

## PCFH

Area/Chapter	Comment
General	<p data-bbox="347 387 630 421"><b><u>Regulatory process</u></b></p> <p data-bbox="347 443 1417 622">Paragraph 2.10 of the Statutory Consultation on the RIIO-2 Licence Drafting modifications - reasons and effects document states that Ofgem’s intent behind certain changes made to SpC 8.2 is “<i>to allow for the re-publication of the AIP to update the ADJR* term prior to the end of the Regulatory Year in case of material changes, to enable more accurate charging by licensees</i>”.</p> <p data-bbox="347 645 1444 857">The Price Control Financial Handbook (<b>PCFH</b>) references throughout the Annual Iteration Process (<b>AIP</b>) only in terms of the calculation of the Allowed Revenue. There is no specific reference to the ability to recalculate the Allowed Revenue post AIP but prior to the end of Regulatory Year t although this can be inferred through paragraph 2.2 of the PCFH which states that ‘Live’ Calculated Revenue “<i>is updated at least annually to reflect new information</i>”.</p> <p data-bbox="347 880 1471 1104">To ensure that the PCFH reflects the addition of an Allowed Revenue re-publication process, we propose Chapter 2 of the PCFH is updated to include the process, scope and governance. The details have yet to be proposed by Ofgem through the licence consultation process or discussed through the Licence Drafting Working Groups. As stated in our response to the licence drafting informal consultation there are many areas relating to re-publication which require setting out in detail, including</p> <ul data-bbox="399 1126 1465 1944" style="list-style-type: none"> <li>• Clarification through the regulatory instruments that any re-publication is bound specifically to the charge setting process and is not designed to provide information on any other elements of the licensee’s performance under the RIIO-2 framework.</li> <li>• Clarification of the status of the PCFM and Allowed Revenue value published under the Annual Iteration Process as compared with those models and values that are re-published. For example, we would require Ofgem to confirm whether it will similarly be required to agree to the re-forecast revenue.</li> <li>• Development of a re-forecasting process and governance structure that has sufficient rigour to ensure that both the licensee and Ofgem support the re-forecast Allowed Revenue values but which is not overly onerous for either the licensee or the regulator.</li> <li>• Agreement over which revenue terms within the Allowed Revenue calculation will be forecast. Currently, in RIIO-T1, only the revenue streams which fluctuate within year and which are likely to have a significant impact on Allowed Revenues are re-forecast and flowed through to the charge-setting process. This limits re-forecasting to a manageable process. We propose that Ofgem considers adopting a similar policy and framework for RIIO-2 with licensees encouraged to consider only those revenues likely to have the most significant impact on charges.</li> </ul>

We welcome the opportunity to work with Ofgem to develop this process over the first quarter of 2021 with the PCFH updated to include the outcome in April 2021.

- We have also set out, in our response to the drafting of SpC 8.2, the changes required to the licence to clarify that the Allowed Revenue value on which charge-setting is based should be taken from the latest published value, whether through the AIP or re-publication process.

### **Forecast Variable Values**

The PCFH contains several mentions of the use of variable value forecasts. The PCFM Guidance document is extensively referenced in relation to these forecast values. For example, in Chapter 2, paragraph 2.17 states that “*The licensee must submit updates to forecast variable values annually, through the AIP, in accordance with the requirements of the PCFM Guidance.*” We have yet to have sight of the PCFM Guidance so, whilst we support inclusion of forecasting within the RIIO-2 framework, we are unable to confirm our agreement to the forecasting methodology.

We understand that Ofgem intends to publish the PCFM Guidance for review in March 2021 but still await clarity as to the consultation process associated with this publication.

## **Chapter 1 - Introduction**

**1.1** – To be consistent with the defined term and to make sure the terms are clear, we propose “...using the *ET2 Price Control Financial Model (ET2 PCFM)*”. The term ET2 PCFM should then be used throughout (providing a more clear distinction from the references to the ET1 PCFM). This correction is also needed on the front page of the PCFH.

**1.2** – We note that the defined term is “*PCFM Variable Values*” and this should be referenced. We do not object to this then being defined as variable values for the purpose of the PCFH.

**1.3(c)** – We propose changing to “*licence*” (lower case), since licence is not a capitalised defined term.

**1.4** – To be consistent with the defined term, we propose “*This document is the ET2 Price Control Financial Handbook...*” and “*ET2 Price Control Financial Instrument*”. These corrections are also needed on the front page of the PCFH.

**1.8(b)** – We note there is a typo at “*theRIIO-ET2*”.

## **Chapter 2 – The PCFM and AIP**

**2.2** – We propose an update to this paragraph to make clear how Adjusted Revenue and Calculated Revenue relate to one another.

**2.5** – We propose “*Regulatory Year*” (capitalised).

**K Correction Term, Heading** – Consistent with our comments on SpC 2.1 Part H, we propose that this should be changed to “*Correction Term*”.

**2.10** – We propose that the final two sentences are removed, since ET does not have a penal rate of interest applied.

2.11 – We propose “Regulatory Year” (capitalised).

2.13 should include reference to the fact that Ofgem will calculate the inflation indexation figure within the PCFM. This is consistent with the model key used in the PCFM. We propose that the PCFH is updated to include a paragraph to this effect. For example, a paragraph similar to those in the Cost of debt and Cost of equity – risk free rate section in Chapter 4 could be added as follows:

“Revised RPI and CPIH values for all Regulatory Years in the Price Control Period will be calculated by Ofgem in accordance with the approach set out below and provided to the licensee prior to the start of each AIP (to the extent possible) with values confirmed at the same time as giving the notice under Special Condition 8.2.11.”

We also note that the formula omits the definition of “ $r$ ”, which is present in the licence.

2.14 - 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.

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 CPI 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 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 its 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 a mathematical error rather than disagreement on policy and are willing to work with Ofgem to develop the most appropriate solution.

**Footnote 4** contains reference to CPIH historic data only. A reference is also required for the forecast data. We are aware that Ofgem are reconsidering the referencing in this note and have used the following sources in the PCFM published as part of the statutory consultation:

<https://obr.uk/efo/economic-and-fiscal-outlook-november-2020/>

<https://obr.uk/download/november-2020-economic-and-fiscal-outlook-charts-and-tables-chapter-2/>

Footnote 4 requires extending to include the correct source. Both the historic and forecast data should be referenced.

**2.18** – We propose a change at the end of the first sentence to “...*previous years’ Allowed Revenue*”.

We also propose that “*or any other adjustments where appropriate*” is removed from part (b) because the licence does not specify any other adjustments.

**2.20** – We consider that this paragraph conflates inputting variable values and recalculated values as part of AIP and other changes to the PCFM. We propose updated drafting below to resolve this issue. Our proposed drafting also reflects the provision in SpC 8.2 for Ofgem to re-publish values after the AIP (which is omitted from the current text):

*“The ET2 PCFM exists as a constituent part of Special Condition 8.1 and will be maintained by Ofgem on its website. The PCFM may be modified under the change control framework set out in Special Condition 8.1 (Governance of ET2 Price Control Financial Instruments) or section 11A of the Act. Special Condition 8.2 sets out the processes by which variable values and recalculated values (which are directly or indirectly dependent upon them) may be changed and the model rerun to calculate updated values”.*

(We note that, in the above, we have also corrected “*RIIO- ET2*” to “*ET2*” in the condition reference – This correction also needs to be made on the front page of the PCFH.)

**2.21** – Our understanding is that Ofgem is giving a specific example of when it will publish the updated copy, but that in other circumstances where updated (such as republication under SpC 8.2.10) it will also be published, as referred to in para 2.20.

The **State of the PCFM** section contains the paragraph stating that Ofgem will keep a log of modifications to the PCFM and publish this log on its website. This paragraph has not been allocated a paragraph number and should be designated as paragraph 2.22. The numbering for all subsequent paragraphs and references to PCFH Chapter 2 will require updating accordingly. We use the existing paragraph numbers for the remainder of the comments on Chapter 2.

The **Annual Iteration Process (AIP)** section sets out each step of the process beginning with the submission of the PCFM containing a completed variable values table by the licensee to the Authority on 31 July each year. Our understanding is that Ofgem will maintain an up to date copy of the PCFM on its website. However, we propose that the version of the PCFM required to be completed for 31 July is provided to the licensee to avoid any ambiguity in submission.

**2.23** – This paragraph (and the heading) should, consistent with the licence definitions refer to the “*ET2 Price Control Financial Model Working Group*”.

**2.36** - sets out that certain variable values will be unknown at the time of the 31 July submission of the PCFM with the subsequent paragraph noting that in such cases a provision value should be forecast. One of the examples given in paragraph 2.36 is the risk free rate. We propose that this example is removed as this variable will be calculated and published by Ofgem (as per paragraph 4.21) and the licensee should therefore not be required to forecast the risk free rate value.

**2.42** - cross references SpC 8.2, specifically the steps comprising the Annual Iteration Process. The reference to Part A of SpC 8.2 does not currently correspond

	<p>with the labelling used in SpC 8.2. However, we propose that the reference to Part A in PCFH is maintained and refer Ofgem to our comments on SpC 8.2 where we propose that the sections in SpC 8.2 are re-labelled aligning them to the PCFM reference.</p> <p><b>2.50</b> - cross references Part C of SpC 8.2. As noted previously, we have proposed in our commentary on Chapter 8 of the licence that the Parts of SpC 8.2 are re-labelled. In order to align with this relabelling, paragraph 2.50 should be amended to reference Part <u>B</u> of SpC 8.2.</p>
<p><b>Chapter 3 – Variable values</b></p>	<p><b>3.6 (b)</b> - does not include the algebraic term used to describe regulatory depreciation. This is not an error but is inconsistent with the rest of the drafting in paragraph 3.6 and its inclusion would provide additional clarity over the linkages between the PCFH and PCFM. Therefore, we propose that “<u>(DPN<sub>t</sub>)</u>” is added after depreciation.</p> <p>Regarding the <b>Legacy Adjustments</b> variable values, we refer Ofgem to our response on Chapter 7 and our concerns that there is no Legacy Revenue term which can be used to phase legacy revenue adjustments across the price control period, increasing the likelihood of revenue volatility and therefore volatility in charges and also representing a change in methodology from RIIO-1.</p> <p><b>3.12 (a)</b> - sets out the finance input variable values which contribute to the calculation of the cost of capital percentage. The CDE term is erroneously included in the input list. This is a calculated term rather than an input and so should be removed from paragraph 3.12 (a).</p> <p><b>3.10(a)</b> – This paragraph incorrectly states that LAR<sub>t</sub> feeds into Calculated Revenue. It should be Allowed Revenue.</p> <p><b>Table 3.1-</b></p> <ul style="list-style-type: none"> <li>References to associated documents are omitted for the ARC &amp; ARCU terms.</li> <li>Additional categories within the Actual Totex section for the UIOLI expenditure are required. This will enable separate treatment of the UIOLI allowance and spend which are not subject to the TIM mechanism (we propose the inclusion of a separate non-TIM tab in our response to the PCFM).</li> <li>The algebraic expressions assigned to the inputs require amending in line with our proposal for revised PCD drafting as set out at the start of Chapter 3. This will remove the duplication of terms.</li> <li>We also note in our comments on the PCFM that the Other Income directly remunerated services (OIDRSt) and Identified directly remunerated services costs (IDRSt) should be treated as fixed values and therefore these terms should be removed from Table 3.1.</li> </ul>
<p><b>Chapter 4 – Cost of Debt and Cost of Equity</b></p>	<p><b>4.2</b> - The parenthesis prior to through should be removed. the text should read: “of equity percentage–through changes to the real (CPIH) risk-free rate (RFR) are updated by ...”</p>

**4.6 (a)** - should read:

“for days up to and including 31 October in the year in which the AIP is being conducted, obtain from the Markit data service the nominal yield in % for the iBoxx Utilities 10yr+ index (ISIN reference DE0005996532).”

**4.6 (b) (i)** - should read:

“the 3-year trailing average spread between the yield on the iBoxx Utilities 10yr+ index and ...”

**4.6 (b) (ii)** - The calculation referred to at the end of this sentence should be defined more precisely, by giving the formula that will be used to derive the 10 year rate  $x$  years into the future. For example, if  $A$  is the current 10+ $x$  year spot rate (in %) and  $B$  is the current  $x$  year rate (in %), the 10 year rate  $x$  years into the future is given by

$$[(1+A)^{(10+x)}]/[(1+B)^x]^{(1/10)} - 1$$

**4.8** - references the two publications per year for Historical Offices forecasts database on the OBR website. The wording of this paragraph does not make clear whether updated values in these publications will be used when the publications themselves are published or will only be included from the date they get added to and included in the Historical Official forecasts database. This should be set out unambiguously. We propose that Ofgem refer to the original publication date of the data as this will provide a more transparent audit trail.

**4.12** - refers to the application of an uplift adjustment specific to each operator to the  $iBTA_t$  values to derive a CDE value. This text should make clear where the uplifts that are referred to are specified. These values are currently omitted from the Handbook.

**4.13** - should be amended to reflect the fact that Ofgem will provide both the  $iBTA_t$  and CDE values to the licensee:

“Ofgem will provide the licensee with a copy of the spreadsheet used to calculate revised  $iBTA_t$  and  $CDE_t$  values at the same time as giving the notice (paragraph 2.46).”

**4.18** states that: “*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. Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP.*” (Underlining included here for emphasis.)

We have the following comments on this:

- We consider that the reference to “*material changes*” is not sufficient to detail the scope of circumstances where Ofgem may seek to change the series. We propose inclusion of an explanation for the basis on which alternatives will be evaluated. For example, that any change should aim for economic neutrality on an expected value basis. That is, 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.
- We note that there might be circumstances where licensees consider that there has been a material change to the basis of a series. In these circumstances, we understand that Ofgem would give due consideration to any submissions on the point in deciding whether to initiate a consultation on alternatives (and which alternatives to consult on).
- We note that this refers to an interim approach being determined where there is insufficient time for the consultation to be concluded. Our understanding is that, in other cases, following consultation any change to the series used would be enacted through a change to the PCFH, using the change control framework set out in SpC 8.1 or statutory modification where appropriate.
- In addition, we note that the interim approach referred to should only apply where the index in question ceases to be published (and we propose that this is made clear). It would not be proportionate for Ofgem to pre-empt the outcome of its consultation with an interim approach in circumstances where the series is still being published.

**4.23(a)** – This does not currently specify that the yield figures should be used in percentage terms. In order to remove any ambiguity from the calculation we propose that the paragraph is updated as follows:

“for days up to and including 31 October in the year in which the AIP is being conducted, obtain the yield (these figures being percentages) for British government securities, 20-year real zero coupon (series reference IUDLRZC)<sup>29</sup>,”

**4.23 (b)** - The text here is in error, as the references to 10 year rate and 10+x year rate should instead refer to 20 year rate and 20+x year rate respectively.

**4.23 (b)** - The calculation referred to in the penultimate sentence should be defined more precisely, by giving the formula that will be used to derive the 20 year rate x years into the future. For example, if A is the current 20+x year spot rate (in %) and B is the current x year rate (in %), the 20 year rate x years into the future is given by

$$[(1+A)^{(20+x)}]/[(1+B)^x]^{(1/20)} - 1$$

**4.25** - references the two publications per year for Historical Offices forecasts database on the OBR website. The wording of this paragraph does not make clear whether updated values in these publications will be used when the publications themselves are published or will only be included from the date they get added to and included in the Historical Official forecasts database. This should be set out unambiguously. We propose that Ofgem refer to the original publication date of the data as this will provide a more transparent audit trail.

**4.32** - states that: “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. Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP.” (Underlining included here for emphasis.)

Our comments above on 4.18 apply equally to the above paragraph.

**4.7a, 4.7b, 4.7 final sentence, 4.8 final sentence, 4.24a, 4.24b, 4.24 final sentence, 4.25, the formula at 4.26** - In multiple places the text refers to the latest Office for Budget Responsibility (OBR) 5yr (or 4 yr) forecast of inflation, in some cases for CPI and in others RPI, where the intention is actually to refer to the relevant (RPI or CPI) forecast inflation rate in 5 (or 4) years' time (rather than the average across the next 5 (or 4) years). This could be clarified by referring to the 'year 5' forecast of inflation' rather than the '5yr forecast of inflation' and the 'year 4 forecast of inflation' rather than the '4yr forecast of inflation'.

## Chapter 5 – Real Price Effects

**General** - The policy on the specific scope of totex allowances to which RPEs are applied should be defined in section 5.2. Specific reference should be given to exclusions from baseline totex allowances, and the extent to which RPEs are applied to variant totex / other uncertainty mechanisms, and the rationale for these. This is to ensure consistency of application between sectors, and that the calculative methodology is appropriately reflected in the PCFM. 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.

**5.2** – This 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.

**5.3** - As a point of record, 5.3 should include a log of the opening position mentioned, including derivation of the percentage RPE index profile, a breakdown of the totex allowances to which this has been applied, and the resulting opening RPE allowances. This should reconcile to the positions included in the final versions of the RIIO-2 Final Determination documentation.

**5.4** - 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 **5.4**. Whilst implied by the algebra, section 5.4 should explain the scope of updates for the first AIP, as indexation for financial years 2019/20 and 2020/21 will be required for the AIP in November 2021.

**5.5** - We are yet to be provided with transparent detail on the derivation of the index weights included in **table 5.1**. We understand that each of the indices has equal weighting within each RPE category (labour, materials, plant and equipment). However, we only have visibility of input values for cost base weightings, but not how these have been derived by CEPA. As these will be fixed terms, it is important that licensees are able to confirm and opine on their basis.

**5.10** - states that: "If, for any reason, the price indices used in calculating RPEt 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 a revised value for RPEt for any AIP, Ofgem may use an interim approach to ensure timely completion of an AIP. Any such interim approach for a given Regulatory Year will be revised at the subsequent AIP." (Underlining included here for emphasis.)

Our comments above on 4.18 apply equally to the above paragraph.

**Other observations:**

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.

**Chapter 6 – Tax liability allowances**

**6.3 (d)** - acknowledges that the tax pool allocation rates are variable but does not include guidance as to how these should be updated. We assume that updates will apply prospectively in the PCFM based on reasonable estimates at each. However, Table 3.1 references the PCFM Guidance as provided further detail and as noted previously, this document has not yet been published. The pool allocations will impact any tax reconciliation differences and therefore Ofgem need to provide some clarity about when they expect pool allocation balances to be updated and on what basis, e.g. updated annual best estimates. We propose that only prospective changes are made to the pool allocations as the TAXA<sub>t</sub> adjustment deals with any retrospective agreed as a result of review of material and unexplained differences in the tax reconciliation template.

The **Materiality threshold and 'deadband'** section (paragraphs 6.26 – 6.30) does not contain a methodology for calculation of the materiality threshold. As the PCFH is effectively a user guide for the PCFM, we consider that the method used to calculate the materiality threshold should be set out within this section.

**6.31** – The current drafting is inconsistent with the licence drafting, where SpC 2.2 provide that Ofgem will direct "*any adjustment... that it considers should be made...*". An adjustment is not automatic. We propose that this paragraph 6.31 is changed to

read "...that the Authority will direct any value of TAXA<sub>i</sub> that it considers should be made".

**6.33 (a)** - should be amended to read "material and unexplained differences" to clarify that a review may only be triggered where a material difference remains unexplained.

**6.33 (a)** - includes reference to the Tax Reconciliation template. We are unable to provide full commentary on this definition as the relevant sections of the PCFM including the tax reconciliation template have not yet been published.

## Chapter 7 – Pensions

- No Comments

## Chapter 8 - Legacy adjustments

### Legacy MOD and RIIO-1 Close out

We recognise that there are LMOD terms which are used to adjust RIIO-2 revenues in respect of the close out the RIIO-1 PCFM. However, decisions on items non mechanistic close out items are outstanding and remain subject to consultation. Currently, the only route for the close-out of the non-mechanistic terms to flow through to revenue is via the LMOD values. 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 may not be agreed by the time the LMOD2 value (2022/23) is updated for RRP21 actuals and according to the RIIO-1 framework under which MOD is defined, once the MOD is set, there should be no retrospective changes.

Whilst we expect updates to the forecast LMOD2022/23 following RRP21, it is still not clear whether LMOD 2021/22 is fixed given there wasn't a formal publication of the AIP in November 2020.

We note footnote 51 of the 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 MODt (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'.

However, the MOD2021/22 (or LMOD1) was not formally directed, which adds further to the confusion of the status.

Also paragraph 8.23 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 clarity from Ofgem on the status of the legacy MOD values.

#### ii) Risks to cashflow and financeability

Secondly, the use of LMODs for all close out items poses a risk to our cashflows and financeability. As discussed previously with Ofgem, we feel strongly that such close out adjustment should be spread over the same number of years in which they arose, in order to avoid such risks. There is precedent for this in RIIO-1 whereby a legacy revenue term was included within the PCFM. We would support this approach for

RIIO2. We propose that an '*LREV<sub>t</sub>*' term is reflected in the licence and incorporated into the PCFM. This means during close out discussions we would determine the items that go into that term but would avoid trying to create a mechanism at the same time and potentially having to make changes to the licence and PCFM.

**8.12** - sets out the procedure by which a revision to the legacy outturn value is included within the PCFM. The timing of the revision is linked to the next AIP. Given that Ofgem intend to introduce a republication process by which the Allowed Revenue can be updated subsequent to the AIP and prior to the end of Regulatory Year  $t$ , we propose the wording is amended as follows to refer to the next publication of the PCFM in order that any updates to legacy terms can be captured in a timely manner:

"...and reflected in a revision to the relevant PCFM Variable Value for the next publication of the PCFM."

**8.13** – The correct reference here is "*Part A of Special Condition 7.1*"). This paragraph also includes a table summarising the licence references for each element of the LAR<sub>t</sub> term. RIIO-1 Network Innovation Competition (SpC 7.11) does not form part of the LAR<sub>t</sub> term calculation within the SpC 7.1.3 of the licence and thus should not sit within this table.

**8.25** - implies that subsequent LMOD values may be calculated if required, for example due a close out methodology. It is unclear how Ofgem intend this mechanism to work as the MOD term is defined through the RIIO-1 regulatory instruments and framework as adjusting revenues based on a two-year lag. The RIIO-2 framework does not contain a MOD adjustment. We required further clarity from Ofgem as to the intent and potential process behind this paragraph before we can provide a complete review of the statement.

**8.26** - contains an incorrect reference point to Regulatory Year 2022/23 and should be amended to:

"To calculate the value of LMOD in regulatory years 2021/22 or beyond, PVF terms for regulatory years within RIIO-2 is required to make the appropriate time value of money adjustment."

**8.32** - states that the  $LRAV_t$  values are provisional and will be updated with outturn data during the AIP ending November 2021. Furthermore, paragraph **8.33** states that the  $LRAV_t$  values will be derived by 31 October 2021. The timebound nature of these statements require that all RIIO-1 close out adjustments will be determined prior to 31 October 2021 in order that they can be reflected in the  $LRAV_t$  values. As the paragraphs do not allow for further adjustment after the November 2021 iteration, there is no mechanism to reflect changes subsequent to this date. We therefore propose that Ofgem removed reference to 2021:

"8.32. The  $LRAV_t$  values for Regulatory 2020/21 are provision and will be updated with ~~the~~ outturn data through subsequent AIPs.

**8.33** – We propose "*By 31 October 2021, the Authority will derive finalised  $LRAV_t$  values for the ~~Regulatory Year 2020/21~~ for the licensee by inputting actual cost data into the ET1 PCFM and restating them to 2018/19 prices.*"

**8.34** - requires a space between “8.30” and “and”.

**8.35** - notes the location of the relevant inputs in the PCFM. However, the PCFM does not have a reference to the licence term. We propose that the  $LRAV_t$  reference in included in the licence term column of Row 139 of the NGET tab.

## Appendix 1 - Glossary

Certain definitions refer to “*R/O*” where, as noted above, the licence does not include this prefix. As requested above, we propose that the PCFH should be consistent with the licence.

**Capitalisation Rate** – The second sentence requires amendment as follows:

“Capitalisation rate 1 refers to the rate used for all relevant expenditure /allowances not dealt with under the uncertainty mechanism capitalisation rate.”

**WACC** – The definition of WACC states that the cost of equity factored in is “*the post tax cost of equity – ie the percentage return equity investors expect to actually receive weighted according to the price control gearing assumption*”. The reference to equity investor expectations means that cost of equity is inconsistently defined with respect to Ofgem’s determined approach to the use of an outperformance wedge as set out in Final Determinations.