore we request that this information is included within the PCFM Guidance.

	<p><u>Forecasting of Variable Values</u></p> <ul style="list-style-type: none"> • We support the seeming extension of the forecasting policy to re-opener terms where these values have not yet determined (paragraph 2.32 of the PCFH). However, we note that this policy has yet to be reflected in the RIIO-2 framework documentation. • Paragraph 2.33 specifies that the licensee must calculate provisional values using the approach specified within the Handbook or the PCFM Guidance and otherwise provide a best estimate with the information available at the time. However, the PCFM Guidance and proposed methodology for calculation of provision values has yet to be shared with licensees on forecasting guidance or policy. <p><u>Chapter 2 – The PCFM and the Annual Iteration Process</u></p> <ul style="list-style-type: none"> • Paragraph 2.31 requires the licensee to publish a version of the PCFM submitted as at 31 July on their website in accordance with PCFM Guidance requirements. Paragraph 2.43 states that the Authority will, by 30 November, publish a copy of the value used to calculate ART. To ensure transparency for the stakeholder and to avoid confusion between the various publications there should be a naming convention adopted to differentiate between the PCFM published on the licensee’s website to the PCFM published on the Ofgem’s website. The naming convention could be used to clarify the purpose of the publications <p><u>Chapter 6 – Tax liability allowances</u></p> <ul style="list-style-type: none"> • Paragraph 6.45 – We assume from the wording “The opening balances (as at 01 April 2021) for these tax pools may be subject to legacy price control adjustments...” that it is Ofgem’s intention to carry forward the notional capital allowances pool balances, with adjustment or the final T1 position, rather than resetting the pool balances to actual. <p><u>Chapter 7 - Pensions</u></p> <ul style="list-style-type: none"> • We are supportive of Ofgem’s ambition to avoid schemes incurring excessive risk, or funding excessive contributions that result in pension scheme surpluses that don’t benefit consumers who have part funded them. We are also supportive of Ofgem’s objective to return a share of scheme surpluses to consumers, where those surpluses are used to reduce ongoing contributions for active scheme members. <p>We appreciate that Ofgem has acknowledged (by inserting “where appropriate” into ET2 PCFH paragraph 7.10 and GT2 PCFH paragraph 7.11) that surpluses will legitimately arise in many cases. However, the current proposed established surplus wording still allows dangerous ambiguity around future pension scheme surpluses. Ofgem should be clearer that the existence of future surpluses does not automatically mean that consumers have overpaid in the past. Nor should network operators be given any impression that they should try to avoid efficiently managed, moderate surpluses from arising, as this could lead to perverse incentives that would be detrimental to consumers’ interests. For</p>
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	<p>example, an efficiently incurred surplus can be effectively used to de-risk scheme funding in a way that reduces the likelihood of consumers needing to fund future deficits.</p> <p>We acknowledge that when schemes move from deficit into surplus, it would be reasonable for Ofgem to review how that surplus arose, and to determine whether or not excessive investment risk or excessive consumer-funded deficit contributions were made to achieve that surplus. However, increases in surpluses arising during PDAM review periods in which consumers have not funded any deficit contribution allowances should not be subject to any close-out adjustments of the type introduced in paragraph 7.12 for ET and paragraph 7.13 for GT (unless those surpluses were used to reduce ongoing scheme contributions for remaining active members).</p> <p>The introduction of new mechanisms like the close-out adjustment referred to above would be a material departure from existing practice and must be fully consulted on as part of a formal consultation process (with appropriate time for responses to be adequately considered).</p> <p>We refer to our previous comments (reproduced below for convenience), which although acknowledged in the current issues log, have not yet been fully considered by Ofgem or reflected in the current draft licences wording.</p> <p>We recognise that as schemes' funding levels improve, they would expect to move into surplus on a Technical Provisions (TPs) basis. As well as being desirable for consumers that schemes are in surplus on TPs rather than in deficit, it is also practically necessary to achieve this position to comply with The Pension Regulator's (tPR) guidance. We don't believe it would be appropriate for Ofgem to review ongoing surpluses for schemes that are no longer receiving deficit allowances and to do so may create incentives for Networks to act inefficiently and not in consumers' interests. We do however recognise that Ofgem may want to review established surpluses at the Reasonableness review when they first arise, to ensure that employers have not made unnecessary deficit contributions.</p> <p>The wording used in paragraph 7.11 of the ET PCFH and paragraph 7.12 of the GT PCFH presumes that networks should be trying to avoid surpluses, but not only would such action not be in consumers interest, it wouldn't be consistent with pension legislation. Given the complexity of this topic, we believe that further thought and consultation is required before including wording to deal with this issue. Furthermore, we believe the proposed wording as it stands would be a significant departure from Ofgem's current position, would introduce 'benefit of hindsight' risk on networks and is unlikely to be consistent with the approaches taken by well-run schemes. Hence, we suggest that this wording is removed at this stage and reconsidered in consultation with key stakeholders.</p>
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DRAFTING ISSUES	
	<p><u>Chapter 2 – The PCFM and the Annual Iteration Process</u></p> <ul style="list-style-type: none"> The formula used to deflate Variable Values from a nominal price base to the 2018-19 price base stated in paragraph 2.9 can be more simply stated for $t \geq 2021/22$ as: $\text{value}_{\{2018/19 \text{ prices}\}} = \text{value}_{\{\text{nominal}\}} \times \text{RPI}_{\{2018/19\}} \times \text{CPIH}_{\{2020/21\}} / (\text{RPI}_{\{2020/21\}} \times \text{CPIH}_{\{t\}})$ <p><u>Chapter 3 – The ET2 / GT2 Price Control Financial Model Variable Values</u></p> <ul style="list-style-type: none"> The Resilience Totex Allowance terms in Table 3.1 require updating to include an algebraic and SpC licence reference where relevant. For example, the Totex Allowances terms relating to resilience have neither a Variable Value expression or licence condition associated with them. The wording used in Table 3.1 of the ET2 PCFH for the totex allowance category is “Totex Allowance Adjustments” compared with “Adjustments to Totex Allowances” in Table 3.1 of the GT2 PCFH. For clarity, the description of these categories should be aligned. <p><u>Chapter 4 – Cost of debt and cost of equity indexation</u></p> <ul style="list-style-type: none"> We do not support the policies proposed by Ofgem which underpin the calculations of cost of debt and risk-free rate (RFR) and refer Ofgem to our response to RIIO-2 Draft Determinations – Finance Annex FQ1, FQ2, FQ3 and FQ9 for our detailed arguments. We do not support the adjustment of the cost of equity for outperformance as stated in paragraph 4.1 and refer Ofgem to our response to RIIO-2 Draft Determinations – Finance Annex FQ10. The footnote attached to the Chapter title is not correct. The values for RFR and cost of debt should only be updated for the next financial year and subsequent years in a given Annual Iteration Process, not for all Regulatory Years as stated in the footnote. In paragraph 4.1, we propose the amendment as shown in the following yellow highlight: <i>“4.1. The licensee’s Calculated Revenue includes amounts to cover the efficient cost of raising finance for the transportation 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 transportation businesses’ weighted average cost of capital (WACC) on a ‘real’ basis determined using a pre-tax real cost of corporate debt percentage, a post-tax real cost of equity percentage (adjusted for expected outperformance) and a notional gearing percentage weighting.”</i> Paragraph 4.9 reads “Ofgem will source the inflation values from the data page of the OBR website¹⁵.” However, the reference given in the footnote (to https://obr.uk) does not seem sufficient or complete. The OBR publish forecasts in different documents and it is not clear which sets of data Ofgem will refer to. This comment is also relevant to

	<p>paragraph 4.8, which needs to be more specific where it refers to which OBR publications will be considered as suitable sources of the OBR's 5yr forecast of CPI.</p> <ul style="list-style-type: none"> • The following comments are in relation to NGET paragraph 4.18 and NGG 4.15. Paragraph starts <i>"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. ..."</i> The highlighted text here is too vague. We therefore suggest that the wording <i>"or if Ofgem believes there is a material change in their basis"</i> is removed. • NGET paragraph 4.18 and NGG 4.15 should include a clear statement to explain the basis on which alternatives to the iBoxx or OBR series will be evaluated. For example, any change should aim for economic neutrality on an expected value basis, i.e. the approach adopted should be that which best approximates to the values that would have been expected if the data had continued to be published and/or there had been no material changes to their basis. In addition, we consider that this paragraph should confirm application only where there is no time to bring forward a change to the PCFH before the AIP to propose another series and that, where there is time, Ofgem will instead propose a change to the PCFM. • NGET paragraph 4.18 and NGG 4.15 should clearly state that where Ofgem adopt an interim approach (if there is not time to consult), and this interim approach is revised at the next AIP, the revisions should apply backwards to previous years where the interim approach was adopted as well as to future years. • The following comments are in relation to the footnote within NGET paragraph 4.25 and NGG paragraph 4.22, which state <i>"Ofgem will source the inflation values from the data page of the OBR website¹⁸"</i>. The footnote refers only to https://obr.uk. The reference given does not seem sufficient complete, as the OBR publish forecasts in different documents and it is not clear which sets of data Ofgem will refer to. • The following comments are in relation to NGET paragraph 4.26 and NGG paragraph 4.23. If the RPI and CPI forecasts are sourced from different documents, the formula in this paragraph could result in an anomalous and unjustified value of the RPI-CPIH inflation wedge. Therefore, further detail and clarification of the source data is required to make full assessment of this paragraph. • The following comments are in relation to 'Step 4' along with NGET paragraph 4.27 and NGG paragraph 4.24, <i>"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 ..."</i>, there is potentially an inconsistency and mismatch here between the horizons for the <u>20yr</u> ILG yield and <u>5yr</u> value of the wedge, as well as a potential mismatch between CPI and CPIH. We would propose Ofgem take a 20yr nominal rate to begin with and deflate with the 5yr OBR forecast for CPI, consistent with para 4.10 as this limits the inconsistency only. • The following comments are in relation to NGET paragraph 4.35 and NGG paragraph 4.29 which read <i>"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</i>
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	<p><i>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. ...". As with paragraph NGET paragraph 4.18 and NGG paragraph 4.15, this creates an asymmetry, and so there is a need for some wording to explain the principles on which any required alternative approach will be set (it should aim for economic neutrality on an expected value basis). The wording 'or if Ofgem believes there is a material change in their basis' seems too vague – it appears to be an asymmetric mechanism (i.e. whilst Ofgem can trigger a change to the mechanism, networks can't request a change) and in addition there is no clear arbitration or appeal mechanism. There should be a sentence to explain the basis on which alternatives will be evaluated – presumably based around 'economic neutrality', i.e. any new approach adopted should be that which best approximates to the eventual substantive outcome that would have been expected if the data had continued to be published or there had been no material changes to their basis.</i></p> <ul style="list-style-type: none"> • 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 32 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 28 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. • The follow comment is relation to the NGG PCFH specifically. SOCDE is not mentioned in chapter 4, where relevant, all other chapters include a reference to the SO equivalent to the TO term, for example TAXA and SOTAXA etc. <p><u>Chapter 5 – Uncertainty Mechanisms</u></p> <ul style="list-style-type: none"> • The chapter refers to SpC 4.3 (Entry Capacity and Exit Capacity Constraint Management) and SpC 4.4 (NTS System Operator external incentives, costs and revenues). These references should be to SpC 4.4 and SpC 4.5, respectively. <p><u>Chapter 6 – Tax liability allowances</u></p> <ul style="list-style-type: none"> • Paragraph 6.3 (c), 6.13 and 6.45 contain square-bracketed references. We require further clarification as what the square brackets are referring to. For example, are these referring to amounts or cells referred to within the PCFM. <p><u>The following comments are in relation to the NGET PCFH only:</u></p>
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	<p><u>Referencing to the appropriate licensee</u></p> <ul style="list-style-type: none"> Paragraph 2.32 refers to the GD2 PCFM and requires correction to refer to the ET2 PCFM.
FINANCE ISSUES	
SUPPORTING INFORMATION	
OFGEM ENGAGEMENT:	