

**Separation of Transco's distribution price control
Draft Proposals**

Annex 2: Capital Expenditure

December 2002

Separation of Transco's distribution price control: capital expenditure

This paper explains how the regional network capital expenditure figures presented in chapter 4 of Draft Proposals document have been derived

September 2001 price control proposals

Ofgem's September 2001 price control proposals¹ included projections of gross capital (before taking account of customer contributions) expenditure for Transco's Local Distribution Zones (LDZ's) in aggregate as shown in table 1 below.

Table 1 Gross Capital Expenditure for the aggregated LDZs (2000 prices, £ millions)

Ofgem projections	2002/3	2003/4	2004/5	2005/6	2006/7	Total
Gross capital expenditure	315	215	168	146	151	996

Following publication of the September 2001 final proposals paper, Ofgem made some minor adjustments to the forecast LDZ capital expenditure. Table 2 shows the revised gross capital expenditure. The licence modifications that implemented Transco's 2002 to 2007 price control were based on total net LDZ capital expenditure as shown in the bottom line of table 2.

Table 2 Adjusted projections of capital expenditure for the aggregated LDZs (2000 prices, £ millions)

Ofgem projections	2002/3	2003/4	2004/5	2005/6	2006/7	Total
Gross capital expenditure	310	212	167	146	153	988
Less contributions	(77)	(68)	(61)	(51)	(47)	(304)
Net capital expenditure	233	144	106	94	106	684

Transco's allocation of the combined LDZ's capital expenditure to the eight regional networks

In its response to Ofgem's business plan questionnaire (BPQ) Transco provided details of historical capital expenditure for the period 1997 to 2002 and forecasts of future capital expenditure for the period 2002 to 2007 for each of its LDZs. During the 2001 price control review, Ofgem's consultants, Mazars, conducted an efficiency study which included Transco's capital expenditure requirements. Ofgem's projections of capital expenditure in the September 2001 price control proposals were based on Transco's BPQ submission and informed by the conclusions of Mazars' efficiency study.

In order to allocate expenditure between the eight Networks, Transco started with the forecasts for each of the LDZ's that it submitted to Ofgem in response to the BPQ. Transco's then deducted savings identified in Mazars' report and further adjustments provided to Transco by Ofgem for each category of expenditure. The savings were driven across the categories as follows:

¹ Review of Transco's Price Control from 2002 - Final Proposals. September 2001

Savings Category	Driver
LTS	Project by project according to Mazars' report
New Housing	In proportion to the BPQ new housing gross capex forecast
EFV and EPC	In proportion to the BPQ total distribution mains gross capex forecast
Other Distribution Capital	In proportion to the BPQ governors and P&M gross capex forecast
Services	In proportion to the BPQ services gross capex forecast
Connections	In proportion to the BPQ total distribution mains and services gross capex forecast
New Techniques	In proportion to the BPQ total distribution mains and services gross capex forecast
Other	In proportion to the BPQ total distribution mains and services gross capex forecast

Where a regional network comprises more than on one LDZ the capital expenditure of the relevant LDZs were combined as shown below

LDZ(s)	Regional Network
Scotland	Scotland
North and Yorkshire	North England
North West	North West
East Midlands and East Anglia	East England
West Midlands	West Midlands
Wales and South West	Wales & West
South and South East	South England
North London	London

The resultant capital expenditure allowances for each regional network is shown in Table 3 below

Table 3 Regional network net capital expenditure 2002/03-2006/07 (2000 prices, £ millions)

Network	2002/3	2003/4	2004/5	2005/6	2006/7	Total
Scotland	30	25	13	11	9	87
North England	39	21	18	14	20	111
North West	15	9	7	9	7	47
East England	34	20	16	18	15	102
West Midlands	33	11	5	7	12	67
Wales/West	41	24	13	13	16	109
South England	26	25	28	16	20	116
London	16	9	7	6	7	44
Total net capex	233	144	106	94	106	684

Adjustment of boundary between London and East England

The operational boundary between the London and the East of England regional networks is different to the boundary defined in Transco's Network Code. If LDZ allowed revenue was allocated between regional networks on this basis, there would be a misalignment between costs and revenues. To correct this anomaly, Transco has proposed modifying the operational boundary to align it with the Network Code boundary. The region affected was a part of the North London LDZ known as the Outer Metropolitan Area. The forecast capital costs associated with this area are shown in table 4. It is proposed that these costs be reallocated from the London network to the East of England network.

Table 4 Capital costs reallocated from the Outer Metropolitan area (2000 prices £ millions)

	2002/3	2003/4	2004/5	2005/6	2006/7	Total
Outer Met Adjustment	0.8	0.7	0.5	0.5	0.5	3.0

The revised regional network capital expenditure allowances are shown in table 5.

Table 5 regional network capital expenditure including Outer Metropolitan Adjustment (2000 prices, £ millions)

Network	2002/3	2003/4	2004/5	2005/6	2006/7	Total
Scotland	30	25	13	11	9	87
North England	39	21	18	14	20	111
North West	15	9	7	9	7	47
East England	34	21	16	18	16	105
West Midlands	33	11	5	7	12	67
Wales/West	41	24	13	13	16	109
South England	26	25	28	16	20	116
London	15	8	6	6	6	41
Total net capex	233	144	106	94	106	684

Future work

Before publishing the final proposals paper in May 2003, Ofgem intends review the capital expenditure allocated to each of the regional networks. This review will investigate the current levels of forecast capital expenditure required in each regional network and compare these to the levels of capital expenditure proposed above to ensure that each regional network has an appropriate capital expenditure allowance.