Your Ref:
Our Ref: RFA/IGT/INTRIM/1
Direct Dial: 020 7901 7089
Email: frances.warburton@ofgem.gov.uk

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Definition of reasonable profit for Condition 4 transportation charges

As you will know I wrote to all IGTs on 22 April 2002 giving initial guidance as to the interpretation of GT standard licence condition (SLC) 4. A number of further complaints and a request for a substantive change in charging methodology by an IGT suggests that it is timely to issue further guidance. This letter deals with two main issues, the interpretation of reasonable profit in SLC 4A and the provision of annual reports to the Authority pursuant to SLC 4A(3).

As you will also know Ofgem published a consultation paper on "Independent Gas Transporter charges and the cost of capital" in February 2002. Views were invited on the overall approach to establishing the cost of capital and on the proposed range for the cost of capital for IGTs charging under SLC 4. A summary of the responses to this paper was published in the "Regulation of Independent Gas Transporter charging" consultation paper published in May 2002. We will consider the responses to the paper on the cost of capital alongside the responses to the regulation of IGT charging paper in formulating draft proposals.

However, notwithstanding measures taken by Ofgem over the last few months, a number of complaints have been made to Ofgem about the current situation governing IGT charging. Ofgem established interim arrangements for acceptance of SLC 4C charging methodologies that came into effect on 7th December 2001. Following the introduction of these interim arrangements it has been suggested that in the absence of clear guidance on the enforcement of SLC 4 and 4A certain IGTs may be seeking to make excessive charges via these conditions.

Given the importance of these matters it might be helpful if I set out Ofgem's initial views on the interpretation of SLC 4 and 4A with respect to the relevant methodology objectives contained therein. SLC 4A (5) defines these objectives as:

> *'(a) that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;*

(b) *that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business; and*

(c) *that, so far as is so consistent, compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers.'*

SLC 4A (6) states that:

'"the relevant methodology objectives" shall include the following objective, namely, that the charging methodology results in charges which, taking one charge with another and one year with another, permit the licensee to make a reasonable profit, and no more, from its transportation business…'.

For the purposes of judging compliance with existing SLC 4 and 4A it is appropriate to consider how to define 'reasonable profit'. This question was addressed in the February 2002 consultation on the cost of capital and while the responses to this consultation will inform the wider review of IGT charging it is also appropriate that they inform a view on compliance with existing SLCs.

Respondents to the February 2002 paper expressed a number of concerns in respect of the discussion of reasonable profits and cost of capital. These included views that insufficient weight had been given to the market structure for transportation services and the costs of debt finance to IGTs.

Careful consideration has been given to these and the other points made by respondents and Ofgem has carried out further analysis of the cost of capital. The May 2002 consultation document concluded that transportation services constitute a monopoly activity and it remains appropriate to assess rates of return on this basis. As for the arguments made in relation to the calculation of the cost of capital, further consideration has been given to the range for the debt premium and rates of gearing used in the calculations in the February 2002 paper. The evidence that is available suggests that these were relatively generous and should allow IGTs to finance the obligations imposed on them by the Gas Act. Further, none of the responses to the February paper provided convincing evidence that the proposed range for the cost of capital would be inappropriate.

The February 2002 paper suggested that until a judgement is reached on whether it is reasonable to require IGTs to accept financial ring fencing provisions it would not necessarily be appropriate to allow a small company premium.

In the light of all these factors, **returns above the range for the cost of capital (excluding the small company premium) set out in the February paper 2002 would appear to be a breach of SLC4A for IGTs charging under SLC4**. As you may know the top of this range was a real pre-tax cost of capital of 7.7 per cent and the present intention is that this would form the basis for Ofgem's assessment of reasonable profits. This is broadly consistent with the rates of return implicit in the charging methodologies of a number of IGTs. Any modifications to SLC 4 charging methodologies, including changes to rates of return and reasonable profit, would still need to follow the formal consultation process set out in SLC 4A.

The following section discusses how costs and revenues should be assessed to determine a level of return consistent with the cost of capital and hence whether an IGT would be complying with the reasonable profits obligation in its licence.

It is our current intention that the above definition of reasonable profit would come into effect on 1 April 2003.

If as a consequence of this determination the resulting level of profits for an IGT were deemed to be unreasonably high then the IGT concerned would have breached SLC 4A. In these circumstances Ofgem would need to consider what sort of enforcement action to take and the IGT might be subject to financial penalties persuant to powers deriving from the Utilities Act.

Calculation of cost of capital

It is our present intention to utilise the following standards for determining whether an IGT has complied with the reasonable profit requirement for SLC 4 charges discussed above. These specific provisions for the calculation of reasonable profit will from time to time be subject to review and revision.

1. Where capital expenditure is recovered through SLC 4 charges, two tests would both need to be satisfied to determine whether an IGT complied with the reasonable profit requirement: an Net Present Value (NPV) test and a test of average return in the last three years. These two tests are summarised below and an illustrative example of the calculation of the two tests provided in Appendix 1.

2. Where no capital expenditure is recovered through SLC 4 charges, only the NPV test would need to be satisfied.

3. The NPV test would be based on each IGT's portfolio of projects that are charged for under SLC4 and on out-turn costs and revenues in the preceding two financial years and the current financial year, plus forecast costs and revenues for the following 20 years. Using a discount equal to the maximum nominal cost of capital, the NPV test would require that the NPV of turnover less operating costs (excluding depreciation) less capital expenditure plus the terminal asset value would not be positive.

4. The average return test would require that the average Return on Capital Employed (ROCE) in the preceding two financial years plus the current financial year would not exceed the maximum nominal cost of capital. The average ROCE is calculated as the sum of the last three years regulatory operating profit divided by the sum of the last three years average regulatory net asset value.

5. Out-turn costs and revenues should be used where available. SLC 4A (6) states that '…for the purposes of this paragraph, "costs" and "revenue" mean costs and revenue determined on an accrual basis.' The basis for future projections of costs and revenues should be clearly set out.

6. Where IGTs undertake multi-utility connections work (or operate multi-utility networks), the costs recovered through SLC 4 charges should only include a reasonable and cost-reflective share of the total costs of the project.

7. Where IGTs also utilise SLC 4B charges to recover some of their costs, then the SLC 4B costs and revenues should be excluded from the determination of reasonable profit under SLC 4A. These excluded SLC 4B costs should include a reasonable and cost-reflective share of the IGT's overhead and administrative costs.

8. Where IGTs also utilise SLC 4C charges to recover some of their costs, then the SLC 4C costs and revenues should be excluded from the determination of reasonable profit under SLC 4A. These excluded SLC 4C costs should include a reasonable and cost-reflective share of the IGT's overhead and administrative costs.

9. Where IGTs also utilise other charging methodologies in addition to SLC 4 methodologies, then the costs recovered through SLC 4 charges should only include a reasonable and cost-reflective share of the total overhead and administrative costs of the IGT's business.

10. The calculation of costs and profits must exclude any excessive payments to developers (including both direct and indirect payments) that do not reflect the market value of goods and services provided by the developer to the GT.

11. Treatment of asset values and terminal values of assets at the end of the time period would require the indexation of gross asset values by the RPI and the application of straight-line depreciation over the accounting lives.

12. IGTs would be expected to continue to comply with the requirement "to develop and maintain an efficient and economical pipeline system for the conveyance of gas', as set out in Section 9(1)(a) of the Gas Act.

<u>Provision of annual reports by IGTs</u>

In addition, SLC 4A requires all GTs that charge under SLC 4 to provide Ofgem with an annual report setting out the extent to which the GT has complied with the relevant methodology objectives. SLC 4A (3) states that:

'...the licensee shall in each calendar year furnish the Authority with a report on the application of the charging methodology during the 12 months preceding 1st October in that year including a statement as to –

(a) the extent to which, in the licensee's opinion, the relevant methodology objectives have been achieved during the period to which it relates;

(b) whether those objectives could more closely be achieved by modification of the charging methodology; and

(c) if so, the modifications which should be made for that purpose.'

Hence, all IGTs that charge under SLC 4 shall provide Ofgem with a report no later than 31 December 2003 that includes a detailed and transparent assessment of the extent to which the IGT has complied with the requirement to achieve the reasonable profit level set out above and

any modifications which should be made for that purpose. This will assist in determining compliance with existing obligations under SLC 4.

For the avoidance of doubt, this letter does not prejudice the outcome of the wider review of IGT charging. The ongoing review of IGT charging may consider other approaches to the determination of 'reasonable profit' in addition to the approach set out above.

If you have any comments on any aspect of the issues raised in this letter, I would be grateful for a response by the **27 January 2003**. If you require any clarification of these matters please telephone me on 020-7901-7089.

Yours sincerely

Frances Warburton
Head of Gas Distribution Regulation

Appendix 1: Illustrative example of calculation of reasonable profit - Version 2
Revenue and costs from SLC 4 charges (£ 000s money of the day) - see notes below.

	NPV	T-2	T-1	T0	T1	T2	T3	Etc
Turnover		20.0	40.0	60.0				
Opex (excluding depreciation)		-16.0	-22.0	-30.0				
Regulatory depreciation		0.0	-5.0	-10.0				
Regulatory operating profits		4.0	13.0	20.0				
Capital expenditure		-100.0	-100.0	-100.0				
Opening gross asset value		0.0	100.0	200.0				
Closing gross asset value		100.0	200.0	300.0				
Regulatory depreciation		0.0	-5.0	-10.0				
Opening Regulatory net asset value		0.0	100.0	195.0				
Closing Regulatory net asset value		100.0	195.0	285.0				
Average Regulatory net asset value		50.0	147.5	240.0				
ROCE*		8.00%	8.81%	8.33%				
Average ROCE**	8.46%							
Terminal asset value***	100							
Total NPV	0							
Inflation	1.025							

Notes:
* Return on Capital Employed (ROCE) equals Regulatory operating profits divided by Average Regulatory net asset value
**Average ROCE equals the sum of the last three years Regulatory operating profit divided by the sum of the last three years Average Regulatory net asset value
***Terminal Asset Value (TAV) equals regulatory net asset value value in T20
Assuming inflation of 2.5% then the maximum nominal cost of capital equals (1.025)*(1.077)=10.4
The calculation of Gross asset values would need to account for retirement of assets after 20 years
See the attached letter of 29 November 2002 for definition of costs and revenues to be included in this calculation

Test One:
Using a discount rate equal to the maximum nominal cost of capital, NPV of turnover less operating costs (excluding depreciation) less capital expenditure plus the Terminal Asset Value should not be positive. Costs and revenues would inlcude the preceding two financial years, the current financial year and forecast costs and revenues for the following 20 years.

Test Two:
The average ROCE in the last three years should not exceed the maximum nominal cost of capital