Approach to setting the rate of return in Final Proposals

Executive Summary

In our Final Proposals we have continued to use the RIIO Gas Distribution (RIIO-GD1) rate of return, consistent with our Initial Proposals. In our Initial Proposals we converted this post-tax rate into a pre-tax rate using the relevant corporation tax rate. Subsequently, we have found that the pre-tax rate does not generate sufficient revenue to fund the tax liabilities of the Metering business to the end of its NMM obligations. Consequently, in our Final Proposals we have adopted the RIIO-GD1 post-tax rate of return and made a separate tax allowance to enable Metering to meet its projected cash tax liabilities, an approach which is consistent with RIIO-GD1. Ofgem has requested that, in our Final Proposals, we include a narrative explaining the issue and setting out why the post-tax approach is correct, which is the purpose of this document. The following should be noted:

- The revenue requirement is higher using a post-tax approach because the Metering Regulatory Asset Value (RAV) is well above the capital allowance pools, causing revenue associated with RAV depreciation to be taxable – in contrast the pre-tax approach implicitly assumes that capital allowances broadly match RAV depreciation.

- Ofgem has raised a potential concern that the post-tax approach could be perceived as funding Metering tax twice, once when accelerated capital allowances were received but the pre-tax revenue calculations of the time assumed a standard rate of tax, and again now.

- We support the use of a post-tax approach because:

    - Revenues based on the pre-tax approach would not be sufficient to finance our existing and new regulated Metering activities during the crucial period of the Smart meter roll-out.

    - It has been Ofgem’s policy since 2003 to use the post-tax approach.

    - We see no logical reason for treating regulated Metering activities differently from any other of Ofgem’s price controlled activities.

- We believe that to use a pre-tax approach would be unwise, as it could be viewed as the claw-back of tax allowances from previous price controls, which we would not support in principle because such an approach would be:

    - Very poor for incentives, involving the retrospective re-opening of past price controls in which the treatment of tax was understood by regulator and companies.

    - Asymmetric, as no adjustments would be considered for areas where the company had underperformed relative to price control assumptions.

    - Counter to Ofgem’s precedent - Ofgem has twice rejected tax claw-back from previous gas price control reviews.

- It is not clear that, post privatisation, the company has obtained undue benefit from Metering tax allowances calculated on a pre-tax basis because:

    - Prior to 2005/6, Metering did not have separate capital allowance pools, but was an indistinguishable part of much larger businesses. Consequently, looking back in history we are using data including many other activities.

    - The RAV would be expected to be higher than capital allowance pools as it was calculated using completely different rules.

    - The Metering capital allowance pool is now higher relative to RAV than that of the company carrying out Metering in 2001 or 1997.

    - Prior to 1997, although the predecessor company carrying out Metering activities may well have derived some benefit from fast capital allowances, it is not clear whether the gap between RAV and capital allowances arose before privatisation and so would have benefitted the State, or even how the RAV should be measured. Data does not exist to take the analysis back prior to 1997, and there was no settled concept of a RAV until the 1997 MMC Report.

    - At the 2001 price control review, although the pre-tax approach was used, Ofgem considered the tax issue and appeared content that the pre-tax approach produced an appropriate level of cash tax.

    - Ofgem's decision not to adopt a post-tax approach to Metering from April 2007, at the same time as both the gas distribution and transmission price controls, has already benefitted customers, reducing allowed revenue by around £187m.

- Overall, the evidence suggests that, both on principled and mathematical grounds, the arguments for using the post-tax approach to calculating Metering Tariff caps without claw-back are strong.

1. Introduction

1.1. Whether revenue calculations are carried out pre or post-tax has become a significant factor in determining the revenue requirement of the Metering business.

1.2. The calculations contained in National Grid Metering (NGM)'s Initial Proposals of January 2013 were carried out on a pre-tax basis, consistent with NGM's Consultation on Approach of September 2012, and as proposed in Ofgem's Decision document of July 2012.

1.3. Subsequent to NGM's Initial Proposals, NGM discovered that Tariff caps calculated on a pre-tax basis, when coupled with slower meter displacement, do not generate sufficient revenue to fund NGM's projected corporation tax cash costs by a significant amount.

1.4. Consequently, before our Final Proposals NGM revised its calculations to be on a post-tax basis, reflecting its projected cash tax costs.

1.5. Due to the change in approach, Ofgem has requested that, in our Final Proposals, NGM include a narrative explaining the issue and setting out why the post tax approach is correct – which is the purpose of this document.

1.6. The structure of the remainder of this document is as follows:

- Description of pre-tax and post-tax approaches
- The application to Metering
- Ofgem's concern
- Why the post-tax approach should be used

1.7. Each section is set out below.

2. Description of pre-tax and post-tax approaches

2.1. Regulatory revenue calculations can either be carried out on a pre-tax or a post-tax basis. Each approach makes an allowance for the payment of tax in respect of the period covered by the price control, but in different ways.

2.2. The pre-tax calculation assumes that corporation tax is payable at the standard rate, presently 23%, on the return due to the equity financed element of the RAV. In contrast, no tax is assumed payable on the debt financed element of the RAV because debt interest is typically wholly allowable against tax. An example of the pre-tax calculation is shown below.

Pre Tax regulatory revenue example			
			£m
RAV gearing	55%	RAV	1000
Cost of debt-real	4%	RAV dep'n	150
Post tax cost of equity	7.7%	Opex	100
Corporation tax rate	23%		
Pre tax cost of equity	10%	[Post-tax cost equity / (1 - tax rate)]	
Revenue components	**£m**		
RAV depn	150		
Opex	100		
Debt return	22	[1000 x 55% x 4%]	
Pre tax equity return	45	[1000 x 45% x 10%]	
Allowed revenue	**317**		
Equity return	45		
Corporation tax rate	23%		
Implied tax allowance	**10.4**		

2.3. The example shows that the post-tax cost of equity, 7.7% is grossed up for tax at 23%, producing a 10% pre-tax return to be applied to the equity financed proportion of the RAV. This produces an implied allowance for tax of £10.4m.

2.4. In contrast, the post-tax calculation makes no allowance for tax in the equity return, but instead works out the projected level of cash tax which the price controlled entity would be expected to incur, and makes a specific allowance for this.

2.5. To do so, it takes the efficient revenue and cost figures for the price control period, deducts capital allowances (a type of depreciation on investment allowed for tax purposes) and the nominal interest cost, and makes other, typically smaller adjustments to mimic the approach of HMRC.

2.6. An example is shown below. This is similar to the previous example but with capital allowances lower than RAV depreciation and showing a deduction against tax for nominal interest costs.

Post tax regulatory revenue example

Revenue components	**£m**		**%**	
RAV depn	150	RPI	2.5%	
Opex	100			
Debt return	22	[1000 x 55% x 4%]		
Post-tax equity return	35	[1000 x 45% x 7.7%]		
Revenue before tax	**307**			
Tax allowance	22	see below		
Revenue including tax	**328**			
Tax allowance calculation	**£m**			
Revenue including tax	**328**			
Less opex	-100			
Less debt interest - nominal	-36	[1000 x 55% x 6.5%]		
Less capital allowances	-100			
Other tax adjustments	2			
Taxable profit	**95**			
Tax allowance at 23%	**21.8**			

Tax reconciliation	***£m***	***£m***
Tax under pre-tax approach		***10.4***
Capital allowances < depn	*50.0*	
Nominal interest > real	*-13.8*	
Other tax adjustments	*2.0*	
	38.3	
Tax allowance at 23%	*8.8*	
Tax due on tax allowance	*2.6*	
Additional tax allowance		*11.4*
Tax under post-tax approach		***21.8***

2.7. The post-tax approach shows a tax allowance of £21.8m. The reconciliation on the right shows the causes of the additional £11.4m of tax allowance compared to the pre-tax approach – largely due to capital allowances being lower than RAV depreciation.

2.8. Although both approaches make an allowance for tax, there are numerous reasons why they can be quite different.

3. The application to Metering

3.1. In the case of the Metering, the revenue requirement produced by the post-tax approach is higher than that of the pre-tax approach. This is largely due to two partly offsetting features, in respect of:

- The difference between the size of the RAV and the value of the capital allowance pool, which acts to increase the revenue requirement – in contrast the pre-tax approach implicitly assumes that RAV depreciation is broadly consistent with the level of capital allowances.

- The mismatch between the timing of remaining revenue and the utilisation of capital allowances, which acts to reduce it.

3.2. The revenue requirement is increased by the fact that the available level of capital allowances is far below the RAV. As at 31 March 2012, the RAV stood at £1.0bn, whereas the capital allowances pool stood at around £220m (c22%).

3.3. Consequently regulatory depreciation, which feeds through into revenue, is well above the level of capital allowances utilised for tax purposes. This causes most of the regulatory depreciation to be taxable, in addition to the equity financed element of return on the RAV allowed under the pre-tax approach. Therefore, the projected amount of cash tax due (i.e. the post-tax approach) is well in excess of the level implicit in the pre-tax approach.

3.4. The revenue requirement is reduced by the second feature, the timing difference between domestic Metering revenue and capital allowances.

3.5. Regulatory revenue calculations typically make the level of revenue equal to the total of regulatory costs over the period of the price control.

3.6. A key feature of the calculations for the new revenue requirement is that it seeks to recover the entire RAV for domestic meters over the period to 2020. No revenue is assumed to be recovered from domestic customers after this point.

3.7. In contrast, the capital allowance pool will not cease in 2020, but is expected to roll forward indefinitely, using the reducing balance method, falling at a rate of 18% per annum.

3.8. Therefore, if we were to carry out a pre-tax revenue calculation, or even a post-tax revenue calculation which stopped when the revenue is expected to stop, in 2020, we would fail to take account of the value of capital allowances which we would expect to receive after this point.

3.9. We believe that customers should, in the Tariff caps, have the benefit of the capital allowances we expect to receive after 2020. Consequently we have reduced the revenue requirement by £13m, to take account of the projected present value of capital allowances on domestic meters as far into the future as 2052, after which their value is negligible.

4. Ofgem's concern

4.1. Ofgem has raised a concern with us that switching from a pre-tax approach now to a post-tax approach could be perceived as leading to customers paying twice for Metering tax liabilities.

4.2. The logic for this perception is that, if the business had received accelerated capital allowances in the past which were in excess of regulatory depreciation, then the business might have benefitted at that time from a lower tax bill than that assumed in the pre-tax approach to calculating revenue.

4.3. Following this logic, now that the level of capital allowances is well below the level of regulatory depreciation, for NGM now to be recompensed for its expected tax costs to 2020 would lead to customers paying twice.

4.4. In essence this is a claw-back argument, as it could be viewed as revenue being clawed back from previous price controls.

4.5. In the section below, we set out our views why the post-tax approach is appropriate, including our thoughts on the claw-back argument.

5. Why the post-tax approach should be used

5.1. There are many arguments why the post-tax approach should be used and claw-back should not be attempted. These are in respect of:

- Metering's ability to finance its regulated activity;
- Ofgem's policy to use post-tax revenue calculations;
- the undesirability of tax claw-back;
- the caveats in comparing RAV to capital allowance pools;
- the longstanding nature of the gap between RAV and capital allowance pools;
- Ofgem checked cash tax in the 2001 Price Control Review; and
- Metering has borne excess tax costs since April 2007.

5.2. Each is considered in turn below.

Metering's ability to finance its regulated activity

5.3. Included in Ofgem's Decision document of July 2012, paragraph 3.28 was the statement that:

"An appropriate tariff level would be one that balances the revenue requirement of this (cost) equation."

5.4. Using this logic, a Tariff level which does not produce a level of revenue sufficient to balance costs is not an appropriate Tariff level. If the difference is material, which it is clearly in this case, revenue would not be sufficient to finance our existing and new regulated Metering activities during the crucial period of the Smart meter roll-out.

5.5. In this event either the activities sought by customers and Ofgem would not be carried out effectively, or shareholders would have to bear the loss, neither of which would seem to represent a desirable or justified outcome.

Ofgem's policy to use post-tax revenue calculations

5.6. The Transco price control review which finished in 2001 used a pre-tax approach to calculating allowed revenue.

5.7. However, since 2003, it has been Ofgem's policy to adopt a post-tax approach. The change, and the logic for it, were set out in Ofgem's GDPCR One Year Control Initial Proposals dated September 2006, paragraph 4.2.

"Ofgem's policy to calculate the cost of capital on a post-tax basis was initiated in the Developing Network Monopoly Price Controls consultation in 2003. It was introduced:

- *in order to provide incentives on companies to manage their tax liabilities that are the same as the incentives they face for other expenses i.e. that they could benefit from outperformance, but customers could also benefit from long-term savings via reduced allowances at subsequent price controls.*

- *It was also recognised that some network operators were likely to face increasing tax liabilities from the ending of accelerated capital allowances on much of their expenditure."*

5.8. One potential counter-argument we have heard is that Metering is different to networks, which are going concern, growing businesses and that the adoption of post-tax returns for networks did not lead to an undue change in the balance of interests between investors and consumers.

5.9. We are not clear how robust this potential argument is for a number of reasons:

- It appears to suggest that only growing businesses need to be financeable. This surprising suggestion would seem to conflict with Ofgem's actions in RIIO-GD1 to ensure the financeability of gas distribution, a business which is clearly not growing - volumes have fallen for a number of years, and most forecasts show them continuing to fall.

- It seems to conflict with Ofgem's statement referred to in paragraph 5.3 above – that Metering revenue should balance Metering costs.

- We believe our Final Proposals strike a very fair balance between the interests of consumers and investors. We propose to lower Tariff caps from their present level while enabling the business to recover its costs and at the same time facilitating the Smart meter roll-out. Such a proposal would not seem an undue change in the balance of interests.

5.10. We agree with Ofgem's position since 2003 that treating tax similarly to other expenses is the optimal approach, which should allow an efficient company to finance its regulated activities, and we see no robust logic for treating Metering differently to other regulated activities.

The undesirability of tax claw-back

5.11. In respect of regulatory policy, were any attempt to be made to claw back revenue from previous years when Ofgem's approach to tax was clear to the company and the regulator, this could be viewed as a re-opening of previous price controls from many years ago.

5.12. We suggest that such a step would amount to retrospective regulation, which we believe to be undesirable as it would undermine incentives. We note that Ofgem has recently stated it is keen to avoid retrospection. The RIIO Handbook of October 2010, paragraph 10.3 states that:

"We will commit to not making retrospective adjustments to revenue in the event that costs turn out to be different to what was assumed in the price control itself, save through the application of the efficiency incentive rate."

5.13. Retrospective regulation would be even more damaging if it were asymmetric. The returns made by the Metering business (even before tax) have been significantly under those projected by Ofgem when the Tariff caps were set in 2001, as shown by Table 1 of Ofgem's Metering Decision document of July 2012. However, we accept that we have lost revenue from this time.

5.14. In addition, we note that Ofgem has already considered the specific argument about the potential double funding of past tax liabilities twice, and on both occasions decided not to seek claw-back.

5.15. The TPCR Updated Proposals document of September 2006, paragraph 8.28 states that:

"…we consider that the approach to tax in past reviews was clear to both the companies and the regulator. Adjusting the tax allowance to reflect deferred tax from past periods would therefore be inappropriate, as it would represent a re-opening of previous price controls."

5.16. Similarly, the GDPCR One Year Control Final Proposals of December 2006, paragraph 4.10 states that:

"We do not consider that it would be appropriate to attempt to claw back tax benefits from previous years as the pre tax policy was part of the overall package and in line with Ofgem's policy at the time. This is consistent with the approach that we have adopted elsewhere. For example, we have not reopened the price control to allow GDNs to recover previous shrinkage losses."

5.17. Both regulatory logic and Ofgem precedent suggest that it would be undesirable to attempt to claw back tax from previous price controls.

The caveats in comparing RAV to capital allowance pools

5.18. Aside from regulatory policy and precedent, the question remains of the extent to which the post-privatisation Metering business has benefitted from receiving capital allowances faster than regulatory depreciation, and so experienced a corporation tax cash cost below that assumed by pre-tax revenue calculations.

5.19. Before presenting any analysis we draw attention to a number of the caveats associated with it.

- First, the Metering business has only had its own separate capital allowance pools since 2005/6. Before then, it was an indistinguishable part of much larger businesses, therefore looking back in history we are using data including many other activities.

- Second, the rules governing the RAV are quite different to those governing capital allowances, and most of these differences would act to increase the RAV as compared to capital allowance pools. In the case of the gas business:

    - Since 1 April 1997 the RAV has been uplifted by RPI, whereas capital allowances are not subject to any indexation at all. Cumulative RPI from March 1997 to March 2012 has been around 55%.

    - Prior to 1 April 1997 the RAV was valued using a replacement cost, rather than a historical cost basis, albeit with an adjustment to reduce the carrying value of assets which had been in existence at 31 December 1991 by 40% (the MAR adjustment).

    - The regulatory treatment of some types of investment differs between the RAV and capital allowance pools. For example, at different times between 50% and 100% of mains and services replacement expenditure (repex) has been added to the RAV, whereas none of this has been added to capital allowance pools. (This is relevant because although mains and services are not Metering assets, when Transco's capital allowance pools were split to facilitate Network Sales in 2005/6, the split was carried out on a RAV basis, therefore such expenditure influenced the split.)

5.20. For these reasons, the results of analysis comparing RAV with capital allowance pools should be treated with a considerable degree of caution.

The longstanding nature of the gap between RAV and capital allowance pools

5.21. Keeping these caveats in mind, we can consider whether the gap between RAV and capital allowance pools is a recent phenomenon, or whether it has existed for a long period of time.

5.22. The table below compares the size of the capital allowance pools relative to RAV for the earliest comparable data we have, from 1997 for BG plc (we actually have capital allowance data from a year earlier, but only have RAV data from the 1997 Monopolies and Mergers Commission (MMC) report), to that for Transco once it had demerged from BG plc in 2001, to that for the Metering business in 2012.

RAV & Capital Allowance Pools	BG plc 31.12.97	Transco 31.12.01	Metering 31.3.12
Nominal prices	£m	£m	£m
RAV	12,200	13,156	983
Capital allowance pools	1,901	2,161	221
Capital allowance %	**16%**	**16%**	**22%**
RAV data sources			
MMC 1997 p388: 1.4.97 in 1996 prices	11,643		
1996 prices	152.7		
December 1997 prices	160.0		
Transco FP 2001 p81 in 2000 prices		12,921	
2000 prices		170.3	
December 2001 prices		173.4	

5.23. The table shows that, since at least 1997, capital allowance pools have been low relative to RAV. Moreover, they were actually lower in 1997 and 2001 than they are in Metering at present.

5.24. Therefore, the evidence suggests that low capital allowance pools relative to RAV are a longstanding issue, having been present at least since 1997.

5.25. After 1997, the addition of repex and the application of RPI to the RAV but not to capital allowance pools act to keep the scale of the pools low relative to the RAV. Despite these factors, by 2012 Metering has grown its capital allowance pools significantly.

5.26. Prior to 1997, the position is less clear. We do not have capital allowance data before 1996, neither is it straightforward to calculate the RAV before 1997, as the approach to calculating it was only settled by the MMC in that year. Consequently, it would not seem reasonable or even possible to extend the mathematical analysis before 1997.

5.27. However, although we cannot extend the analysis before 1997, and in spite of the different rules applying to the RAV and capital allowance pools, the scale of the gap between them in 1997 suggests that at some point before this, the company carrying out Metering activities may well have derived some benefit from fast capital allowances.

5.28. That said, given that the industry was only privatised in December 1986, any benefit derived from fast capital allowances to that point would have been received by the state.

5.29. The evidence suggests that the gap between RAV and capital allowance pools is very longstanding but it is not clear how large the gap was at privatisation.

Ofgem checked cash tax in the 2001 Price Control Review

5.30. During the 2001 Transco Price Control Review, although Ofgem used a pre-tax approach, it appeared to check this against the actual amount of tax the company would be expected to pay, and gave the company an assurance that it would consider adjusting the price control should the cash tax be significantly higher if HMRC changed the tax treatment of replacement expenditure.

5.31. The Initial Proposals of June 2001, paragraph 7.59 states that:

"Ofgem is currently minded to use the mainstream rate, rather than the actual rate. However, it is for consideration which approach produces an appropriate amount of cash to meet the corporation tax liabilities associated with Transco's business."

5.32. The Final Proposals of September 2001, paragraph 5.23 states that:

"The use of the 1.429 multiplier will be retained, consistent with the approach previously adopted by the Competition Commission and the present mainstream rate of corporation tax. Neverthless, there remains uncertainty as to the amount of corporation tax Transco will actually pay as the Inland Revenue is presently considering the tax treatment of replacement expenditure. If the Inland Revenue changes the tax treatment of replacement expenditure it may be appropriate to consider adjusting the price control."

5.33. For Transco as a whole, for the period April 2002 – March 2007, even though Ofgem adopted a pre-tax approach, it clearly considered the issue of corporation tax, and expected the pre-tax approach to provide an appropriate level of cash tax.

Metering has borne excess tax costs since 1 April 2007

5.34. After March 2007, because Transco's capital allowance pools had been split between the different price controls enabling Network Sales to proceed, the gas distribution and transmission price controls were reset using the post-tax basis, which overall led to considerably lower costs for customers than the pre-tax approach from April 2007 onwards.

5.35. Ofgem decided not to re-set the Metering Tariff caps at that point, but if they had been re-set, they would have needed to be increased to reflect the fact that the Metering business cash tax was higher than assumed by the pre-tax approach. Because this was not done, the Metering business has lost money since April 2007 in respect of tax.

5.36. The table below quantifies the additional revenue which should have arisen if Tariff caps had been adjusted to reflect excess RAV depreciation as compared to capital allowances.

Metering: RAV depn v C.A.	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13*	**Total**
Nominal prices	£m	£m	£m	£m	£m	£m	**£m**
RAV depreciation	145.9	145.7	143.2	145.1	145.9	141.2	**867.1**
Capital allowance	75.0	58.8	72.7	57.1	55.4	49.0	**368.0**
Excess RAV depreciation	70.9	86.9	70.5	88.0	90.5	92.2	**499.1**
Corporation tax rate	30%	28%	28%	28%	26%	24%	
Tax on excess depreciation	21.3	24.3	19.7	24.7	23.5	22.1	**135.7**
Revenue grossed up for tax	30.4	33.8	27.4	34.2	31.8	29.1	**186.8**

** estimate*

5.37. The table shows that between 2007/8 and 2012/13, if Ofgem had re-set the Tariff caps on a post-tax basis, in the same way as for gas distribution and transmission, then the Tariff caps would have been raised to allow the recovery of a further £187m of revenue.

5.38. It could be argued that, had Ofgem reset the Tariff caps from April 2007, then it would have taken account of all costs, not just tax in its calculations, and these other costs may have acted to reduce the increase in the Tariff caps due to tax.

5.39. We cannot second guess with confidence what assumptions would have been made for opex, capex, gearing etc had a price control for Metering been carried out in 2006.

5.40. However, it is clear from Ofgem's analysis (Table 1 of the July 2012 Decision document), that by 2006, the Metering business had not, in any year since the start of the Tariff caps in 2002/3, achieved Ofgem's target 7% pre-tax return. Therefore, Tariff caps could not have been reduced to hand back any regulatory outperformance, which typically represents a major element of revenue reduction in a price control review.

6. Conclusion

6.1. Calculating Metering Tariff caps using a post-tax approach with a separate allowance for tax leads to a higher revenue requirement than the pre-tax approach. This is because the Metering RAV is well above the capital allowance pools, which causes a significant element of the revenue associated with RAV depreciation to be taxable.

6.2. We support the use of a post-tax approach because:

- Revenues based on the pre-tax approach would not be sufficient to finance our existing and new regulated Metering activities during the crucial period of the Smart meter roll-out.
- It has been Ofgem's policy since 2003.
- We see no logical reason for treating Metering activities differently from any of Ofgem's other price controlled activities.

6.3. We believe that to use a pre-tax approach would be unwise, as such an approach could be viewed as the claw-back of tax allowances from previous price controls, which we would not support in principle because:

- It would be very poor for incentives, with retrospective re-opening of past price controls where the treatment of tax was understood by regulator and companies.
- It would be asymmetric, as no adjustments would be considered for areas where the company had underperformed relative to price control assumptions.
- It would run counter to Ofgem precedent - Ofgem has already twice rejected the claw back of tax from previous price controls in Gas Distribution and Transmission.

6.4. The present capital allowances pool for Metering is far below the RAV, but it is not clear that, post-privatisation, the company has obtained undue benefit from Metering tax allowances calculated on a pre-tax basis because:

- Prior to 2005/6, Metering did not have separate capital allowance pools, but was an indistinguishable part of much larger businesses. Consequently, looking back in history we are using data including many other activities.

- The RAV has been calculated using different rules than the capital allowance pools which typically act to make the RAV higher. In particular the use of replacement cost, RPI and the addition of repex to the RAV but not capital allowance pools would all be expected to make the RAV higher, although these are partly offset by the MAR adjustment.

- The Metering capital allowance pool is now higher relative to RAV than that of the company carrying out Metering in 2001 or 1997.

- Prior to 1997, although the predecessor company carrying out Metering activities may well have derived some benefit from fast capital allowances, it is not clear whether the gap between RAV and capital allowances arose before privatisation and so would have benefitted the State, or even how the RAV should be measured. Data does not exist to take the analysis back prior to 1997, and there was no settled concept of a RAV until the 1997 MMC Report.

- At the 2001 price control review, although the pre-tax approach was used, Ofgem considered the corporation tax issue and appeared to satisfy itself that the cash tax provided was appropriate for the company as a whole.

- We note that the gas distribution and transmission price controls switched to a post-tax basis in April 2007, giving customers the benefit of their lower tax charges. In contrast, had Metering switched to a post-tax basis at that time, we estimate that additional revenue of around £187m would have been allowed to fund our increased tax liabilities.

6.5. Overall, the evidence suggests that, both on a principled and mathematical basis, the arguments for using the post-tax approach to calculating Metering Tariff caps without claw-back are strong.

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17 May 2013