

Transco Price Control 2002-2007

Final proposals

Ofgem's final proposals for Transco's price control 2002-7 deliver:

- Protection for customers on price, quality of service, and security of supply – reflecting Ofgem's primary concerns and duties
- A reduction in Transco's revenues of 4% in the first year and 2% thereafter. This means £5 a year off domestic customers' bills
- New quality of service targets and output measures
 - For domestic customers this means guaranteed and overall standards of service, for example in relation to the number and duration of interruptions to supply
 - For shippers and producers, new incentives for Transco to invest in the National Transmission System to meet future demand
- Sufficient funding to ensure that Transco, operating efficiently, can replace the mains pipeline network according to the Health and Safety Executive's new requirements
- A fair allocation of the significant costs of the mains replacement programme between current and future customers of Transco
- A cost of capital commensurate with the risks of Transco's business
- A significant development in RPI-X price regulation which creates a stable and forward looking regulatory environment for Transco, with new incentives for investment and guaranteed outputs for customers.

Ofgem's final proposals are firm but fair. They create a forward looking and stable regulatory environment for Transco to deliver a safe and secure gas supply to customers at a fair price.

	Ofgem's draft proposals in June 2001	Ofgem's final proposals September 2001	Transco's business plan
Regulatory value	Unfocused	Unfocused	Unfocused
Cost of capital	6.0-6.25%	6.25%	at least 7.0%
Controllable operating expenditure (five year total)	£4.3 billion	£4.6 billion	£5.9 billion
Forecast annual reduction in operating expenditure	(3.5%) (1999/2000 – 2006/2007)	(2.5%) (1999/2000 – 2006/2007)	+1.2% (1999/2000 – 2006/2007)
Forecast capital expenditure (five year total)	£1.9 billion	£2.3 billion	£3.0 billion
Forecast replacement expenditure (five year total)	£1.7 billion	£2.1 billion	£2.4 billion
Reduction in Transco's cost	PO cut 14% X 2%	4% 2%	– –

Financial issues

- In June Ofgem decided that the 'unfocused' method should be retained as the approach to setting the regulatory value of Transco assets.
- This closed debate on this issue once and for all and removed uncertainty and risk for Transco.
- Cost of capital represents the interest payable on debt finance and the return to shareholders.
- Ofgem's final proposals set a real cost of capital of 6.25% which is at the upper end of the range and is commensurate with the risks which Transco faces.

Operating expenditure

- This is the revenue allowed for day-to-day costs of running Transco's business such as staff costs, IT and insurance.
- Transco's track record shows that it has reduced operating costs by around 4% per year over the life of the current price control. Ofgem's final proposals set a reduction in operating costs of 2.5% which is less than that for electricity distribution companies and within the competence of Transco to achieve.

Capital expenditure

- This is principally the investment in the capacity of the pipeline and network systems allowed as part of the regulatory asset base.
- Ofgem is proposing a new regime to improve investment in the NTS.
- The capital expenditure allowance sets a baseline. The new incentives regime delivers rewards for Transco if it responds well to market signals by allowing it to keep revenues over and above this base.

Replacement expenditure

- This is the revenue allowed for Transco's mains replacement programme.
- New HSE requirements (18 September 2001) call for a level of expenditure significantly above £1.3 billion in the current period.
- Ofgem's allowance of £2.1 billion ensures that Transco, operating efficiently, can meet the HSE requirements.
- Ofgem's final proposals divide this cost 50:50 between capital and operating expenditure. This ensures that the costs of this programme do not fall wholly (and unfairly) on today's customers but are shared with future customers who also stand to benefit from the new investment which the HSE's proposals require.

Gas bills

- Ofgem's proposals mean £5 off the average domestic gas customers bill.

Between 1994 and 2000 Transco's transportation charges, which make up around 35-40% of the domestic customers' bills have fallen by 16.2%.

Form and scope of the control

- RPI – X formula will be retained
- The final proposals create separate price controls to recognise and incentivise Transco's different businesses and roles
- Separate price controls will be set for Transco for the National Transmission System (NTS), where there will be Transmission Owner (TO) and System Operator (SO) controls, and for Local Distribution Zone (LDZ) businesses
- Separate controls are set for metering and meter reading businesses
- There will be one price control for the 12 LDZs

The new arrangements represent an important development of the RPI – X form of price control. They provide guaranteed outputs and ensure better signals and rewards for more efficient investment.

Health and safety requirements

The Health and Safety Executive (HSE) sets the standards which need to be met to ensure a safe gas network. Ofgem's job is to ensure that Transco, operating efficiently, has the funds to maintain and replace the gas network to meet the HSE's requirements.

The HSE has recently announced an accelerated mains replacement programme. Key points of the programme include:

- Transco to replace 91,000 km of iron mains within 30 years, with Transco increasing their replacement rate to reach 3,500 km/year over the next five years
- This will replace all iron mains within 30 metres of buildings
- The recommendations follow a in-depth HSE review of Transco's replacement programme.
- The financial implications of these new requirements have been accounted for in Ofgem's final proposals.

Transco system operator incentives proposals

Transco's role as system operator (SO) means that it is responsible for managing the day-to-day operation of the gas transportation network. A new incentives regime for Transco as system operator has been proposed. This will work alongside the price controls.

New arrangements for Transco

Metering and meter reading

Local Distribution Zones (LDZs)

NTS Transmission Owner (TO)

New Price Control

Final Proposals end September 2001
Transco decision end October 2001

NTS System Operator (SO)

SO incentive arrangements

Initial Proposals published September 2001
Final Proposals end December 2001

Problems with existing SO arrangements

Customers and industry have concerns about the costs they have incurred as a result of network constraints. They have called for improved incentives on Transco to invest in the NTS so that the changing needs of the market are met.

Ofgem's proposals

Long Term investment incentives

As system operator, Transco will sell entry capacity to NTS customers and buy back when capacity is physically unavailable.

Under the new arrangements, Transco will auction long term capacity rights, which can be traded. Emerging market signals from capacity trading will help Transco plan its future investment more effectively.

Day to day operating incentives

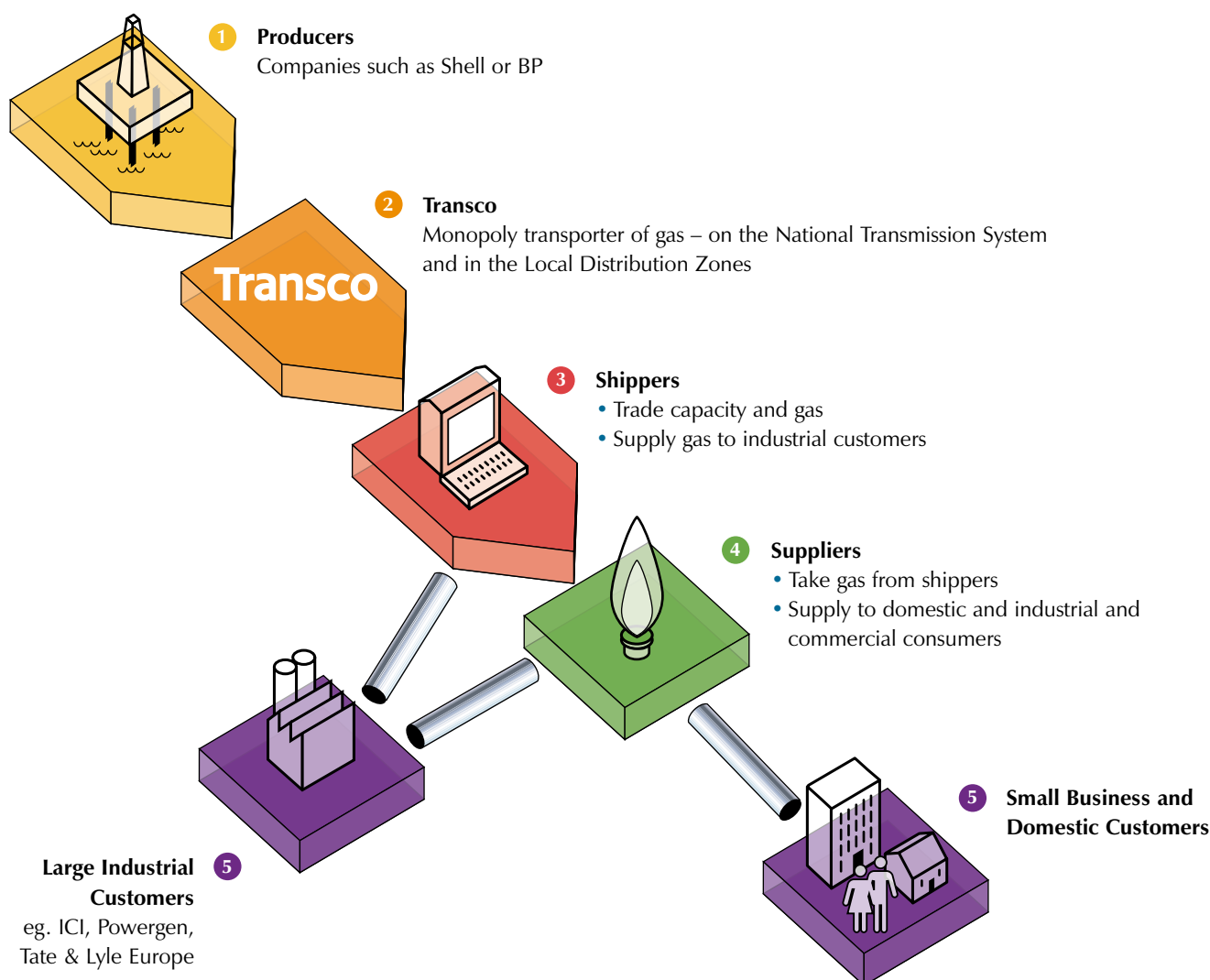
The new arrangements mean that Transco will operate under a series of incentive schemes covering:

- the cost of running the NTS i.e staff

- the costs of dealing with constraints at both system entry and exit, and
- the costs associated with balancing the system day to day.

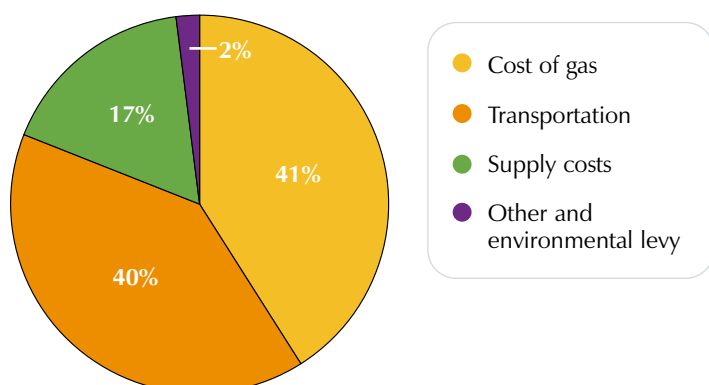
Transco will be set a target in each scheme. If it exceeds that target, it will keep a share of the difference. If it does not meet that target, it will have to pay a proportion of the shortfall. Under Ofgem's proposals, Transco could earn an extra £38 million a year if it exceeds all its incentive targets.

In Summary, Ofgem's proposals will deliver enhanced security of supply, lower system operator costs which are passed through to customers and, potentially, improved competition.



How are gas bills made up?

- The cost of transportation makes up 35-40% of the domestic bill
- Between 1994 and 2000, Transco's transportation charges fell by 16%
- This represents a saving of £480 million per year for customers
- The new proposals cut transportation charges by a further 4%



Gas Prices in Britain

- The annual bill for a BGT customer with medium usage, paying by Standard Credit, is around £331
- Despite higher gas prices in recent months, prices in Great Britain are still among the lowest in Europe
- 6.3 million gas customers have switched supplier
- Customers who switch can save up to £60 per year on their gas bill
- For more information on switching supplier ring the energywatch helpline on 0800 887777

For more information on Ofgem's final proposals for Transco's price control 2002-7 you can contact:

Graham Jones graham.jones@ofgem.gov.uk
020 7901 7468