

April 1999

**Ofgas' review of Transco's Economic
Purchasing Obligation for Non-Daily Meter
Reading Services for 1997/98**

The Director General's Determination

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1. Introduction

1.1 *The Purpose of this Document*

Transco can only recover its costs of providing non-daily meter reading services for gas shippers if it has satisfied Ofgas that the costs it is claiming have been economically incurred.

This document sets out Transco's non-daily meter reading cost claim for the year April 1997 to March 1998 and outlines Ofgas' review of that claim.

1.2 *Background*

Special Condition 9C of BG Transco's public gas transporter (PGT) licence restricts the prices Transco can charge for its regulated services. Most of these services are covered by an RPI-X price control. However, the costs Transco incurs in the provision of non-daily meter reading services for shippers are subject to 'pass-through' into Transco's charges, subject to these costs being economically incurred.

The reason for the special treatment of non-daily meter reading services in Transco's price control is because this service is open to a degree of competition, so that shippers need not take the service from Transco. Since the extent to which shippers use Transco for this service is unpredictable it is therefore difficult to determine in advance the level of revenues associated with non-daily meter reading. For these reasons, non-daily meter reading was treated separately to the majority of Transco's activities.

Further background information is set out in chapter 2. Chapter 3 sets out Transco's non-daily meter reading costs claim for 97/98 and summarises Ofgas' deductions.

1.3 *Ofgas' Economic Purchasing Review*

Ofgas' economic purchasing review of Transco's non-daily meter reading cost claim examined Transco's external costs and Transco's internal costs.

In examining the external costs, Ofgas reviewed Transco's process for competitively tendering for the non-daily meter reading services that shippers asked Transco to carry out for them. This part of the economic purchasing review is discussed in chapter 4.

Ofgas' review of Transco's internal costs associated with the provision of a non-daily meter reading service for shippers included examining to what extent such costs had already been taken into account in the calculation of Transco's RPI-X price control. This aspect of Ofgas' economic purchasing review is covered in chapter 5.

1.4 Ofgas' Conclusions

Transco claimed a total of £31.98m of costs for the provision of its non-daily meter reading service in 1997/98, broken down between £17.35m external costs and £14.63m internal costs.

Ofgas concluded that £27.31m in total should be passed through, broken down between £16.24m external costs and £11.07m internal costs. Thus in total Ofgas' disallowed £4.67m of Transco's 'pass-through' cost claim as being 'uneconomically purchased'. These conclusions are discussed more fully in chapter 6.

1.5 Views Invited

If you wish to comment on the matters raised in this document then please send responses to:

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London SW1V 1LQ.

It would be helpful if responses were received by 17 May 1999. Please mark your response as confidential if you do not want it placed in the Ofgas library. If you have any questions about the issues discussed in this document please do not hesitate to contact Colin Sausman (0171 932 5939, sausmanc@ofgas.gov.uk) or Kevin James (0171 932 5905, jamesk@ofgas.gov.uk), who will be pleased to help.

2. Background

2.1 *Monopolies and Mergers Commission's (MMC) Conclusions*

As part of the Director General of Gas Supply's (DGGS) final proposals for British Gas' 1997-2002 transportation and storage price control,¹ Ofgas proposed that Transco's non-daily meter reading costs should not be included within the 'RPI-X' part of the control proposed for most of Transco's costs, but should be passed through. The costs to be passed through would be subject to a requirement on Transco to obtain the services in the most economically advantageous manner possible, having regard to all available sources of the services. This proposal recognised the uncertainty of forecasting the extent to which shippers would purchase meter reading services from Transco during the period of the price control.

Transco rejected the DGGS' final price control proposals and the DGGS referred the issue to the Monopolies and Mergers Commission (MMC) in accordance with section 24 of the Gas Act. In May 1997, the DGGS published the MMC's conclusions.

The MMC stated that it believed that Transco's non-daily meter reading activities should remain subject to some form of price control until competition had become established for the provision of such services and proposed that the costs of non-daily meter reading be separately passed-through subject to an economic purchasing requirement.

The MMC stated that the licence condition should apply "...to costs of non-daily meter reading, namely those of six-monthly reads, monthly reads, opening meter readings and associated non-routine, performance improvement and internal costs (currently estimated at £29 million in 1997/98). (This would require an allocation of BG's meter reading contracts and internal costs- for example, query resolution and general overheads.)".

2.2 *BG plc's 1997-2002 Transportation Price Control*

Following publication of the MMC report, Ofgas proposed licence modifications that the DGGS believed remedied the adverse public interest affects identified by the MMC.

¹ '1997 Price Control Review, British Gas' Transportation and Storage, The Director General's final proposals', Ofgas, August 1996.

In February 1998, Ofgas implemented the new licence conditions that applied retrospectively from 1 April 1997.² Special Condition 9C³ of BG plc's Public Gas Transporter licence implemented the pass-through, subject to economic purchasing requirement, for non-daily meter reading.

a) *Definition of non-daily meter reading*

Special condition 9C defines non-daily meter readings relevant to the pass-through as meter readings obtained by or on behalf of Transco:

- ◆ where shippers have requested such reads;
- ◆ which are required to meet any contractual obligations in obtaining those reads; and
- ◆ which are required to meet any contractual standards of performance.

The condition specifically excludes any daily meter readings required under Transco's network code; 'must' reads; or any other readings that Transco obtains on its own behalf to maintain the efficiency of the transportation system.

b) *Ofgas' economic purchasing guidelines*

Following the MMC report and as the licence modification proposals were being developed, at Transco's request, Ofgas set out some guidance as to how the pass-through requirement might be interpreted. The guidelines were finalised and published in July 1997⁴ (see appendix 2).

In the guidelines, Ofgas stated that in general it expected Transco to seek to minimise the costs of running its meter reading business as a whole. This implies that Transco should compare the costs of putting activities out to tender against the cost of providing these services internally. This also recognises that some meter reading costs fall within the scope of the 'RPI-X' part of the price control. However, Transco requested specific guidance on certain issues. Ofgas' guidance on these issues is summarised below:

² 'BG Transportation and Storage, The Director General's Price Control Proposals April 1997-March 2002', Ofgas, February 1998.

³ Relevant extracts from Special Condition 9C are reproduced in Appendix 1.

⁴ 'BG Transportation and Storage, The Director General's Price Control Proposals April 1997-March 2002, A Consultation Document', Ofgas, July 1997.

i) *Retrospection*

Ofgas stated that it would only require Transco to purchase economically on the basis of the information reasonably available to it at the time of any procurement decision. Any investigation conducted by Ofgas would not be performed with the benefit of hindsight.

ii) *Level of service*

Ofgas stated that it was aware that Transco might be able to choose from a variety of offers with different price/service combinations. Transco should choose the contracts that represented the best value for money, with due consideration of the requirements of its customers.

iii) *Embedded costs*

Ofgas recognised that an appropriate proportion of overheads, for example those associated with the purchasing of meter reading services, will be included within the pass-through. Transco would be required to demonstrate that all costs proposed to be passed-through had been incurred efficiently. Ofgas stated that in considering whether Transco had acted efficiently, we might wish, for example, to compare the levels and trends of meter reading costs with costs falling within the 'RPI-X' part of the price control.

iv) *1997 tender process*

Ofgas stated that we would expect Transco's tender process to comply with the economic purchasing obligations from May 1997 (the date of the publication of the MMC report).

v) *Time profile of contracts*

Ofgas stated that it would expect the time profile of meter reading costs not to be unfairly biased against customers in earlier years, when the market may be relatively less competitive.

c) ***Process for determining the pass-through***

Special Condition 9C sets out the process Ofgas used to monitor Transco's compliance with the pass-through part of the licence condition. Transco is required to provide Ofgas with a submission no more than six weeks after the end of the formula year. The submission must include:

- ◆ details of the steps taken to comply with the economic purchasing requirement to provide non-daily meter readings or associated services in respect of that formula year;
- ◆ an estimate of 'F', the costs incurred by Transco in procuring non-daily meter readings including such proportion of its overheads as is properly attributable to those readings; and
- ◆ a list of any quotations or offers made by third parties to Transco.

After receiving Transco's submission, Ofgas has ten weeks in which to inform Transco whether it intends to conduct an investigation into Transco's compliance with the licence requirements. Ofgas then has six months, from the date of informing Transco of its intention to conduct a full investigation, in which to determine the amount to be deducted from Transco's submission of 'F'. The DGGS' determination is deducted from Transco's submission to arrive at an appropriate value for 'F'. Following the calculation of the appropriate value, 'F' then forms part of the calculation of the average price cap under Transco's price control.

2.3 Additional Regulatory Provisions

Transco is subject to various regulatory provisions that may limit the way in which it is able to obtain meter reading services on the most economically advantageous terms.

Standard Condition 11 requires Transco to conduct its transportation business in the manner best calculated to secure that neither itself, nor any gas shipper or supplier obtains an unfair commercial advantage from preferential or discriminatory arrangements. This condition requires Transco not to discriminate in favour of its own meter reading business through the conduct of its transportation business.

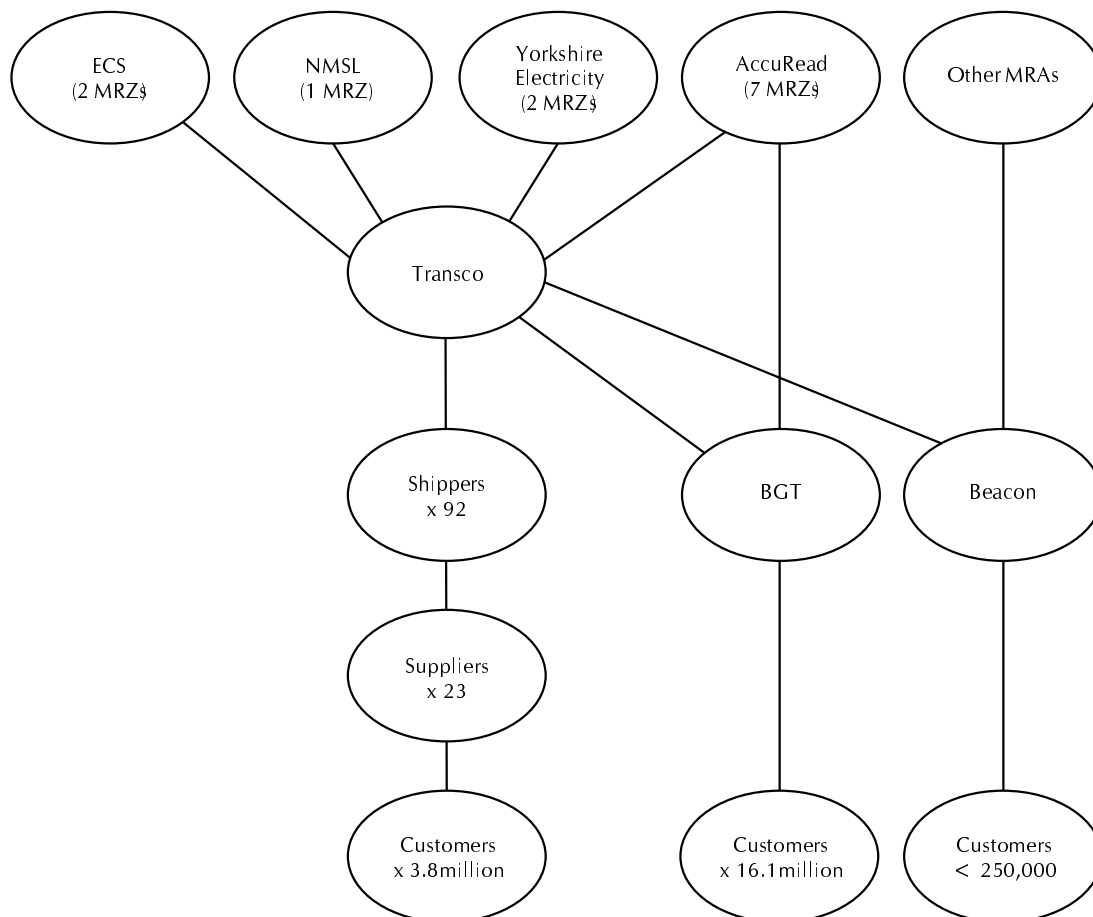
The DGGS also has a number of functions under the Fair Trading Act 1973 and Competition Act 1998.⁵ The Competition Act 1998 contains prohibitions against agreements or decisions that have the effect of preventing, restricting, or distorting competition and the abuse of a dominant position.

⁵ These powers are exercised concurrently with the Director General of Fair Trading.

2.4 The Non-Daily Meter-Reading Market

Transco provides a domestic cyclic non-daily meter reading service to suppliers, via shippers under a contract outside Transco's network code called the incentive-based contract. Transco does not use its own staff to carry out manual reading of meters, but procures this service from Meter Reading Agencies (MRAs). Two shippers, BGT and Beacon, have chosen to purchase their domestic cyclic non-daily meter reading services directly from MRAs. There are currently two main contracts that cover meter reading arrangements between Transco and shippers: Transco's network code and the incentive-based contract for non-daily meter reading (see appendix 3). Figure 1 below illustrates the contractual relationships within the non-daily meter reading markets.

Figure 1 – Non-Daily Meter Reading (Domestic) Relationships



3. Ofgas' Assessment of Transco's Submission

3.1 Transco's Submission

Transco submitted an initial amount of £31,981,756 for costs to be included in the pass-through for 1997/98.

Transco used its Activity Based Costing (ABC) system to identify costs to be included in the pass-through.⁶ Transco classified these costs in terms of three 'types': non-daily meter reading activities; 'direct overheads'; and 'indirect overheads'. The first category, costs associated with non-daily meter reading activities, included the following activities:

- ◆ payment to its Meter Reading Agencies (MRAs) for the meter reads provided;
- ◆ negotiating, implementing and managing contracts with MRAs;
- ◆ validating meter read transactions;
- ◆ handling meter read rejects;
- ◆ handling queries from shippers; and
- ◆ obtaining reads from dataloggers at sites classified as non-daily by Transco's network code.

Transco sub-divided 'overheads' into 'direct overheads' and 'indirect overheads'. Direct overheads included costs associated with domestic competition, business development, site management and upkeep, and staff recruitment. Indirect overheads included costs associated with business accounting and finance, payroll, network code modifications, ad hoc reads carried out by Transco districts, and IT costs.

3.2 Summary of Ofgas' Assessment

Ofgas has conducted a full investigation of Transco's submitted costs, and has determined a total amount of £4,668,224 to be deducted from Transco's submission. The Director General's determination of the amount to be passed through for non-daily meter reading for 1997/98 is therefore £27,313,532.

⁶ Transco's ABC costs are produced on a calendar year basis. Transco's submission therefore combines last nine months of its 1997 accounts and the first three months of its 1998 accounts. Transco has made some explicit adjustments to reconcile the changes in ABC activity centres between 1997 and 1998.

Table 1 below summarises Transco's pass-through claim and Ofgas' deductions.

Table 1 - Summary of Transco's pass-through claim and Ofgas' deductions

| | Transco's submitted amount (£) | Ofgas' deduction (£) |
|-----------------------|---------------------------------------|-----------------------------|
| External Costs | 17,348,849 | 1,110,000 |
| Internal Costs | 14,632,909 | 3,558,224 |
| TOTAL | 31,871,756 | 4,668,224 |

The following two chapters of the document report Ofgas' assessment in detail, and explain why deductions have been made. Chapter 4 reviews Transco's external costs (ie. £17.35m) paid by Transco to MRAs for meter reading services. Chapter 5 reviews Transco's internal costs (ie. £14.63m), including Ofgas' assessment of relevant 'overheads' or shared costs.

4. Ofgas' Assessment of Transco's External Costs

4.1 Transco's Submission

Transco included external costs of £17,348,849 within its submission. These costs cover the purchase of meter reading services from MRAs in 1997/98.⁷

4.2 Transco's Approach

Until October 1996, Transco purchased its manual meter reads for all twelve Meter Reading Zones (MRZs) from AccuRead under the competitive area agreement. In October 1996, following a tendering process, Transco appointed Northern Metering Services Limited (NMSL) for the Northern MRZ and AccuRead for the North Eastern MRZ. As these two contracts were made before the pass-through licence condition came into effect, they are not discussed further within this document.

In March 1997 Transco issued an invitation to tender (ITT) for the remaining ten MRZs. Transco sent ITTs to 13 organisations identified as suitable through the pre-qualification exercise conducted for the 1996 tendering process. Eight organisations responded. Transco issued the same ITT for each MRZ, apart from differences in expected volumes.

The ITT set out the range of services being contracted for and the required skills for tendering organisations. A small proportion of non-daily meter reading services, such as processing read rejects, were excluded from the tender. Transco also prescribed standards of performance together with a regime of liability payments for MRAs failing to meet those standards.

Transco stated that it would award contracts on the basis of value-for-money, and listed the criteria to be used in assessing tender proposals. Following the ITT, Transco held a pre-tender meeting and issued a number of amendment/clarification notices. Tendering organisations were required to submit prices for each read type by MRZ, and for different read volumes. They were also asked to state any discounts for providing services in more than one MRZ.

⁷ In a letter dated 16 September 1998, Transco stated that an error had occurred in the submission, which overstated the amount to be passed through by £1.11m due an overaccrual for MRA charges.

Transco's evaluation criteria were applied to each proposal in four stages: financial and technical evaluation by Transco; presentation by tendering organisation; site visit by Transco; and negotiations. The financial and technical evaluation considered bids under three scenarios for read volumes. The different scenarios in the initial evaluation saw volumes to fall by 80% in the base case, 90% in the low case, and 30% in the high case. These volume assumptions were subsequently revised to take account of better information on the likely effects of phase III of competition in domestic gas supply.

Two organisations were eliminated following Transco's financial and technical evaluation. A further two companies were eliminated following presentations and site visits. The remaining four companies were invited to the negotiation stage. Following the negotiation stage Transco awarded contracts to AccuRead for six MRZs, Yorkshire Electricity for two MRZ, and Energy Communication Services for two MRZs. The total value of the contracts in 1997/98 was £16.61m (including monitoring costs).

4.3 Ofgas' Assessment

Ofgas has examined the decisions made by Transco during its procurement of non-daily meter reading services for 1997/98 in some detail. Ofgas' full review of Transco's external costs is attached as appendix 4. Following this examination, Ofgas has a number of general observations:

- ◆ European Union procurement legislation states that a pre-qualification list remains valid for up to twelve months. There was an eleven month gap between the issuing of the pre-qualification questionnaire for the 1996 tender process and the ITT for the 1997 tendering process. While Transco complied with the legislation, it may be desirable for Transco to consider a shorter period of validity for future pre-qualification lists in recognition of the rate of change within the market.
- ◆ When the ITT was issued, AccuRead already had BGT's contract to read all its sites consuming less than 73,200 kWh (2,500 therms) per annum. AccuRead was therefore uniquely placed to cope with uncertainty surrounding numbers of customers switching from BGT to other shippers who used Transco for meter reading. This may have discouraged competition. Further, seven of the companies receiving the ITT were the meter reading subsidiaries of Regional Electricity

Companies (RECs). Within the relevant REC areas these companies may be able to offer greater flexibility for gas meter reading services by adjusting electricity meter reading cycles.

- ◆ Some MRAs requested further information following the ITT, including the walk order for each MRZ, which Transco could not provide. The information may have been available to AccuRead as the incumbent meter reader. Ofgas understands that this information was unavailable because AccuRead were not required to provide the information under their existing contract with Transco. Ofgas also understands that this omission has now been rectified, and the information will be available for future tender exercises.
- ◆ Ofgas noted that charges in the contracts for the 10 MRZs are generally lower than comparable charges in the contracts from the 1996 tender exercise for the other 2 MRZs.
- ◆ Ofgas has compared charges in Transco's contract with AccuRead with those obtained by BGT from AccuRead for domestic gas supply points. While rates charged by AccuRead differ between Transco and BGT, Ofgas accepts that differences may reflect differences in customer density. MRAs cite density as an important factor in determining cost.
- ◆ Transco's contracts with MRAs include a provision covering the situation where a shipper chooses to 'unbundle' its meter reading services, and purchase meter reading services directly from the same MRA as Transco. If this is seen to occur, then the lower read request volume does not trigger a consequent change in per read charges by the MRA. While this provision acts to reduce costs for Transco, Ofgas is concerned that it may also reduce incentives for MRAs to offer services direct to shippers. This may adversely affect competition in meter reading.

4.4 Summary

In summary, Ofgas was broadly content with Transco's competitive tendering process. There have been no complaints from MRAs, and Ofgas has found no clear evidence that Transco's decisions during the tendering process were unreasonable. Ofgas has therefore allowed Transco to pass-through £16,238,849, ie. 17,348,849 less £1.11m overaccrual.

Nevertheless, Ofgas expects Transco to have regard to the issues raised in respect of subsequent tender processes, eg. in respect of pre-qualification arrangements, to ensure

that changing customer needs are met and innovation is encouraged. Ofgas will monitor closely competitive developments in a meter reading market that remains highly concentrated.

5. Ofgas' Assessment of Transco's Internal Costs

5.1 *Transco's Submission*

Transco included internal costs of £14,632,909 within its submission. These costs covered activities associated directly with non-daily meter reading, and Transco's assessment of relevant 'overheads'.

Details of Transco's submission are considered by individual cost component in sections 5.3, 5.4 and 5.5 below. Before that, in section 5.2 we set out the principles which Ofgas has adopted in determining the extent to which each cost component should be permitted to be passed through.

5.2 *Ofgas' Principles of Cost Attribution*

Ofgas has investigated each element of Transco's internal costs to assess efficiency and the degree to which costs are correctly attributed to non-daily meter reading. Ofgas has conducted this assessment using the principles of cost attribution followed by Ofgas in developing its initial proposals to secure effective competition in gas metering and meter reading services.⁸ These principles are consistent with those used by Ofgas to consider BGT's request to rebalance its domestic gas tariffs.⁹

Under the principles adopted for the 'unbundling' proposals Transco's costs were analysed at the level of Transco's ABC (Activity-Based Costing) categories. For each activity Ofgas determined to which of the three separate businesses (ie. transportation, metering and meter reading) the activity related. All the costs for those activities which related to just one business were directly assigned to that business. For activities which related to more than one of the businesses a cost structure was estimated by considering the extent to which the costs of that activity varied with a change in the level of output of that activity. The proportion of the cost that varied with a change in the level of output of the activity was called the 'linear' component, and the remainder that did not vary was termed the 'constant' component.

⁸ 'Securing effective Competition in Gas Metering and Meter Reading services, The Director General's initial proposals', Ofgas, October 1998.

⁹ 'Review of British Gas Trading's Domestic Supply Tariffs, A Decision Document', Ofgas, July 1998.

Where an activity was common to more than one business, the 'linear' element of costs were allocated to the relevant businesses using a suitable output measure (or 'cost driver'). For example, payroll activities may vary with the number of employees. Therefore, by measuring the number of employees within each business, it is possible to attribute these costs. The 'constant' element of costs, where costs were not directly related to output or where a suitable output measure or proxy did not exist, were allocated across the relevant businesses in proportion to the attributed costs.

Ofgas has applied these principles to the costs submitted by Transco to be included in the pass-through.¹⁰ Individual cost categories have been grouped under three headings:

- ◆ directly attributable to the pass-through (section 5.3);
- ◆ shared costs which are wholly 'linear' (section 5.4); and
- ◆ shared costs with a 'constant' element' or with no plausible linear component (section 5.5).

In general, shared costs which are wholly linear have been identified as appropriate for the pass-through. However, Ofgas believes that the constant element of shared costs, as identified through the application of the cost attribution principles, should not be included in Transco's pass-through. Ofgas has therefore deducted these costs from Transco's submission. This is consistent with the MMC's recommendation that an allocation of BG's internal costs was required in determining the pass-through amount, and with the terms of Special Condition 9C whereby the pass-through only includes such proportion of overheads as is properly attributable to non-daily meter reading.

5.3 Ofgas' Assessment of Directly Attributable Costs

a) Contract monitoring costs

Transco stated that the activity of monitoring the performance of MRAs incurred costs of £371,000 in the formula year.

¹⁰ It is important to note that the coverage of the pass-through is different from the amount allocated and attributed to meter reading within the 'unbundling' proposals. The pass-through does not include daily meter reading activities, or shared costs which cannot be properly attributed to non-daily meter reading. Further, the unbundling proposals are based on 1997 ABC data, while the pass-through is based on costs for 1997/98 submitted by Transco.

Ofgas expressed concern that Transco's monitoring costs increased over the period of the formula year. In the last quarter of 1997/98, these costs were £157,550, accounting for 40% of the annual total for contract monitoring. However, Transco stated that the increase in contract monitoring costs arose from the commencement of the additional MRA contracts in the last quarter of 1997/98.

On the basis that Transco moved from monitoring and controlling the performance of two MRAs to five MRAs within the last quarter, Ofgas accepts that this increase is justified. Ofgas therefore considers that no deduction should be made from the value of F in respect of contract monitoring.

b) *Validate meter read transactions*

Transco stated that the activity of processing and validating non-daily meter readings received from MRAs to the standard set out in its network code incurred costs of £572,811 in the formula year.

Transco's network code sets out the required standards of service for the validation of meter reads and this standard did not change during the formula year. Ofgas is therefore satisfied that Transco complied with the network code validation standards.

Ofgas considers that no deduction should be made from the value of 'F' in respect of validating meter read transactions.

c) *Monthly/Non-monthly read rejects*

Transco stated that it incurred costs of £1,090,837 in the formula year for:

- ◆ processing meter read rejects, including manual requests for reads from MRAs;
- ◆ sending reads to shippers; and
- ◆ chasing outstanding read checks and queries.

This amount is made up of £854,178 for the first three quarters of the formula year plus monthly and non-monthly read rejects from individual cost centres of £32,225 and £204,434 respectively for the last quarter.

Ofgas was concerned that Transco's read reject costs (including for opening reads as discussed below) may be inefficient because a proportion of rejects are caused by incorrect meter information on Transco's database, which, under its network code, Transco and shippers are required to co-operate to update. Transco has inserted into the MRAs contracts a requirement to provide updated meter information and there is a standard of service on Transco requiring meter asset information to be updated following meter works. Ofgas has reviewed this issue and has not found evidence of inefficiency of this nature. Nonetheless, as explained in the initial proposals document for securing effective competition in gas metering and meter reading services, Ofgas is considering the introduction of a standard of service to maintain appropriate data quality.

There was a decrease in costs (of approximately 18%) in the last quarter of 1997/98 compared to costs in the preceding 3 quarters. Ofgas was concerned that Transco's costs were higher in the last quarter of 1997/98 than the last quarter of 1996/97. Read volumes were considerably higher in the last quarter of 1996/97 in comparison with 1997/98, as BGT had not 'unbundled' its domestic meter reading services from Transco. Therefore, Ofgas would anticipate that the number of rejects and associated costs would fall following the 'unbundling' of BGT. However, Transco has explained that the additional costs occurred due to the introduction of new MRAs in 1998 and Ofgas accepts this explanation.

Ofgas was also concerned that the definition of read rejects might include the processing of 'unbundled' shippers meter reads. Transco has confirmed that this is not the case.

Taking all of the above arguments into account, Ofgas considers that no deduction should be made from the value of 'F' in respect of processing meter read rejects.

d) Industrial and commercial opening meter read rejects

Transco stated that it incurred costs of £955,286 in the formula year for:

- ◆ processing opening meter read rejects (required on change of supplier);
- ◆ requesting reads from MRAs;
- ◆ forwarding reads to shippers;

- ◆ forwarding queries to districts; and
- ◆ chasing outstanding queries.

Following a complaint from a shipper in August 1998, Ofgas became aware that Transco might be raising opening read requests when a cyclic read, falling within the opening read window, had already been requested. This is likely to lead to inefficient costs being incurred because the shipper does not require two reads. The cost of these unnecessary read requests in the formula year was not very significant. Furthermore, it is not clear that these costs would not have been outweighed by other additional costs that Transco might have had to incur to develop the flexibility required to avoid these unnecessary request requests. Ofgas expects Transco to consider the costs of functionality to suppress read rejects against the cost of generating and paying for unnecessary reads.

Ofgas considers that no deduction should be made from the value of 'F' in respect of processing opening meter read rejects.

e) *Meter read queries*

Transco stated that it incurred costs of £2,507,297 in the formula year for:

- ◆ receiving queries from shippers;
- ◆ logging queries onto Transco's database;
- ◆ investigating queries on the system;
- ◆ liaising with districts and MRAs; and
- ◆ monitoring performance against its network code standards.

Ofgas was concerned that Transco may have included within this activity the costs of providing this service to shippers procuring their non-daily meter reading services from MRAs other than Transco. Transco has confirmed that no queries relating to 'unbundled' shippers meter reading have been costed to this activity.

Ofgas considers that no deduction should be made from the value of 'F' in respect of processing meter read queries.

f) Domestic opening meter read rejects

Transco stated that the activities of processing domestic read rejects and amending related details incurred costs of £622,988 in the formula year.

Ofgas has calculated an annual cost of some £380,000 for the formula year, based on the cost per read of 12.1p in the last quarter of 1997/98. This compares to Transco's submission of £622,988. This suggests that costs in the first three quarters of 1997/98 were higher than in the last quarter. However, Ofgas is satisfied that this change in cost levels may be put down to the automation of Transco's system for generating estimated reads which would have reduced costs in 1998.

Ofgas considers that no deduction should be made from the value of 'F' in respect of processing domestic read rejects. However, in the future we would expect that suppliers will be able to provide their own estimates for agreement with the outgoing or incoming supplier and that these costs will consequently decrease.

5.4 Ofgas' Assessment of Wholly 'Linear' Shared Costs

a) Recruitment and selection of staff

Transco stated that recruitment and selection of staff incurred costs of £27,899 in the formula year.

Transco has allocated this cost on a "number of employees" basis. Ofgas considers that this output measure is reasonable for this activity and that these costs would vary in proportion to the number of employees and therefore this cost could be described as 100% linear. Ofgas therefore considers that no deduction should be made from the value of 'F' in respect of recruitment and selection of staff.

b) UK Link running costs

Transco stated that running UK Link incurred costs of £537,855 in the formula year on the basis of the number of non-daily meter reading transactions.

Transco has used the number of transactions as an output measure for these costs. This appears reasonable and Ofgas therefore considers that these costs can be said to be '100% linear'. Ofgas therefore considers that no deduction should be made from the value of 'F' in respect of running UK Link.

c) UK Link development

Transco stated that upgrading UK Link in accordance with Transco's requirements incurred costs of £432,000 in the formula year in respect of non-daily meter reading. This amount is taken from a total of £720,000 for all meter reading development work.

These costs are for the development of new facilities of the system and supporting new developments. Transco has stated that these costs vary in proportion to the number of new UK link developments undertaken. Ofgas agrees with Transco that these costs are wholly linear and no deduction from the value of 'F' should be made in respect of these costs.

d) Business process development

Transco stated that raising, analysing and prioritising non-daily meter reading related UK Link change requests incurred costs of £618,930 in the formula year.

Ofgas' review of Transco's ABC as part of the work in splitting the price controls indicates that the activity code to which Transco has mapped business process development costs is related to developing, delivering and attending external training programmes. Ofgas is concerned that the activity code does not appear to describe the nature of the costs proposed to be passed-through by Transco. Transco stated that certain sections of business process development evolved from a team that organised external training related to UK-Link and therefore business process development was mapped to this activity code. Ofgas understands the explanation provided by Transco, but would expect Transco to review its activity descriptions in future, in order to maintain clarity.

Transco has used the number of change requests as an output measure for these costs. This appears reasonable and Ofgas therefore considers that these costs can be said to be '100% linear'. Ofgas therefore considers that no deduction should be made from the value of 'F' in respect of business process development costs.

e) Facilities management

Transco stated that the management of facilities including site rental, maintenance, heat and power incurred costs of £124,650 in the formula year.

Transco has allocated this cost on a “number of employees” basis. This output measure appears reasonable for these costs. Ofgas considers that broadly these costs vary in proportion to the number of employees and can be considered wholly linear. Therefore, Ofgas has decided not to deduct any of the proposed amount for these costs from the value of ‘F’.

f) NDM/Datalogger

Transco stated that the activities of monitoring and controlling datalogger operations and the co-ordination and collection of datalogger reads incurred costs of £3,846,988 in the formula year.

Transco’s network code requires dataloggers to be installed at sites consuming more than 58,600,000 kWh per annum and at interruptible sites below that threshold. In addition, approximately 23,800 other sites have dataloggers and are classified as non-daily metered (NDM). Transco provides daily meter reads to shippers for these sites but does not guarantee to provide this daily service as the minimum requirement for such sites under the network code is to provide one meter read per month during the read window. Transco only pays liabilities for the failure to deliver daily reads at sites requiring a datalogger under network code.

Ofgas understands that datalogger costs are shared between daily and non-daily services. However, Ofgas considers that datalogger costs are broadly linear and vary in proportion to the number of dataloggers installed.

Transco has stated that it requires NDM dataloggers for demand estimation purposes. However, historically, Transco installed the dataloggers in anticipation of a lower daily read threshold. Ofgas is not aware of shippers specifically requesting an NDM datalogger service. Furthermore, as Transco only levy the equivalent of a charge for monthly read sites for these datalogged sites, there is no pricing signal to shippers. For these reasons, until such time that the appropriate pricing signals are in place and shippers can choose between a monthly read and a datalogger service, Ofgas considers that the cost of providing a datalogger service to NDM sites which may not require these services is inefficient.

Ofgas considers that a deduction of £2,308,090 should be made from the value of 'F' in respect of datalogger operations. This amount is calculated on the basis of the cost difference between the two services and the number of expected monthly reads required for the formula year in respect of datalogged sites.

5.5 Ofgas' Assessment of Shared Costs with a 'Constant' Component or with no Plausible Linear Component

a) DC III development

Transco stated that the activity of planning and introducing domestic competition incurred costs of £1,232,361 in the formula year.

The number of domestic customers switching supplier may be a proxy output measure for these costs. However, Ofgas would not expect development costs to vary proportionately with the expected number of switchers, as certain costs may be incurred irrespective of the number of switchers, eg. costs of the development of systems to generate estimated reads. For this reason, Ofgas estimates that 50% of these costs will vary with the number of switchers. We therefore consider that the constant element of the cost, ie. £616,180.50, should be deducted from the value of 'F' in respect of planning and introducing domestic competition.

b) Business development

Transco stated that it incurred costs of £935,181 in the formula year for:

- ◆ developing pricing and charges;
- ◆ making changes to network code; and
- ◆ developing processes to conform with licence conditions.

These costs are shared between daily meter reading and non-daily meter reading. Transco's estimate of the business development associated with daily meter reading is £40,000. Transco therefore revised its submission of business development to £895,181.

Since business development costs are shared costs, Ofgas would ordinarily wish to estimate the structure of these costs using the principles explained at the beginning of this chapter. For the purposes of this review, Ofgas accepts Transco's estimate of the

amount of £40,000 as the appropriate cost to be attributed to daily meter reading, and has therefore deducted £40,000 from Transco's submission of 'F'.

c) Business costs

Transco stated that the non-daily meter reading share of the business overhead costs amounted to £756,827 in the formula year. This amount comprises:

- ◆ IT costs;
- ◆ service development costs; and
- ◆ district costs for ad hoc reads.

i) IT costs

Transco has proposed to pass-through £361,112 for IT costs.

Ofgas considers that the part of these costs which relate to general management, contractor and supplies administration, finance and system development are wholly constant. Transco has stated that the costs associated with payroll and other support systems, and telecomms vary linearly with the number of employees. Ofgas agrees that these costs would vary with the number of employees, but that some systems costs would be incurred irrespective of the number of employees, eg. a telecomms network.

On this basis, Ofgas has treated these costs as 50% linear. Ofgas has therefore deducted £240,842.50 from Transco's submission of 'F' for the constant element of these costs.

ii) Service development costs

Transco has proposed to pass-through £353,111 for service development costs, associated with supporting meter reading changes to its network code.

Ofgas understood that these costs included payments of £255,883 to shippers for sub-standard performance in meter reading, in accordance with the Transco's network code standards and liabilities package. Transco has subsequently explained that these costs do not relate to liability payments, but to a team reviewing the liability regime and dealing with modifications to Transco's network code. Ofgas understands the

explanation provided, but would expect greater clarity in activity descriptions in the future.

However, Ofgas is not persuaded that there is a relevant output measure or suitable proxy that would indicate a level of linear cost for this activity. Therefore, Ofgas has treated this as a wholly constant component, and deducted £353,111 from Transco's submission of 'F'.

iii) District costs for ad hoc reads

Transco has explained that the proposed pass-through of £42,603 for these activities is derived from the same activities for handling read rejects and queries. It has confirmed that these costs were not also included in the earlier cost categories. Ofgas considers that these costs should be treated the same as other read reject and query costs, so no deduction has been made to 'F' in respect of these costs.

5.6 Summary

Transco submitted £14,632,909 as the amount of internal costs to be included in the pass-through. Ofgas considers that some of the costs proposed by Transco cannot be properly attributed to non-daily meter reading. Ofgas has applied its principles of cost attribution to determine the amount to be included in the pass-through. In total, Ofgas has deducted £3,558,224 from the internal costs proposed by Transco.

6. Conclusions

Transco submitted an amount £31,981,756 to be included in the pass-through for non-daily meter reading services for 1997/98. Following Ofgas' investigation, the Director General has determined a deduction of £4,668,224 from Transco's submission. This deduction comprises £1.11m for an overaccrual in Transco's external costs, and a deduction of £3,558,224 from Transco's internal costs. The total amount for the pass-through for 1997/98 is therefore £27,313,532.

Ofgas' initial determination for the amount to be passed through for 1997-98 of 20 January 1999 made provision for further representations from Transco before deciding on the final amount. Ofgas has considered Transco's further representations in deciding on the appropriate deductions as presented in this document. Both of Ofgas' determinations can be viewed on the public register held in Ofgas' library.

a) External costs

Ofgas was broadly content with Transco's competitive tendering process. There have been no complaints from MRAs, and Ofgas has found no clear evidence that Transco's decisions during the tendering process were unreasonable. Ofgas has therefore allowed Transco to pass-through £16,238,849, ie. 17,348,849 less £1.11m overaccrual.

Nevertheless, Ofgas expects Transco to have regard to the issues raised in respect of subsequent tender processes, eg. in respect of pre-qualification arrangements, to ensure that changing customer needs are met and innovation is encouraged. Ofgas will monitor closely competitive developments in a meter reading market that remains highly concentrated.

b) Internal Costs

Transco submitted £14,632,909 as the amount of internal costs to be included in the pass-through. Ofgas considers that some of the costs proposed by Transco cannot be properly attributed to non-daily meter reading. Ofgas has applied its principles of cost attribution to determine the amount to be included in the pass-through. In total, Ofgas has deducted £3,558,224 from the internal costs proposed by Transco.

Appendix 1 **Special Condition 9C of Transco's PGT Licence**

This appendix provides relevant extracts from special condition 9C of Transco's PGT licence relating to restriction of prices for transportation and storage services.

Special Condition 9C Restriction of Prices for Transportation and Storage Services

1¹¹. The Licensee shall in setting its prices for the use made of the Transportation system having effect on or after 1st October 1997 take all reasonable steps to secure that in each Formula Year commencing on or after 1 April 1997 its Average Transportation Price per kilowatt hour shall not exceed the Maximum Transportation Price per kilowatt hour calculated in accordance with the following formula –

$$M_t = \frac{A_t B_t + C_t D_t + F_t - K_t}{Q_t}$$

where

F_t = costs incurred by the Licensee in accordance with paragraph 5 of this Condition in procuring Non-Daily Meters Readings including such proportion of the Licensee's overheads as is properly attributable to those readings

2(1) "Non-Daily Meter Readings" means all those meter readings obtained by or on behalf of the Licensee:

- (a) pursuant to requests by Shippers to obtain such readings;
- (b) to meet any of its contractual obligations in relation to the obtaining of such readings; or
- (c) required to meet any of its contractual standards of performance

¹¹ Substituted 18 February 1998 pursuant to section 26 of the Gas Act 1986.

and shall not include:

- (a) Daily Meter Readings, as defined in Section M paragraph 4.2.3 (i) of the network code of the Licensee and readings obtained to meet its contractual standards of performance thereto;
- (b) meter readings obtained pursuant to Section M paragraph 3.6 or 4.7 of the network code of the Licensee; and
- (c) any other meter readings that the Licensee obtains on its own behalf for the purposes of securing the continued efficient and economical physical operation of its Transportation System

and for the purpose of this definition references to the network code of the Licensee are to the version of the Licensee's Network Code having effect as such on 1 April 1997.

- 5(1) The Licensee shall procure any Non-Daily Meter Readings on the most economically advantageous terms reasonably obtainable having regard to all the available sources of each of the services necessary to procure those readings.
- 5(2) The Licensee shall, not later than six weeks after the end of each Formula Year s submit to the Director:
 - (a) and publish in such a manner as the Director may direct a statement of the steps that the Licensee had taken during the previous Formula Year to comply with its obligations under this paragraph 5;
 - (b) details of each quotation or other offer or invitation to treat received from third parties in respect of its obligation in paragraph 5(1) above; and
 - (c) a statement showing the value of F during the immediately preceding Formula Year.

5(3) If

- (i) by no later than 10 weeks after receipt by the Director of all of the information that the Licensee is required to furnish to the Director pursuant to paragraph 5(2) of this Condition, the Director informs the Licensee that he intends to carry out an investigation into the compliance by the Licensee with its obligation under paragraph 5(1) of this Condition; and
- (ii) by no later than six months after the Director informs the Licensee that he intends to carry out an investigation under sub-paragraph (i) above the Director has made a determination that, during the immediately preceding Formula Year, the Licensee failed to comply with its obligations under paragraph 5(1) of this Condition and naming the value (the "overspend amount") by which, in his opinion, the value of F shown in the statement submitted by the Licensee pursuant to paragraph 5(2) of this Condition exceeded the value which he would have reasonably expected F to have in respect of that Formula Year, had the Licensee complied with its obligations under paragraph 5(1) of this condition

then the value of F in respect of that Formula Year shall be the value shown in the statement submitted pursuant to paragraph 5(2) of this Condition less the overspend amount.

Appendix 2 Ofgas' Economic Purchasing Guidelines

The following guidelines were published in appendix 7 of Ofgas' notice of proposed licence modifications following the publication of the MMC's findings for the April 1997-March 2002 price control.¹²

A2.1 Ofgas' Economic Purchasing Guidelines

Transco and Ofgas agreed that it would be helpful if Ofgas set out some guidance as to how the proposed licence condition covering the treatment of the 'pass-through' costs associated with Transco provision of meter reading services might be interpreted. In future, Ofgas would expect Transco to seek clarification on how the licence condition would take account of significant new issues as they arise, but not to seek guidance on a contract by contract basis.

The guidance given in this note cannot address all the considerations which might arise when we come to apply the economic purchasing requirement. Ofgas' guidance is intended to illustrate the philosophy and spirit of the requirement rather than define a strict set of rules.

A2.2 General Principles

Ofgas expects that in general Transco will seek to minimise the costs of running its meter reading business as a whole. This is partly because some meter reading costs will continue to fall within the scope of the RPI-X control, and partly because Transco will wish to prepare itself for an increasingly competitive market.

However, Ofgas is presently conducting a review as to whether there are any impediments to the development of competition in the provision of meter reading services to suppliers/shippers. Although Ofgas has not reached any firm conclusions at this stage, we nevertheless consider it likely that during the next few years competitive pressures in this market will not be as great as they are subsequently likely to be. Similarly, we would expect that competitive pressures may develop more quickly in

¹² 'BG Transportation and Storage: The Director General's Price Control Proposals April 1997-March 2002: Notice of Proposed Licence Modification', Ofgas, October 1997.

some parts of the market than in others (eg. there could be differences in the intensity of competition between different regions, or as between daily and non-daily meter readings).

It is for this reason that Transco will be required to demonstrate that it purchases meter reading services for suppliers/shippers on the most economically advantageous terms.

A2.3 Specific Areas where Transco has Requested Guidance

a) Retrospection

Ofgas would not consider Transco to be in breach of the economic purchasing requirement in circumstances where more economic alternatives are only revealed after the dates on which Transco has entered into contracts for meter reading services. In other words we would consider Transco's behaviour in the context of the circumstances prevailing at the time the decision to enter into the contract was made, without the benefit of hindsight. This would mean assessing Transco's decision to enter (or not to enter) into particular contracts against the alternative options available at the time, including, for example, the options not to enter into a contract at all, or to enter into shorter term contracts, rather than longer term contracts.

b) Level of services

Transco has sought to clarify as to whether service levels and other non-price considerations should be taken into account in assessing the extent to which purchases are economically advantageous. Ofgas recognises that Transco may be able to choose from a range of offers with different price/service combinations. More expensive contracts are likely to offer greater activity levels and performance guarantees than less expensive contracts. We would expect Transco to choose the contracts representing the best value for money, with due consideration of the requirements of its customers.

c) Embedded costs

Transco suggested guidance on how its own costs would be treated. Ofgas believes that it is unlikely that Transco will resource meter reading services internally, but appreciates that an appropriate proportion of overheads, for example those associated with the purchasing of meter reading services, will be included within the pass-through. If these are to be passed through, Transco will be required to demonstrate that the costs have been incurred efficiently. In considering whether Transco had acted efficiently, Ofgas

may wish, for example to compare the levels and trends of meter reading with costs falling within the RPI-X cap.

d) 1997 Tender process

Transco requested guidance on how it should proceed with its tender process. Since the MMC report was issued to interested parties at the end of May 1997, Transco has been aware that it would face an obligation to purchase meter reading services economically. Ofgas would therefore expect Transco to be able to demonstrate that it has complied with the economic purchasing condition from that date. From the date of this consultation, Ofgas would expect Transco also to benefit from the guidance set out in this appendix.

e) Time profile of contracts

Competition in the provision of meter readings is developing. This might allow meter reading to be removed from the scope of the price control within the next price control period. In the meantime, where Transco enters into longer term contracts, Ofgas would expect the time profile of meter reading costs not to be unfairly biased against customers in earlier years, when the market may be relatively less competitive.

f) Ongoing requirement to seek competitive offers

Transco requested clarification of the assessment of meter reading costs incurred via a contract which had been signed in an earlier year. In particular, Transco expressed concern that Ofgas would compare Transco's meter reading costs directly to competitive offers then available, without taking into account the costs of terminating the existing contract. In these circumstances, providing that the initial contract was deemed to be consistent with the economic purchasing condition, Ofgas would not reopen that decision. That is not to say Transco, having signed a contract which was not in breach of the condition, would have immunity from the terms of the economic purchasing obligation for the duration of the contract. If other opportunities arose during the life of the contract, we would expect Transco to consider these. Any assessment of a decision not to pull out of an existing contract would, however, need to take termination charges into account.

Appendix 3 Transco's Meter Reading Contracts

a) *Suppliers purchasing of non-daily meter reading services*

Shippers are currently entitled to procure non-daily meter reading services from various third parties. The developments in the meter reading market, up to the introduction of Transco's incentive-based contract are outlined below.

i) *Opening meter reading services*

Since the rollout of domestic competition began on 29 April 1996, suppliers have been entitled to purchase domestic opening meter reading services from any provider. Some suppliers have chosen to provide the meter reading service internally and others have used outside Meter Reading Agencies (MRAs). Transco does not currently offer a domestic opening meter reading service.

ii) *Cyclic meter reading services*

It has been possible for suppliers to purchase cyclic non-daily meter reading services other than via Transco since 1 October 1996. Transco's procedures for handling so-called 'unbundled' meter reads were developed in a network code review group.¹³

From 1 April 1997, BGT opted to procure 'unbundled' meter reading services directly from AccuRead for all of its sites consuming less than 73,200 kWh per annum. In June 1998 Beacon Gas began purchasing cyclic meter reading services other than via Transco. Ofgas has recently been informed that a shipper with a small portfolio has now 'unbundled' most of its sites consuming more than 73,200 kWh per annum.

Table A1 below shows the market share by domestic customer for meter reading at sites consuming less than 73,200 kWh per annum.

¹³ Network code modification review group 005.

Table A1 - Domestic meter reading services

| Meter reading provider | Number of sites, week ending 3 January 1999 |
|--------------------------------|--|
| AccuRead for BGT | 16,143,799 |
| Beacon | Less than 250,000 |
| Transco for all other shippers | 3,768,962 |

b) Transco's network code

Transco's network code is the contractual framework required by Standard Condition 7 of the PGT licence to govern 'transportation arrangements' between Transco and shippers.

i) Performance targets

The network code includes obligations on shippers to use their 'best endeavours' to achieve specified levels of non-daily meter reading performance. Shippers have chosen to delegate these responsibilities to Transco and other MRAs. Table A2 below sets out the percentage of valid reads which should be delivered to Transco by shippers within the read and submission windows.

Table A2 - Network code non-daily meter reading target performances

| Meter reading type | Performance target (%) |
|---|-------------------------------|
| Monthly read ¹ | 90 |
| Non-monthly I&C reads ² | 90 |
| Non-monthly domestic reads ³ | 70 |
| Opening (I&C) reads | 90 |

¹ Sites consuming more than 293,000 kWh (10,000 therms) per annum.

² Sites consuming more than 73,200 kWh (2,500 therms) per annum.

³ Sites consuming less than 73,200 kWh (2,500 therms) per annum.

Transco's meter reading performance for the formula year April 1997 to March 1998 is summarised in table A3 below.

Table A3 – Transco’s meter reading performance

| | Monthly reads | Non-monthly reads at sites consuming more than 73,200 kWh per annum | Non-monthly reads at sites consuming less than 73,200 kWh per annum | Opening reads at sites consuming more than 73,200 kWh per annum |
|--|---------------|---|---|---|
| April 97 | 91 | - | - | 75 |
| May 97 | 90 | - | - | 82 |
| June 97 | 86 | - | - | 75 |
| July 97 | 89 | - | - | 74 |
| Aug 97 | 89 | - | - | 77 |
| Sep 97 | 93 | 76 | 63 | 86 |
| Oct 97 | 92 | - | - | 87 |
| Nov 97 | 94 | - | - | 86 |
| Dec 97 | 93 | 77 | 53 | 92 |
| Jan 98 | 85 | 78 | 54 | 86 |
| Feb 98 | 92 | 85 | 63 | 83 |
| Mar 98 | 86 | 74 | 56 | 77 |
| Formula year 97/98 average performance | 90 | 78 | 58 | 82 |

For the formula year April 1997 to March 1998, Transco met the required standard for monthly reads in 7 out of 12 months. For domestic, non-monthly I&C and opening reads, Transco did not reach the required standards, and failed by more than 10 percentage points on average. For opening and, to a lesser extent, I&C non-monthly read performance generally improved over the period.

ii) Must reads

As well as endeavouring to read meters at regular intervals, shippers have an obligation to ensure that every meter is read at least once in a period defined by the network code. For the 1997/98 formula year monthly read sites (sites consuming more than 293,000

kWh per annum) shippers must obtain a meter reading at least every 3 months. A network code modification has recently been implemented to extend the minimum requirements for monthly read sites from 3 to 4 months.

For non-monthly read sites (sites consuming less than 293,000 kWh per annum), a shipper must obtain a reading at least every 2 years. Where a shipper fails to comply with this requirement, Transco will use reasonable endeavours to obtain a meter reading from such a meter and the shipper will pay Transco the £40 charge for 'must reads' as contained within Transco's transportation charging statement. Standard Condition 23 of the gas suppliers' licence requires suppliers to read all meters at least once every 2 years.

iii) Updating meter asset information

Shippers and Transco are required by the network code to co-operate to ensure that the information contained in the supply point register is as accurate as possible.

Additionally, shippers and Transco are required to use reasonable endeavours to inform the other party of any inaccuracies they become aware of in Transco's supply point register. Transco is required, where a shipper notifies it of an inaccuracy, to revise the meter information, unless Transco is not satisfied that the details provided by the shipper are correct. In such a case, both Transco and the shipper are required to co-operate, with a view to establishing the correct details.

Therefore, where a shipper has delegated the responsibility for the provision of meter readings to Transco, Transco's meter reading agencies should provide details of any inaccuracies with regard to meter information, as they become aware.

iv) Meter reads obtained from dataloggers

Transco currently provides a daily read service to shippers from datalogger equipment, which transmits meter readings via a phone line. Daily readings are required at sites consuming over 58,600,000 kWh per annum, and at sites below that threshold where the gas supply can be interrupted. Under the network code, standards of service apply to Transco's daily read service. Transco pays shippers liabilities where it fails to meet the required performance levels.

The definition of non-daily meter reading under the licence condition does not include daily readings covered by Transco's network code. However, Transco obtains daily readings for approximately 23,800 other sites that have a Transco datalogger installed. Transco does not guarantee a daily read service as the minimum requirement for such sites under the network code is one meter reading per month during the read window. Transco only pays liabilities for the failure to deliver daily reads at sites requiring a datalogger under network code.

c) *Transco's meter reading contracts with shippers*

Network code modification 132A provided for the withdrawal of non-daily meter reading services from the network code from 1 October 1997. This was agreed on the basis that Transco would continue to offer identical non-daily meter reading services via a contract outside the network code until 31 March 1998. Following consultation with shippers and Ofgas, Transco introduced the contract from 1 October 1997 and agreed that no changes would be made up to 31 March 1998.

In August 1997, Transco began discussing with shippers its proposed new 'incentive-based' contract outside of the network code from 1 April 1998. Transco and shippers were unable to agree a contract for implementation in April and Transco agreed to extend the existing contract with reduced liabilities until 1 July 1998. All shippers, except those who had 'unbundled' at that time, signed the 'incentive-based' contract to run for six months from 1 July 1998.

The main differences between the incentive-based contract and the previous regime are as follows:

- ◆ Transco only levies a charge for actual reads returned to shippers rather than an annual meter reading charge per supply point;
- ◆ there are separate charges for monthly reads, non-monthly reads for sites with annual consumption above and below 73,200 kWh, opening reads at sites with annual consumption's above 73,200 kWh, and special reads; and
- ◆ Transco receives additional payment for performance above target levels rather than paying shippers liability payments for failure to meet performance targets.

Shippers and Transco have reviewed the operation of the 'incentive-based' contract, and Transco proposed a revised contract to have effect from 1 January 1999. Shippers were concerned that the proposed contract was being introduced before they had had sufficient opportunity to review the operation of the existing contract. Transco also proposed changes to its meter reading pricing methodology which Ofgas vetoed in accordance with the procedures set out in Standard Condition's 3 and 4 of the PGT licence and its Gas Act duties.

Transco has signalled that it intends to roll over the prices of the existing contract for the revised contract, but has raised the standard performance level for monthly reads from 90% to 92%. The revised contract has been in operation since 1 February 1999.

Appendix 4 Ofgas' Report on Transco's Procurement of Non-Daily Meter Reading Services

A4.1 Introduction

Transco purchases most of its manual non-daily meter reads from MRAs who are independent of BG plc. Occasionally it uses its own staff to obtain one-off manual reads, such as special reads. Until October 1996, Transco purchased its manual meter reads from AccuRead¹⁴ in all its Meter Reading Zones¹⁵ (MRZs), under the competitive area agreement. In October 1996, following a tender process, Northern Metering Services Limited¹⁶ (NMSL) were awarded a contract to manually read meters in Transco's Northern MRZ, and AccuRead were awarded a new contract for the North Eastern MRZ. As these agreements were made before the current price control and the economic purchasing requirement came into effect (1 April 1997), Ofgas cannot consider the appropriateness of these purchases by Transco in relation to the licence requirements. If Transco had solicited and received any offers to provide meter reading services in these two zones, since the price control came into effect then Ofgas could have reviewed Transco's reaction to such offers.

In March 1997 Transco issued an invitation to tender (ITT) for manual non-daily meter reading services in the remaining 10 MRZs, to the approved tenderers list it had compiled following a pre-qualification exercise carried out before tendering the first 2 MRZs. Following this tender exercise Transco awarded contracts to AccuRead for 6 MRZs, Yorkshire Electricity for 2 MRZs and Energy Communication Services Limited (ECS)¹⁷ for 2 MRZs. Compared to pre-October 1996 when it was responsible for 100% of the manual gas meter reading, after these contract awards, AccuRead was responsible for about 45-50% of Transco's manual gas meter reading. The total value of contracts awarded for the 12 MRZs in 1997/98 was £17.72m.¹⁸

This appendix considers the decisions Transco made in procuring meter reading services in the ten MRZs tendered in 1997 against the requirements of its PGT licence.

¹⁴ AccuRead was created from the old British Gas meter readers and is 51% owned by AccuRead and 49% owned by BGT.

¹⁵ MRZs are very similar in geographical coverage to Transco's LDZs, with only minor postcode adjustments.

¹⁶ NMSL are a wholly owned subsidiary of Northern Electric.

¹⁷ ECS are wholly owned by London Electricity.

¹⁸ The total of £17.72m includes contract monitoring costs incurred by Transco.

We consider Transco's decision as to which services to tender and the appropriateness of the levels of service tendered, the criteria Transco used to evaluate the bids received and the process Transco used to apply the criteria for evaluating the bids.

A4.2 The Meter Reading Services Tendered by Transco

In its Invitation to Tender (ITT), Transco explained the services for which it required bids. These services were the same, with the exception of estimated volumes of reads in each MRZ. Transco stated that its contracts would include all meter reading services at sites consuming more than 73,198 kWh per annum and readings at sites consuming less than 73,198 kWh per annum as domestic competition rolled-out. Transco set out the MRAs main responsibilities for each meter read visit:

- ◆ accurately reading meters and correctors;
- ◆ visual safety and theft of gas checks; and
- ◆ informing Transco of changes in meter reading access details or meter location details.

Transco gave the MRAs the same read windows as in the network code to provide manual reads for each read type. Transco used the submission periods in the network code to return valid reads to shippers. Longer or more flexible read windows may reduce the validity of reads for customer billing. A change was recently made to the six month read window under Transco's IBC II, implemented on 1 February, which had the effect of reducing the length of the read window from 2 months to 1 month.

In addition, Transco set out requirements for MRAs to:

- ◆ have appropriately trained staff;
- ◆ have a customer care code of conduct,
- ◆ be registered with Ofgas; and
- ◆ develop operational and technical processes to interact with Transco, and it set out the information that the contractor would be required to supply to Transco for each meter read.

Transco included a copy of its standard contractual terms in its ITT, but indicated that these would be subject to negotiation with successful MRAs. Transco proposed a 2 year

contract with the option to extend the contract for three month periods up to a further 1 year.

Transco also set out the performance levels it would require from MRAs and the liability payments for failure to reach the performance standards. It believed that these standards and liability payment levels were compatible with the network code's standards and liabilities package, to which Transco is subject. Table A4 below compares Transco's performance requirements and liability payments for MRAs with the network code requirements in May 1997.

Table A4 - A comparison of Transco's ITT standards and liabilities package and the network code package in May 1997

| Read type | Performance requirement (%) | | Liability for mild failure (£) | | Liability for severe failure (£) | | Liability for continuing failure (£) | |
|--|-----------------------------|-----|--------------------------------|-------|----------------------------------|--------|--------------------------------------|--------|
| | NC | ITT | NC | ITT | NC | ITT | NC | ITT |
| Monthly | 90 | 93 | 18.98 | 16.88 | 189.84 | 168.75 | 189.84 | |
| Non-Monthly at sites consuming more than 73,200 kWh per annum | 90 | 93 | 6.33 | 5.63 | 31.64 | 28.12 | | |
| Non-Monthly at sites consuming less than 73,200 kWh per annum Domestic | 70 | 75 | 3.16 | 5.63 | 15.82 | 28.12 | | |
| Opening | 90 | 93 | 47.46 | 42.19 | 118.65 | 105.47 | 118.65 | 105.47 |

There are differences between performance requirements and liability packages of the ITT and the network code. For the purposes of the pass-through, Ofgas believes that the overall performance and liability package should not result in Transco benefiting from these differences. MRAs could potentially include the additional costs of liability payments into their meter reading unit charges, if Transco's liability regime is overly severe. Ofgas will continue to review the efficiency of such incentive or liability packages.

a) *The range of services tendered*

Transco did not tender for all of its non-daily meter reading services. It processes read rejects and returns reads to shippers internally. It also provides the services required to obtain meter reads at sites that have a datalogger.

In its submission to Ofgas, Transco did not explain why it chose not to put these other services out to tender. Subsequently, Transco stated that in March 1997 it did not believe that these additional services were defined clearly enough to develop a tender, eg. processing rejected domestic opening reads. Also, it was concerned that the MRAs likely to be bidding lacked experience in providing these types of services, which may have jeopardised initiatives to improve data quality. Transco believed that its use of agency staff to provide these services enabled it to minimise costs through flexible manpower levels. Ofgas would expect Transco to consider in the future, and to the extent that it is possible, compare the expected costs of outsourcing services covered by the pass-through with the cost of providing these services internally. Ofgas has considered the efficiency of Transco's internal costs in Chapter 5.

It is possible that internally Transco may have been able to obtain manual meter reads at lower cost than the prices obtained under a competitive tender. Ofgas would expect that a tender process that selected the mostly economically advantageous MRAs would produce the best price/service combination available. Also, as Transco did not have any employees skilled in manual meter reading, there may have been significant set up costs to providing these services. Ofgas has considered below whether Transco chose the most economically advantageous MRAs through its tender process.

b) *The requirements of Transco's non-daily meter reading customers*

Transco stated that it developed the services and standards based on those within the network code and ongoing discussions with shippers. Shippers would always like larger numbers of valid meter reads, however, probably not at unlimited extra cost. From discussions with MRAs, Ofgas is aware that the additional costs of obtaining reads to achieve performance levels over those set by Transco for its MRAs are significant. Transco appears to have struck a reasonable balance between performance and cost.

Transco stated that it believed that its discussions with shippers to develop the IBC contract had helped to develop its understanding of its customer's needs. These

discussions took place after the ITT was issued, but before the contracts were awarded to MRAs. Ofgas expects Transco to take account of its meter reading customer's needs when developing future tenders. However, it may not be possible at a reasonable cost to meet all customers needs. Competition in the provision of non-daily meter reading services allows shippers/ suppliers and customers to reveal better their service/ price preferences.

A4.3 Transco's Criteria for Evaluating the Bids Received

In its ITT Transco stated that it would award contracts on the basis of the most economically advantageous offers, taking account of the following criteria (the criteria are not shown in order of importance):

- ◆ costs incurred by Transco, ie. tender prices and contract administration costs;
- ◆ full compliance of the offer with the ITT;
- ◆ the managerial merit of the tenderers;
- ◆ the technical merit of the tenderers;
- ◆ the proposals detailed in the ITT;
- ◆ a credible and sustainable programme for establishing the services;
- ◆ the capability and commitment to support the IT requirements;
- ◆ information submitted as part of the pre-tender qualification exercise;
- ◆ confirmation that the proposed IT systems are year 2000 compliant;
- ◆ ability to demonstrate adequate resources if concurrent contract for Transco were operated;
- ◆ the financial strength of tenderers with, where Transco considers it appropriate, agreement to provide Transco with adequate security on terms acceptable to it, with any costs borne by the tenderer;
- ◆ ability to form a working partnership/ alliance with Transco and the ability to demonstrate that cultural values are in line with those of Transco. For the avoidance of doubt Transco and the tenderer will not form a partnership;
- ◆ presentations from the selected tenderers of their proposals, including responses to questions from Transco; and
- ◆ information obtained by Transco from a visit to the premises of the selected tenderer.

Transco's evaluation criteria included consideration of MRAs' recruitment processes, training programmes, codes of conduct, complaints handling, confidentiality, and meter reading access policies.

The criteria listed appear to be comprehensive. The appropriate balance of service and price considerations when awarding contracts is reviewed below.

A4.4 Transco's Process for Awarding the Contracts

a) The pre-qualification selection

Prior to issuing an ITT for the Northern and North Eastern MRZs Transco carried out a pre-qualification exercise to eliminate unsuitable bidders. A pre-qualification questionnaire was issued to 25 companies who responded to a notice in the European Journal. Transco received 22 responses. Following evaluation by Transco, 13 companies were placed on the approved list of tenderers. Under European Union procurement legislation this pre-qualification exercise remained valid for one year.

Ofgas understands the need to carry out a pre-qualification exercise to eliminate unsuitable bidders at an early stage, thus reducing the costs later in the process. However, although it did not breach European Union procurement legislation, Ofgas is concerned that the pre-qualification exercise used for the Northern and North Eastern MRZs was also used for the remaining 10 MRZs, without the shortlist being reviewed. There was an 11 month gap between the issuing of the pre-qualification questionnaire and the ITT for the 10 MRZs.

During this period MRAs had the opportunity to gain more experience of gas meter reading through carrying out domestic opening meter reads in areas open to domestic competition, which might have allowed them to pass a later pre-qualification exercise. Also, other companies might have been able to enter what was a newly developing market in 1997 who were not ready to do so in 1996.

Nine companies were excluded from Transco's approved tenderers list by the pre-qualification exercise. Subsequently, some of the companies excluded joined with those who passed and therefore received the ITT. Notification of their impending joint venture was given to Transco at the pre-qualification stage.

No complaints have been received from companies excluded by the pre-qualification exercise or from companies unable to participate in that exercise. There is also no evidence that the exclusion of the companies named materially affected the ability of Transco to select the most economically advantageous MRAs. However, although the timing of the exercise was not in breach of European Union procurement legislation. In any future exercise, Ofgas considers that Transco should recognise the rate of change in a market before deciding the period of time for which a pre-qualification exercise should remain valid.

b) *Material to be provided in response to the ITT*

Following the issuing of the ITT a pre-tender meeting was held by Transco and a series of amendment/ clarification notices were issued.

Transco required tenderers to submit proposed prices for each read type by MRZ and for different read volumes. Tenderers were also asked to state the level of any discount for providing services in more than one MRZ. Tenderers were also required to set out proposals to ensure the selection of appropriately qualified staff, a complaints handling procedure, good management processes, and reliable IT systems compatible with Transco's.

In fixing the means by which services are provided, Transco may have deterred MRAs from offering more innovative packages, such as providing all reads of a particular type across the whole country, or disaggregating or combining MRZs. Such flexibility may have increased Transco's internal systems and contract monitoring costs. It may also have increased customer confusion if different companies read their gas meter for different purposes. Also, comparing a range of options may increase Transco's bid evaluation costs. The two shippers that have chosen to purchase meter reading services other than via Transco are using the same MRA for all read types within any geographical area.

c) *The position of companies issued with the ITT*

13 companies were issued with an ITT, of which 8 responded. 5 companies declined the invitation. The outcome of the tender process may have been affected by the different positions of the MRAs in the utility meter reading market.

When the ITT was issued AccuRead already had BGT's contract to read all of its sites consuming less than 73,200 kWh per annum. Therefore, in any MRZs that it was awarded Transco's contract it would be able to move resources between the BGT and Transco contracts as domestic customers switched away from BGT and to shippers who used Transco for meter reading. This prospective advantage may have been increased because BGT and Transco's meter reading walk orders are inherited from the old British Gas walk orders, which AccuRead had gained experience of when it had the competitive area agreement. Transco has recently given its MRAs the opportunity to revise target read dates to remove peaks. This change falls outside the 1997/98 formula year. AccuRead's unique ability to cope with the uncertainty attending Transco's future required levels of reads may have discouraged competition.

Also, 7 Regional Electricity Companies meter reading subsidiaries received the tender. Within their REC area they may have been able to adjust electricity meter reading cycles to improve flexibility for gas meter reading. Of the other five companies that received the ITT, only one had contracts to provide opening meter reading services at sites consuming less than 73,200 kWh per annum.

Some of the MRAs that received the ITT requested further information from Transco that was not available. This included:

- ◆ the number of sites with more than one meter;
- ◆ the number of read requests leading to access being denied to read the meter; and
- ◆ the walk order for each Meter Reading Zone.

The information may have been available to AccuRead as the incumbent meter reader, and NMSL from its experience in the Northern MRZ. These MRAs, and in particular AccuRead, may have been able to reduce the risk premium attached to their bids due to better information.

Ofgas understands that this information was unavailable because AccuRead's previous contract for the 12 MRZs did not include clauses requiring AccuRead to provide Transco with such information. A clause has been inserted in the new contracts requiring MRAs to provide this information for any future tender process.

Four of the five companies that did not return the invitation to tender gave reasons for withdrawing at this stage of the process. These included:

- ◆ the risk of TUPE claims;
- ◆ a two year contract being too short to obtain a return on investment in hand held terminals;
- ◆ the financial implications of liability payments;
- ◆ an interest in 'dual fuel' meter reading; and
- ◆ focusing on electricity supply competition.

Ofgas has also contacted some of the MRAs eliminated and it is not clear that any particular aspect of Transco's ITT or other behaviour contributed to the withdrawal of the five companies. The companies who withdrew appear to have done so for other commercial reasons.

Table A5 shows the MRZs tendered for by the MRAs who replied to the ITT.

Table A5 - MRZs tendered for by each company

| Tenderer | Scotland | North West | Wales | West Midlands | East Midlands | East | South East | North Thames | South | South West |
|--------------|----------|------------|-------|---------------|---------------|------|------------|--------------|-------|------------|
| AccuRead | X | X | X | X | X | X | X | X | X | X |
| NMSL | X | X | | X | X | X | | | | |
| YE | | X | | | X | | | | | |
| Schlumberger | X | X | | X | | | | | | |
| Seeboard | X | X | X | X | X | X | X | X | X | X |
| UKDCS | X | X | X | X | X | X | X | X | X | X |
| ECS | | | | X | X | X | X | X | X | X |
| Lowri-Beck | X | X | X | X | | | X | | X | X |

At least 4 MRAs had bid for each of the MRZs.

d) Transco's evaluation of the responses to the ITT

Transco applied the selection criteria set out in section 4.3 through four main processes:

- ◆ a financial and technical (including operational/management and IT) evaluation;
- ◆ a presentation from the tenderer;
- ◆ a site visit to the tenderer; and
- ◆ negotiations.

i) *The Commercial and Technical Evaluation of the Bidders*

Transco's first commercial evaluation considered bid prices against read volumes existing at May 1997, under three scenarios:

- ◆ a Base Case where market share falls to 20% of existing read volumes in the fourth quarter of the two-year contractual period;
- ◆ a High Case where volumes fall to 70%; and
- ◆ a Low Case where volumes fall to 10%.

At the time of developing these read volume scenarios there was some uncertainty as to the number of domestic customers who would switch away from BGT to new domestic gas suppliers, and the extent and timing of shipper 'unbundling' of non-daily meter reading.

Following this initial commercial evaluation, Transco revised the expected volume information to take account of better information about the likely effect of phase III of domestic gas supply competition. The effect of the review of DCIII volumes was to increase the overall value of the contracts (ie. a higher volumes of reads).

Following these evaluations Transco eliminated 2 companies. The poor financial value of both of these bids was not compensated by the technical evaluation. This decision appears to have been reasonable based on the information available to Transco.

Transco did not consider the technical ability of tenderers to provide services in specific MRZs rather than an overall technical evaluation. RECs may have been able to provide a better service for MRZs covering their own electricity meter reading area. However, as explained below there is no clear evidence that this affected Transco's ability to choose the most economically advantageous MRA for each MRZ.

ii) Tenderers presentations

The remaining six tenderers were invited to give presentations of their tenders during the week commencing 26 May 1997.

iii) Site visits

Transco also made site visits to the six remaining tenderers. The site visits focused on the IT and security of the tenderers premises, and ensuring that the presentations were a fair reflection of the level of service that Transco could expect. Following the presentations and site visits, Transco eliminated 2 more companies.

Transco was concerned that one company did not yet have the operational or technical capability to satisfy the contractual obligations. It also considered the company's proposed manpower levels to be very low and its prices in some MRZs to be unrealistically low. The company has suffered subsequent operational problems.

Transco had a number of concerns about the other company eliminated:

- ◆ the lack of disaster recovery systems;
- ◆ the lack of security at the site; and
- ◆ the lack of a clear relationship between the company and one of its sub- contractors.

The company's exclusion does not appear to have had a material effect on Transco's ability to choose the most economically advantageous MRAs.

iv) Negotiation

Following the 2 companies' elimination, AccuRead, Yorkshire Electricity, ECS and NMSL were invited to the negotiation stage.

Transco's decision as to which MRA to award the contract to in 7 MRZs was justified by both the expected service level and bid prices. However, for three LDZs, Transco's decision required a balance between the bid prices and the expected service level. It is not clear that any of the decisions Transco made were unreasonable and the initial relative poor performance of one of its chosen MRAs may justify Transco's decision not to have awarded it more contracts.

Transco had a financial incentive to use the negotiation stage to ensure a particular balance of MRA charges, eg. by increasing the level of charges covered by the pass-through, and reducing the level of charges covered by its 'RPI-X' price control. Also, as Transco is required by Standard Condition 4 of its PGT licence to levy charges on shippers which reflect the costs it incurs, it may have an incentive to reduce MRA charges for read types for which it believes competition will develop more slowly than other read types. On this occasion there is no evidence that the negotiation stage was used to rebalance MRA charges in this way.

e) *The outcome*

The MRA charges in the contracts for the 10 MRZs are for most read types and MRAs, lower than the charges in the contracts for the first two MRZs. This may be because of increasing competition in the meter reading market and the experience Transco obtained from the first tender exercise. There is some variation between the charges agreed with the three MRAs who were awarded contracts for the 10 LDZs. This may be partly due to different characteristics in the zones.

Ofgas has also compared Transco's negotiated rates with those obtained by BGT from AccuRead for its domestic gas supply points. AccuRead is only providing BGT with reads at sites consuming less than 73,200 kWh per annum. Rates levied by AccuRead, for these types of reads, differ between BGT and Transco. Ofgas expects that both contracts meet the requirements of the network code, but there may be different additional services covered by the contracts. BGT has a greater number and regional density of customers than Transco. MRAs have stated that density is a very important factor in determining cost. Ofgas is satisfied that Transco selected the most appropriate MRAs following its tender process.

A4.5 Overall Procurement Timetable

There was a period of 11 months in progressing the procurement in the 10 zones because an ITT was not issued directly on completion of the earlier procurement for the Northern and North Eastern zones. This period may have increased potential MRA costs in formula year 1997/98. Transco has stated that this period was used to prepare for the second tender process. The lower rates obtained for the 10 MRZs tendered after the first 2 suggests that Transco did use the time to learn lessons which allowed it to

obtain better value for money in the second tender process. In these respects Transco's conduct appears reasonable.

A4.6 Impediments to Effective Competition in Gas Meter Reading

Transco has included within its contracts with MRAs, a provision that where the workload volume for an individual read type falls due to the MRA providing a meter reading service to a shipper or supplier, and that shipper or supplier no longer requiring Transco to provide a meter reading service, the MRA charge that is applicable is the MRA charge that would have applied if the shipper or supplier had not 'unbundled' its meter reading requirements to that particular MRA. Broadly, MRAs are paid a lower price per read for higher volumes of read requests issued by Transco. This provision would prevent the MRA charging Transco a higher per read charge to reflect the lower volume of read requests issued.

This arrangement may deter MRAs from offering their services directly to shippers. If the loss of revenue resulting from the MRA's inability to increase its charges to reflect Transco's lower read request volumes outweighs the additional revenue that the MRA could receive by providing the 'unbundled' shipper or supplier with a meter reading service, then the MRA may be unwilling to take on the 'unbundled' shipper's portfolio. In the case of Public Electricity Suppliers (PESs) that provide their electricity meter readings internally, this arrangement may deter the PES from developing and using its own meter reading services for gas.

This provision acts to reduce Transco's non-daily meter reading costs. However, Ofgas is concerned that this provision may adversely affect competition in gas meter reading and we will be investigating its effect.

A4.7 Subsequent Offers Received by Transco

Transco has stated that it has received one offer to provide meter reading services in one MRZ since it signed its contracts with MRAs. According to Transco no price was discussed for the services. Ofgas would expect Transco to consider offers received in comparison to its current contracts (including the efficient costs of termination), but also bearing in mind a need to be seen to honour contracts.

A4.8 Summary

There have been no complaints from any MRAs not awarded contracts or not awarded as many MRZs as they would have liked, and there is no clear evidence that Transco's decisions were unreasonable with respect to this tender process. Ofgas expects Transco to have regard to the issues discussed in this chapter for subsequent tender processes. In particular, with regard to pre-qualification exercises, understanding meter reading customers needs and flexibility in the way ITT's are structured.

Therefore, Ofgas considers that no deduction should be made from the submission of £17.72m in respect of the total value of contracts with MRAs. However, as explained in chapter 3, Transco has agreed to deduct £1.11m due to an overaccrual of MRA charges in 1997/98.