

# **The Regulation of Independent Gas Transporter Charging**

## **Final Proposals**

July 2003

## Summary

This paper sets out final proposals for the regulation of Independent Gas Transporter (IGT) charging arrangements. Although IGTs currently account for a relatively small proportion of the gas distribution sector, they are growing businesses that are responsible for most new extensions to the gas network. This document follows an extensive period of consultation throughout the industry and builds upon ideas set out in the Draft Proposals issued in December 2002<sup>1</sup>.

Existing arrangements that control IGT charges have been ineffective. There is considerable variation in the level of IGT charges with some IGTs having charges at about the same level as Transco while others charge significantly more than Transco. The Draft Proposals included an analysis of the costs that IGTs face in providing transportation services to new housing developments. This indicated that IGTs do not need to make transportation charges in excess of Transco-equivalent charges.

The proposals for Relative Price Control (RPC) require that in future IGT transportation charges to new developments should be capped at a level broadly consistent with the Transco-equivalent charge. This approach to regulation should protect the interests of consumers, create incentives for IGTs to operate efficiently and provide for charges that are reasonably cost reflective. RPC should also provide for transparent and readily verifiable charging arrangements that can be implemented in a relatively straightforward manner. This should encourage competition in the supply and connections markets.

Sites charging under existing arrangements will be migrated to RPC as soon as practicable, bearing in mind the advantages of consistency with previous approvals and the advantages of having a relatively straightforward migration process.

The paper also sets out proposals for IGTs to financially ring-fence their transportation activities. This will provide important safeguards for the financial stability of IGT businesses and offer increased protection for consumers.

Final proposals for dealing with infill sites - where IGTs provide transportation services to existing households not already connected to the gas network – will follow the publication of this document.

It is intended to implement these proposals by modifications to GT licences and for RPC to be introduced by January 2004.

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<sup>1</sup> The Regulation of Independent Gas Transporter charging – Draft Proposals; December 2002 87/02

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# 1. Introduction

## ***Purpose of this document***

- 1.1 This paper sets out Ofgem's final proposals for the regulation of IGT transportation charging. A key feature of the proposals is the introduction of a system of Relative Price Control (RPC) - linking IGT charges to the transportation charges levied by Transco. As well as dealing with transportation charges to new housing developments and Industrial and Commercial (I&C) consumers the paper includes proposals for dealing with legacy sites (sites on networks where charges are governed under existing licence conditions). In addition it includes proposals for the financial ring-fencing of transportation businesses.

## ***Rationale***

- 1.2 The review of IGT charging has considered both the level and structure of IGT transportation charges. Transportation charges are levied on shippers, who arrange for the delivery of gas to consumers through agreements with gas suppliers. Shippers delivering gas to consumers on IGTs networks will also use Transco's network. As a result shippers will face two sets of charges, those from Transco for shipping gas to the connected system exit point, and those from the IGT for shipping to the consumers' premises. Transportation is a monopoly activity and it is important to ensure that consumers are protected from monopoly power. For domestic consumers these charges represent a significant cost - typically some 35 to 40 per cent of their final gas bill.
- 1.3 Existing arrangements that control IGT charges have been ineffective. There is considerable variation in the level of IGT transportation charges with some IGTs having charges at about the same level as Transco while other IGTs charge significantly more than Transco. The Draft Proposals included an analysis of the costs that IGTs face in providing transportation services to new housing developments. This analysis indicated that IGTs do not need to make transportation charges in excess of Transco-equivalent charges.
- 1.4 The large majority of networks developed by IGTs serve new housing developments. The proposals for RPC require that in future IGT transportation

charges to new developments should be capped at a level broadly consistent with the Transco-equivalent charge. This approach to regulation should protect the interests of consumers, create incentives for IGTs to operate efficiently and provide for charges that are reasonably cost reflective. RPC should also provide for transparent and readily verifiable charging arrangements that can be implemented in a relatively straightforward manner.

- 1.5 A number of respondents, particularly shippers and suppliers, have welcomed the review of IGT charging. They reiterated the views previously highlighted in the Draft Proposals that the best approach for the future regulation of IGT charges to new housing developments is RPC. A number of IGTs expressed concern as to whether Transco charges would be an appropriate benchmark for RPC because of a perceived lack of cost reflective charging by Transco. A review of Transco's structure of charges was therefore deemed necessary by the majority of IGTs, many of whom said it should be undertaken ahead of implementation of RPC. Ofgem is committed to start work on a review of Transco's distribution charges following the publication of this document.
- 1.6 RPC should be consistent with the development of competition in supply and connection services. Suppliers should face consistent and transparent charging arrangements. IGTs will no longer be able to cross subsidise connection charges by making higher transportation charges and so there should be more competition in the market for final connections.
- 1.7 The intention is that RPC will apply to all future networks developed by IGTs to serve new housing developments and I&C consumers. However, there are approximately 400,000 consumers using networks that are regulated under existing arrangements. Where appropriate consumers should be protected through a common approach to regulation. Harmonisation of transportation charging arrangements also has benefits for shippers and suppliers. It is proposed to phase in arrangements for RPC so that in time they will apply to all sites. These matters are discussed in chapter four.
- 1.8 Financial ring-fencing of monopoly businesses provide important safeguards for the financial stability of licensed companies and offer two key advantages for consumers:

- ◆ they should provide protection from certain events that might otherwise lead to the insolvency of the licensee and so protect consumers from the associated uncertainty and possible disruption; and
  - ◆ they should allow the licensee to retain access to financial markets on reasonable terms and so facilitate the funding of future investment programmes.
- 1.9 Nevertheless, it is important to ensure that the costs of any proposals are proportionate to the benefits. The financial ring-fencing arrangements discussed in the Draft Proposals have been modified in the light of the views of respondents. Only IGTs that provide transportation services to more than a specified number of consumers will be subject to the financial ring-fencing arrangements. These matters are discussed in more detail in chapter five.
- 1.10 An annex to this document containing final proposals for regulating IGT charges to domestic infill sites – where existing houses were not previously connected to the gas network – will follow the publication of this document.

### ***Previous documents and correspondence***

- 1.11 In May 2002 Ofgem published a consultation document on IGT charging. Draft Proposals were published in December 2002 and discussed five possible approaches to the regulation of IGT charging. The Draft Proposals set out initial conclusions suggesting that RPC would be in the best interest of consumers.
- 1.12 The December 2002 paper also discussed the treatment of legacy sites and the financial ring-fencing of IGTs. Responses to the Draft Proposals are available on Ofgem's website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)). Ofgem has held a number of meetings with IGTs and shippers to discuss issues arising from the Draft Proposals. The responses to previous papers and issues arising during industry meetings have been considered in formulating the proposals set out in this paper.

### ***Other relevant workstreams***

- 1.13 Following the conclusion of Transco's price control (in September 2001) it will now be appropriate to consider whether Transco's charges for distribution

services are cost reflective and provide appropriate price signals for users of Transco's services. The review will cover a range of issues including the balance of charges between end users and CSEPs, and the boundary between connection and ongoing use of system charges. An initial consultation paper on these matters will be published later this year.

- 1.14 Ofgem has a workstream looking at the regulatory arrangements for independent electricity distribution network operators. Where appropriate a consistent approach will be adopted to the regulation of IGTs and independent electricity network operators.
- 1.15 It will be appropriate for Ofgem to continue to monitor the development of effective competition in the provision of gas connection services. It will be important that non-statutory connection providers are able to compete with GTs in the provision of connection services.

### ***Structure of the document***

- 1.16 This document is structured as follows:
- ◆ chapter two – a summary of responses to the December 2002 Draft Proposals;
  - ◆ chapter three – future arrangements for new domestic and I&C consumers;
  - ◆ chapter four - arrangements for legacy sites;
  - ◆ chapter five – financial ring-fencing proposals; and
  - ◆ chapter six – the way forward.

### ***Responding to this document***

- 1.17 If you have comments on the final proposals, treatment of legacy sites or other issues arising from this review please address written responses to:

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## ***Timetable***

- 1.18 Ofgem intends to publish a draft licence modification to implement these proposals in September 2003. Chapter six provides more detailed information on the way forward.



## 2. Summary of responses

- 2.1 Ofgem received twelve responses to the December 2002 Draft Proposals paper on the Regulation of Independent Gas Transporter Charging. There were four confidential responses and the remaining eight non-confidential responses are located on Ofgem's website. GTs provided eight responses with shippers and suppliers accounting for the remainder.
- 2.2 The Draft Proposals identified a number of specific topics relating to the implementation of new regulatory arrangements for IGT charging. It also raised questions relating to possible financial ring-fencing arrangements. The detailed responses to these particular topics are dealt with in the relevant chapters of this paper. Chapter three covers the responses to the specific issues concerning the form and scope of RPC for new housing developments and I&C consumers. Respondents' views on legacy arrangements are discussed in chapter four and financial ring-fencing in chapter five. Responses regarding the future regulation of IGT charges for domestic infill developments will be dealt with in a separate annex which will follow the publication of this document.
- 2.3 This chapter sets out a summary of respondents' views on the overall review and other issues not covered in the chapters mentioned above.
- 2.4 A number of respondents, particularly shippers and suppliers, welcomed the review of IGT charging. They reiterated views previously highlighted in the Draft Proposals that the best approach for the future regulation of IGTs for new housing developments is RPC. A number of IGTs expressed concern as to whether Transco's charges would be an appropriate benchmark for RPC because of the perceived lack of cost reflective charging by Transco. A review of Transco's structure of charges was therefore deemed necessary by the majority of IGTs, many of whom said it should be undertaken ahead of implementation of RPC. Ofgem is committed to start work on a review of Transco's distribution charges following the publication of this document.
- 2.5 One shipper questioned whether RPC would remain valid following the separation of price controls for Transco's regional distribution networks. Chapter three of this document sets out proposals for regional price floors and

ceilings for RPC so making these proposals consistent with separate regional price controls for Transco.

- 2.6 Comments were also received on the IGT charging and costs analyses summarised in the Draft Proposals. One respondent questioned the size of the sample used, stating that a larger sample would have made comparisons more meaningful. Another respondent questioned the analysis of charges being carried out at a particular point in time. They said that using historical prices would have shown that in many cases charges had initially equalled Transco with subsequent divergences due to Transco's rebalancing of distribution charges at the connected system exit point.
- 2.7 While it is true that the analysis of costs was based on a relatively small sample, the overall results of the charging and costs analyses were clear. At present a number of IGTs charge significantly more than Transco. Evidence that is available on costs suggests that these additional charges are not justified.

## 3. Future arrangements for new domestic housing and I&C consumers

### *3.1 Introduction*

- 3.1 This chapter sets out final proposals for the future regulation of IGT charges for new housing developments and I&C consumers. The future regulation of IGT charges for domestic infill developments will be covered in a separate annex, which will follow the publication of this document. Migration arrangements for existing sites are discussed in chapter four.
- 3.2 The Draft Proposals explained the advantages of RPC for new housing developments and I&C consumers. The main advantages of RPC are that it protects the interests of consumers and offers a straightforward approach to the regulation of IGT transportation charging. It should also facilitate effective competition between shippers and suppliers for consumers across all gas networks. This form of regulation received support from a number of the respondents to the Draft Proposals, and several IGTs already have Transco equivalent charges.
- 3.3 It will be appropriate to extend RPC to I&C consumers. If an I&C consumer wishes to negotiate a reduction in its upfront connection charge then this can be achieved via the introduction of annualised connection charges, payable in future years. RPC will lead to transportation charges that are broadly equivalent to Transco charges and so encourage competition in supply.
- 3.4 This chapter starts by considering issues relating to the form and scope of RPC. Section 3.3 then goes on to discuss some of the other issues raised in the Draft Proposals relating to RPC. Section 3.4 sets out further details on how the new RPC arrangements will be implemented and operated. Section 3.5 provides a summary of the new arrangements and section 3.6 discusses the way forward.

## ***3.2 Respondents' views on the form and scope of RPC***

3.5 The Draft Proposals discussed a number of issues relating to the form and scope of RPC. These included:

- ◆ starting point of control;
- ◆ path of charges over control;
- ◆ period of control;
- ◆ basis for adjusting charges; and
- ◆ use of standard AQs.

3.6 Each of these issues is dealt with below.

### ***Starting point of control***

#### **Choice of relative comparator**

3.7 The Draft Proposals suggested Transco would be the most appropriate comparator against which to set RPC as it is the only GT subject to full price control regulation and is a natural comparator in the sense that if the IGTs did not exist then Transco would provide and operate many of the IGT networks.

#### *Respondents' views*

3.8 Six GTs commented on this issue and three supported the proposition that Transco is the most appropriate comparator against which to set RPC. The remaining GTs said Transco would be an inappropriate comparator for a variety of reasons. These included the view that Transco's transportation charges are not closely related to the costs of developing and operating a network extension as its charges are influenced by historical and technical elements unique to Transco (such as the mains replacement programme). Among shippers all four respondents said Transco would be the appropriate comparator.

### *Final proposals*

- 3.9 The reasoning set out in the Draft Proposals remains valid. Transco, the largest GT in Britain, is the most appropriate comparator for RPC. It is subject to full price control regulation and has substantial experience in developing new system extensions. It is also the default service provider for most new system extensions, in the sense that if IGTs did not exist then Transco would provide and operate many of these networks. Furthermore, the results of the IGT cost analysis set out in the Draft Proposals did not reveal any significant divergence in the costs of constructing network extensions between IGTs and Transco.

### **Basis of comparison**

- 3.10 Respondents were asked to consider whether IGT charges should be compared to Transco's equivalent incremental charges from the Connected System Exit Point (CSEP) to the Single Supply Point (SSP).

### *Respondents' views*

- 3.11 Four IGTs and two shippers responded with all but one of the IGTs in agreement that IGT charges should be compared to Transco's incremental equivalent charges (from CSEP to SSP). However, some respondents stated their support was conditional upon a review of Transco's distribution charging methods, with a view to ensuring that Transco's equivalent charges would be cost reflective. The lack of cost-reflective charging by Transco was the main argument put forward by the respondent that opposed RPC.

### *Final proposals*

- 3.12 Given that IGTs connect their network at the CSEP then it is logical to compare their charges with Transco's equivalent incremental charges. There will be a review of Transco's distribution charging methods in 2003/04 that will give Ofgem the opportunity to consider whether Transco's charges properly reflect its costs.

### **Application of the control**

- 3.13 The Draft Proposals raised the question of whether RPC should apply to charges at the property or site level.

### *Respondents' views*

- 3.14 Six of the nine respondents to this issue favoured the application of RPC to site level charges. The main argument put forward by these respondents was the flexibility a site level control would allow for charging structures between different property types, which they said could be more cost-reflective. They contrasted this with property level charging, which was perceived by some to be excessively onerous, burdensome and costly to administer. However, two shippers noted that checks might be needed on site level charging since the flexibility could see some individual consumers paying more than Transco. One of the shippers said that a combination of site and property level charging might avoid this. Those in favour of property level charges alone (two IGTs and one shipper) commented on the ease of calculating charges by using the NExA property AOs and the advantages in promoting shipper/supplier competition.

### *Final proposals*

- 3.15 RPC will apply at the property level. This will be more equitable and cost-reflective as individual properties will be charged according to their consumption band. In contrast, site level charging, although offering IGTs flexibility in the way they structure charges, could see charges to some properties at a significantly higher level than the Transco-equivalent.
- 3.16 The approach to implementing RPC described in section 3.4 should mean the new arrangements are straightforward to operate. Therefore, concerns that these arrangements would be burdensome and difficult to administer should prove to be unfounded.

### **Level of relative comparison**

- 3.17 The Draft Proposals considered whether the interests of consumers would be best served by setting IGT charges at either the same level as, or less than, the Transco-equivalent.

### *Respondents' views*

- 3.18 All five IGTs and three shippers were unanimous in their opposition to setting initial IGT charges at less than the Transco-equivalent. Respondents said there

would be an adverse impact on competition in the connections market if IGTs charged more for connection to offset the lower transportation charges

#### *Final proposals*

- 3.19 Consistent with the views of respondents it would not be appropriate to set IGT use of system charges below the Transco-equivalent as this would have an adverse impact on competition in the connections market. Charges above the Transco-equivalent would not be in the interests of consumers. Therefore RPC will set initial IGT charges at the same level as the Transco-equivalent charge.

#### ***Path of charges over control***

- 3.20 The Draft Proposals considered three broad options for the path of charges over the control period:
- ◆ continually follow Transco-equivalent charges;
  - ◆ remain constant in real terms (i.e. follow RPI) until the next review; or
  - ◆ fall in real terms until the next review.

#### *Respondents' views*

- 3.21 This issue received a mixed response from the six IGTs and two shippers who responded. While the requirement for certainty in revenue streams to finance investment in their networks underpinned the comments of all IGTs, their views on the best method of achieving this showed some variation. Two IGTs proposed that they should not be subject to a review of prices at all, while another suggested that a twenty year period would provide stable charges at the same time as minimising regulatory intervention. In both instances, it was suggested that IGT prices should change in line with the annual movement in RPI. Another IGT suggested charges following RPI but within a shorter review period, with the intention of protecting IGTs from windfall losses or gains. An alternative to an RPI adjustment was proposed by the two remaining IGTs and shippers, both of whom favoured a fixed floor and ceiling.

### *Final proposals*

- 3.22 Having IGT charges continuously track the Transco-equivalent has the advantage of being easily verifiable by shippers and delivering uniform benefits to consumers. However, it would be important to recognise that an IGT might incur windfall losses or gains due to unexpected movements in Transco's charges. On balance, a combination of these approaches appears to be the best way forward. Some certainty with respect to the recovery of IGT costs could be provided by allowing IGT charges to track Transco charges within a pre-determined ceiling and floor. This would enable IGTs to calculate the minimum revenue stream that would be guaranteed for a given property over the control period.
- 3.23 The second option of IGT charges remaining constant in real terms would provide IGTs with a high degree of certainty with regard to revenue, but divergences between IGT and Transco charges would occur almost immediately resulting in greater administrative burden and costs for shippers that could eventually lead to higher prices for consumers.
- 3.24 Under the third option, IGT charges would decline in real terms over the course of the review period by RPI-X, with the X factor reflecting expected future efficiency improvements. However, as with the second option, divergences between IGT and Transco charges could occur and some of the advantages of RPC would be lost.

### ***Period of control***

#### **Scope and timing of the review**

- 3.25 The Draft Proposals outlined three broad options for the period of control for RPC:
- ◆ set periods, for example every five or ten years;
  - ◆ a rolling review; or
  - ◆ a phased review.



### *Respondents' views*

- 3.26 Seven respondents commented on the review periods. A review process was not deemed necessary by two IGTs if continuous tracking to Transco was implemented, while another suggested that given the small size of IGTs they should not be subject to efficiency reviews at all until they reach one million supply points. For those respondents who favoured a review, the length of the period appropriate for the proposed control varied from one to twenty years.

### *Final proposals*

- 3.27 Future reviews will be necessary because unexpected changes in the gas transportation sector over a twenty year period could result in windfall losses or gains for IGTs and consumers. It is Ofgem's intention that any review of the RPC mechanism would take effect no sooner than ten years after its implementation. Should Ofgem wish to change these arrangements after ten years has passed it would propose a suitable licence modification. This would give IGTs the option of having these matters referred to the Competition Commission for final determination.

## ***Basis for adjusting charges***

- 3.28 The Draft Proposals considered whether performance measures would be appropriate in deciding how to adjust IGT charges.

### *Respondents' views*

- 3.29 The use of performance measures to adjust charges generated little support among the five respondents commenting on this issue, with some considering it to be unwarranted under RPC and costly to establish. Some respondents said that the current provisions to incentivise IGT performance were adequate and any move to introduce additional measures should be considered through a separate consultation.

### *Final proposals*

- 3.30 Ofgem agrees with the views expressed by the respondents and does not intend to use RPC as a vehicle for introducing supplementary incentive arrangements.

## ***Use of standard Annual Quantities (AQs)***

- 3.31 The Draft Proposals considered the most appropriate approach for setting AQs (the measure of gas consumption used in determining IGT transportation charges).

### *Respondents' views*

- 3.32 The current lack of uniformity in the estimation of AQs was recognised by many of the respondents as a problem. Several respondents also said that the outcome of an AQ Review in 2003 should result in standard AQs that could be adopted by the industry as a whole.
- 3.33 They considered that standard AQs should be subject to periodic review, which would enable them to be updated if the need arose to ensure that AQs continued to reflect typical consumption levels.

### *Final proposals*

- 3.34 As discussed in the Draft Proposals, the use of different AQs for billing shippers can result in higher charges and difficulty for shippers in validating invoices. It is expected that an AQ review in 2003 will go some way to improving the accuracy of IGT billing. The AQ review, run by shippers and IGTs via the Gas Forum's IGT Workgroup, is currently finalising its proposals for the 2003 gas year. Following the AQ review, the industry could consider replacing the values in the existing National Exit Agreement (NExA) table.
- 3.35 The existing NExA table was established in 1999 and some IGTs use this to derive their AQs. It is a standard matrix of AQs based on domestic property type and location, and is used in the SLC 4C interim arrangements. It was also used in the IGT charging analysis. The current NExA table is included in appendix 2 of this document.
- 3.36 Until a final set of AQs is established by the AQ review and accepted by Ofgem, IGTs should adopt the existing NExA AQs for the purpose of calculating Transco-equivalent charges. Once the AQs from the review are finalised Ofgem will determine whether it is appropriate to use these new AQs in determining compliance with RPC.

### ***3.3 Respondents' views on other issues relating to RPC***

3.37 The Draft Proposals invited views on a range of other issues relating to RPC, including:

- ◆ I&C consumers;
- ◆ annualised connection charges;
- ◆ unbundling of metering and meter reading charges;
- ◆ enforcement and governance;
- ◆ incentives and low cost sites; and
- ◆ the review of Transco's distribution charges.

3.38 Each of these matters is dealt with below.

#### ***Industrial & Commercial Consumers***

3.39 The Draft Proposals considered whether the application of RPC should be extended to I&C consumers.

##### *Respondents' views*

3.40 The majority of respondents called for I&C consumers to be exempt from RPC. They proposed retaining existing SLC 4C charging methods or some other form of supplemental charging. Reasons given focused on the relative high connection costs of some I&C projects, the fact that I&C consumers generally have the choice to pay either a higher up-front connection charge or supplemental transportation charges, and the need to encourage extensions to the gas network. Two IGTs and one shipper among the 12 respondents supported the application of RPC to I&C consumers.

##### *Final proposals*

- 3.41 Under existing charging arrangements, I&C consumers are able to enter into agreements with IGTs to negotiate a reduction in the cost of the up-front connection charge by paying more than the Transco-equivalent transportation charge on an ongoing basis. A number of suppliers / shippers are content with these arrangements and pass on additional transportation charges to the consumers concerned. However, Ofgem understands that some shippers / suppliers are reluctant to serve I&C consumers on IGT networks due to the additional administrative costs of these arrangements. These difficulties should be ameliorated with the introduction of RPC.
- 3.42 Annualised connection charges could be used in conjunction with RPC to reduce up-front connection charges to I&C consumers.

### ***Annualised Connection Charges (ACCs)***

- 3.43 The Draft Proposals discussed whether annualised connection charges (ACC) would be appropriate for some types of consumers, including I&C consumers.

#### *Respondents' views*

- 3.44 ACCs received little support from the majority of respondents, although many of the comments were focused on domestic infill developments. ACCs were considered to be ineffective by most IGTs as the arrangement would equate to an unsecured loan if the consumer moved premises. Those in support of ACCs stated that the choice as to whether to adopt them or not should rest with the interested parties (the IGT and consumer) and not be a matter for the regulator.

#### *Final proposals*

- 3.45 ACCs could enable the customer to pay a smaller up-front connection charge and spread the remaining connection cost over a number of years. The connection agreement could allow the IGT to de-energise in the event of payment default and so provide the IGTs with an enhanced level of protection from bad debt.
- 3.46 On this basis, ACCs are an appropriate mechanism to allow for the funding of network extensions. It is for individual IGTs and consumers to decide whether they enter into such agreements. Introducing ACCs for domestic consumers

might increase transaction costs and so in practice they may be less effective where domestic consumers are concerned. Nevertheless, the availability of ACCs to fund network extensions to larger I&C consumers should provide sufficient flexibility such that supplementary transportation charges are unnecessary.

### ***Unbundling of metering and meter reading charges***

- 3.47 The Draft Proposals asked whether the unbundling of metering and meter reading charges should also be extended to IGT charges, given that Transco's transportation charges no longer recover the costs of metering and meter reading services.

#### *Respondents' views*

- 3.48 There was general support for the unbundling of metering and meter reading charges among the five IGTs and three shippers that responded to this issue. A number of IGTs said they had already unbundled these charges from transportation charges and welcomed the extension of this to all IGTs. One IGT said the separation of these charges could not be justified on the grounds that it would increase the administrative burden on IGTs. Shippers said that unbundling would enhance the validation of and comparison between IGT and Transco charges.

#### *Final proposals*

- 3.49 At present the transportation charges of some IGTs include the provision of metering and meter reading services, while other IGTs charge separately for these services. All IGTs should follow the same arrangement and unbundle metering and meter reading charges to increase transparency and promote competition in metering services.

### ***Enforcement and governance***

- 3.50 The Draft Proposals considered whether new governance arrangements or other changes were required to standardise IGT invoicing methods in order to improve the validation of IGT charges by shippers under RPC.

### *Respondents' views*

- 3.51 Most respondents rejected the introduction of governance arrangements for IGT charging. Although all eight respondents supported the need for clearer and more transparent invoicing and billing arrangements, most respondents said this could be achieved without the need to implement some form of governance arrangements. Such arrangements were viewed to be costly, unnecessary under RPC and a potential constraint on innovation and the development of efficient new invoicing models. The four IGTs and two shippers opposed to the introduction of governance arrangements proposed alternatives that involved some standardisation of IGT invoicing methods, including appropriate modifications to the network codes and establishing a voluntary code of practice.

### *Final proposals*

- 3.52 Given the general lack of support for governance arrangements from respondents no such arrangements will be introduced as part of these final proposals, although network codes will remain subject to the existing modification procedures. Ofgem will work to ensure that RPC is implemented in such a way as to make the ongoing validation and enforcement of these arrangements as straightforward as possible.

### ***Incentives and low cost sites***

- 3.53 The Draft Proposals discussed whether RPC would provide undue incentives for IGTs to focus on developing low cost sites.

### *Respondents' view*

- 3.54 Three of the four IGTs that responded to this issue said that the application of RPC would not lead to an undue focus on low cost sites. The view put forward by these respondents was that the competitive market would drive IGTs to offer lower up-front connection charges on low cost sites. One IGT chose to direct its concern towards high cost sites, and said that high costs might deter the development of these sites by IGTs. Both shippers that responded to the issue said the benefits of RPC would outweigh any disadvantages in terms of the incentives to develop high cost sites.

### *Final proposals*

- 3.55 Consistent with the views of the majority of respondents, RPC should not lead to an undue focus on low cost sites by IGTs. The competitive connections market should drive IGTs to offer lower up-front connection charges to low cost sites and higher up-front connection charges to high cost sites.

### ***Review of the structure of Transco's distribution charges***

- 3.56 The Draft Proposals asked whether a review of Transco's structure of distribution charges should be undertaken, and whether such a review should occur before or after implementation of RPC.

### *Respondents' views*

- 3.57 Many IGTs stated that their support for RPC would be conditional upon a review of Transco's distribution charges. Their concerns largely focused on establishing an appropriate balance of charges between the CSEP and supply points, which they considered to be fundamental if RPC is to send efficient price signals to consumers and IGTs.
- 3.58 With regard to the timing of the review, IGTs who responded emphasised the need for completion of the review of Transco's distribution charges before the implementation of RPC. On the other hand, some shippers took the opposing view and while acknowledging that a review was important, argued that it should not delay the implementation of RPC, especially as some IGTs already set charges equivalent to Transco.

### *Final proposals*

- 3.59 Ofgem is committed to reviewing Transco's distribution charging methods on a periodic basis. Given the introduction of RPC and that Ofgem's last review of Transco's distribution charging methods was carried out in March 2000 it will be appropriate to undertake a further review of Transco's distribution charges. This will include consideration of the boundary between connection and use of system charges.

3.60 It is the intention to start the review of Transco's distribution charges in August 2003, following publication of this paper. The interaction with this review and the licence modifications to introduce RPC are discussed in more detail in section 3.6 and chapter six.

### ***3.4 Relative Price Control – final proposals***

3.61 This section sets out more detail about how RPC will operate. In summary, IGT transportation charges will track Transco's charges, subject to a pre-determined floor and ceiling. The movement in the floor and ceiling will be defined relative to the movement in a forecast of Transco's distribution charges. A separate floor and ceiling will apply for each of Transco's eight regional networks.

#### **Calculating the initial Transco equivalent charge**

3.62 The initial IGT charge for a particular property will be set at the Transco-equivalent charge, calculated at the date of meter installation for that property. As described in section 3.2 above, the Transco-equivalent charge will be defined as the difference in charge to the SSP and the charge to the CSEP, based on industry standard AQs, currently those published under the NExA. Once calculated, the initial IGT charge is used in determining both the floor and ceiling, together with future IGT charges.

#### **The path of the floor and ceiling**

3.63 The floor and ceiling for IGT charges are defined by two variables:

- ◆ the starting point; and
- ◆ the path over subsequent years.

3.64 The starting point of the charging floor and ceiling will be based on a fixed percentage band around the initial IGT charge for each property. The band will be set at five per cent either side of the initial IGT charge, so that the starting point of the ceiling will be the initial IGT charge plus five per cent, and the starting point of the floor will be the initial IGT charge minus five per cent.



- 3.65 The future path of the floor and ceiling will be expressed in terms of a single percentage decrease applied each year. This will be calculated so that over a twenty year period, the total decrease reflects the expected decrease in Transco's distribution charges for that particular region. For example, in Scotland Transco's charges are projected to decrease by 9.33 per cent in real terms over the next twenty years and so the annual equivalent decrease (taking into account the compound effect of the decrease) would be 0.49 per cent<sup>2</sup>.
- 3.66 Table 3.1 shows projections of real regional distribution charges between 2002/03 and 2021/22 and the annualised decrease in the regional floor and ceiling that these equate to. The projections are consistent with the analysis set out in Ofgem's Separation of Transco's distribution price control – Draft Proposals (December 2002).

**Table 3.1: Projected movement in real gas distribution charges\* (2002/03 - 2021-22)**

	Scotland	N & Yorks	North west	East England	West Mids	Wales & SW	N London	South & SE
<b>Indexed start point (year 1 charges)</b>	71.27	77.14	73.57	77.91	74.32	73.97	75.22	76.52
<b>Indexed end point (year 20 charges)</b>	64.62	60.68	54.84	55.36	53.57	67.87	58.03	55.82
<b>% change in charges from year 1 to 20</b>	9.33%	21.34%	25.46%	28.94%	27.92%	8.25%	22.85%	27.05%
<b>Annual equivalent % change (X)</b>	0.49%	1.19%	1.46%	1.69%	1.62%	0.43%	1.29%	1.56%

\* charges are at 2000 prices.

- 3.67 The annual percentage decreases given in Table 3.1 are based on *real* movements in charges. They therefore define the real movement in the floor and ceiling. In order to establish the nominal floor and ceiling, the real value will need to be inflated each year by RPI. Ofgem will publish the relevant RPI figure in October each year. The figure will be based on the average value of

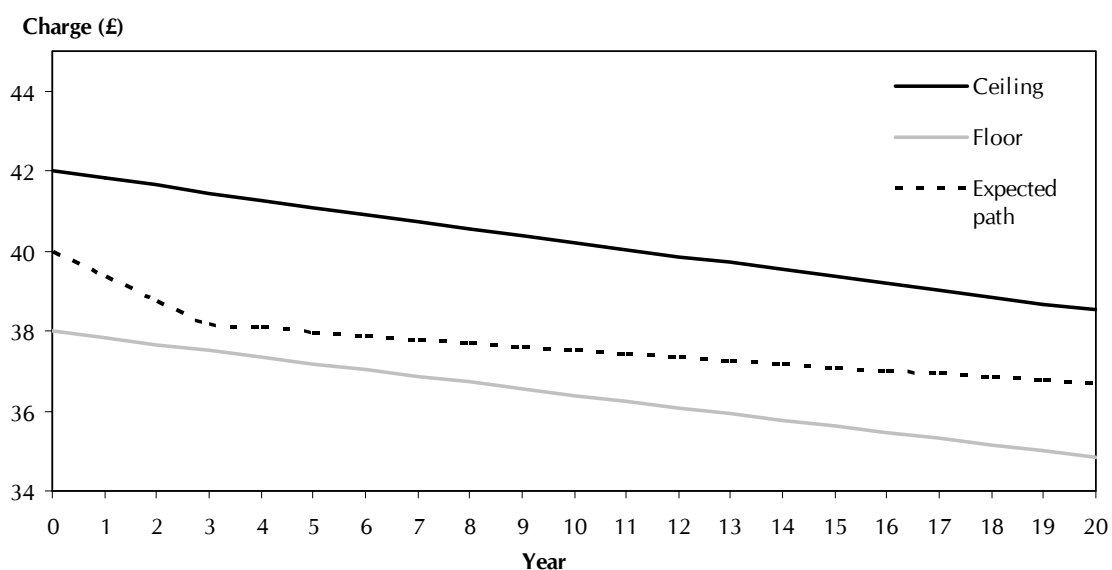
<sup>2</sup> A decrease of 9.33% is equivalent to applying a factor of 0.9067. The 20<sup>th</sup> root of this factor gives the annualised factor (i.e.  $\sqrt[20]{0.9067} \approx 0.9951$ ) which is equivalent to applying a decrease of 0.49% each year.

the RPI index of the previous six months compared to the corresponding value in the same period of the previous year.

### **Annual calculation of IGT charges**

- 3.68 Having established the floor and ceiling it is necessary to calculate the Transco-equivalent charge. The Transco-equivalent charge for a particular property will be based on the initial IGT charge uplifted by the increase in Transco's SSP charge. This is to give IGTs some protection against any future re-balancing of Transco's charges between the CSEP and supply points. In the first year of operation of RPC, the IGT charge for a particular property will be equal to the initial IGT charge. In the following year, the IGT charge will be equal to the initial IGT charge increased by the proportionate increase in Transco's SSP charge over the year, except where the IGT charge would fall outside the relevant floor or ceiling. Charges for future years will be calculated on the same basis.
- 3.69 The increase in the SSP charge for each region will be calculated and published by Ofgem in October of each year. The published increase will be a weighted average across the exit zone charges in the particular region. Based on this increase, the new IGT charges will take effect on January 1<sup>st</sup> the following year.
- 3.70 Where the Transco-equivalent charge for a particular property as calculated above exceeds the ceiling for that year, then the IGT charge shall equal the ceiling. Similarly, where the Transco equivalent charge for a particular property is below the floor for that year, then the IGT charge shall equal the floor.
- 3.71 Taking the projections of gas distribution charges in Scotland as an example of the possible movement in SSP charges, Figure 3.1 illustrates the paths of the floor and ceiling over twenty years, assuming that the initial IGT charge for a particular property is £40. Each year the floor and ceiling both decrease by 0.49%, giving a decrease over twenty years of 9.33%. This figure also illustrates the expected movement in Transco's distribution charges over this period.

**Figure 3.1: Scotland floor and ceiling based on projected gas distribution charges**



3.72 A more detailed worked example of the application of the RPC mechanism is given in appendix 3.

#### **Review of RPC arrangements**

3.73 As set out above, Ofgem does not intend to complete a review of these arrangements prior to ten years after their introduction.

3.74 New properties entering RPC during the first ten years of its operation will face the same annual rate of decline in their floor and ceiling as calculated above for a period of ten years from the date of meter installation, regardless of the outcome of any subsequent review of the overall RPC mechanism. In this way, IGTs will have a degree of certainty over their charges for a period of at least ten years.

3.75 It is Ofgem’s present intention that after twenty years of operation of RPC the floor and ceiling will no longer apply and IGT charges will track Transco-equivalent charges on a continuous basis, based on Transco’s equivalent incremental charges from CSEP to SSP. This will be subject to any review of the arrangements taking place after ten years.

### ***3.5 Summary of final proposals***

3.76 Below is a summary of the future arrangements for new housing developments and I&C consumers.

- ◆ IGT charges will be regulated on the basis of RPC;
- ◆ It is the intention for RPC to take effect from January 1<sup>st</sup> 2004;
- ◆ Transco is the most appropriate comparator against which to set RPC;
- ◆ the starting point of the IGT charge will be equal to Transco's incremental charge from the relevant CSEP to the SSP. In subsequent years, the IGT charge will be adjusted by the proportional change in the SSP charge;
- ◆ RPC will be applied to property level charges;
- ◆ the path of charges under RPC will track Transco's charges within a pre-determined floor and ceiling;
- ◆ Ofgem will publish the proportional change in the SSP charge for each region, the RPI figure and if applicable, any revisions to the standard AQs in October each year;
- ◆ the new IGT charges for each year will take effect on January 1<sup>st</sup>;
- ◆ it is Ofgem's intention that any review of the RPC mechanism would take place only after ten years. The outcome of any review will only effect future properties joining RPC and existing properties that have been in RPC for at least ten years;
- ◆ subject to any further review after ten years, after twenty years, the floor and ceiling will no longer apply and IGT charges will track Transco-equivalent charges continually based on Transco's equivalent incremental charges from the CSEP to the SSP;
- ◆ IGTs will adopt standard AQs for charging (currently the NExA AQs);

- ◆ IGT metering and meter reading charges will be unbundled from transportation charges; and
- ◆ a review of Transco's structure of distribution charges will be initiated following the publication of this document.

### ***3.6 The way forward***

3.77 It will be necessary to modify the GT licence to formalise RPC for new domestic housing and I&C consumers. These matters are discussed in more detail in chapter six. A brief summary of the process is given below:

- ◆ following publication of this paper Ofgem will produce a draft licence modification in consultation with GTs;
- ◆ it is Ofgem's intention to publish the final draft of the licence modifications in November 2003. Following a statutory consultation period, Ofgem will consider any representations and should then be in a position to modify the GT licence;
- ◆ the modifications should take effect on 1<sup>st</sup> January 2004; and
- ◆ the licence modification will contain a disapplication request provision to allow the IGTs to disapply the licence conditions following a review of Transco's structure of charges. If an IGT were to issue a disapplication request it is likely that Ofgem would refer the matter to the Competition Commission for determination.

## 4. Arrangements for legacy sites

### 4.1 Introduction

- 4.1 Chapter three set out final proposals for the regulation of IGT charging to new housing and I&C sites. However, there will remain a significant number of legacy sites that pre-date the new arrangements. As part of the overall review of IGT charging Ofgem has considered whether revised arrangements for the treatment of legacy sites should be introduced. Where practicable these arrangements should lead to the consistent treatment and regulation of legacy sites with new sites. Proposals for the treatment of legacy sites are set out in this chapter.
- 4.2 Current IGT transportation charges are determined on the basis of charging methods set out in Standard Licence Conditions (SLCs). In general, charges are based on either the use of SLC 4C and SLC 4 together, or the use of SLC 4 alone. Ofgem has introduced arrangements for the regulation of both SLC 4C and SLC 4 transportation charges. The background and further details of these arrangements are set out in a series of letters to IGTs. These letters are available on the Ofgem website under IGT Regulation.
- 4.3 The existing charging arrangements for IGT sites are discussed in sections 4.2 and 4.3 below. Sections 4.4 and 4.5 set out proposals for migrating sites charged under the existing arrangements to RPC, and section 4.6 provides a summary of the way forward.

### 4.2 Arrangements for charges made under SLC 4C

- 4.4 SLC 4C methods specify charges for up to twenty years and are accepted on a site-by-site basis. There are three categories of IGT charges made under SLC 4C:
- ◆ SLC 4C charges approved before 8 December 2001;
  - ◆ SLC 4C charges approved under the *original* Interim Arrangements (from 8 December 2001 to 31 July 2003); and

- ◆ SLC 4C charges that will be approved under the *revised* Interim Arrangements (from 1 August 2003 until the implementation of RPC).

4.5 Each of these categories of SLC 4C charges is discussed below.

### ***SLC 4C charges approved prior to 8 December 2001***

4.6 SLC 4C methods approved prior to 8 December 2001 specify charges for up to twenty years on a site-by-site basis. Where Ofgem has already given explicit consent for long term charging arrangements, there is limited scope for imposing new arrangements on companies. Ofgem has consulted legal counsel and has concluded that it is not appropriate to impose new arrangements that would have the effect of reducing revenue from SLC 4C charges approved prior to the introduction of the Interim Arrangements in December 2001. Therefore section 4.4 sets out arrangements for the migration of charging arrangements on a basis that should be broadly revenue neutral.

### ***SLC 4C charges under the original Interim Arrangements***

4.7 After consultation Ofgem introduced Interim Arrangements for all applications for charging methodology acceptances under SLC 4C received after 7 December 2001. The Interim Arrangements established criteria for acceptance of SLC 4C charging methods for new gas networks. The criteria required that the combined SLC 4 and SLC 4C charges for transporting gas to IGTs' sites should not exceed the equivalent charge levied by Transco to similar sites on its network. In subsequent years charges are allowed to vary with changes in the retail price index. Therefore, the original Interim Arrangements did not require charges to be changed to reflect future movements in Transco's charges. It was indicated that these arrangements would remain in effect until the wider review of IGT charging was complete.

### ***SLC 4C charges under the revised Interim Arrangements***

4.8 Ofgem wrote to all IGTs on 31 March 2003 to consult on the introduction of *revised* Interim Arrangements for SLC 4C approvals for the period between completion of the review and the implementation of new arrangements for regulating IGT charges. This letter proposed that from 1 June 2003 SLC 4C

acceptances would only be given if the combined SLC 4 and SLC 4C charges for transporting gas to IGTs' sites would not exceed the equivalent charge levied by Transco to similar sites on its network *for each year of the project*.

- 4.9 Based on responses received to this letter, Ofgem made some amendments to the proposed arrangements and wrote again to all IGTs on 2 May 2003 to further consult on the revised Interim Arrangements. This letter proposed that from 1 August 2003 SLC 4C acceptances would only be given if the combined SLC 4 and SLC 4C charges would not exceed the equivalent charge levied by Transco on the basis of RPC (as set out in chapter three of this paper). Views on these proposals were originally invited by 30 June 2003. In view of the final publication date of this document, responses will now be accepted until 15<sup>th</sup> July 2003.
- 4.10 Following consideration of the responses to the 2 May letter Ofgem intends to write again to IGTs in late July giving final guidance on the revised SLC 4C Interim Arrangements.

### ***4.3 Arrangements for charges made under SLC 4***

- 4.11 SLC 4A requires that SLC 4 charging methods result 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...'.
- 4.12 Ofgem published a consultation paper on IGT 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 responses to this paper was published in the May 2002 consultation paper.

#### ***Interpretation of reasonable profit***

- 4.13 Based on responses to the February 2002 consultation paper and further analysis of the cost of capital, Ofgem wrote to all IGTs on 29 November 2002, setting out initial proposals for the interpretation of reasonable profit under SLC 4A. The letter suggested that returns above the range for the cost of capital (excluding the small company premium) set out in the February 2002 paper



would appear to be a breach of SLC 4A for IGTs charging under SLC 4. The top of this range was a real pre-tax cost of capital of 7.7 per cent. The letter also discussed how costs and revenues should be dealt with in calculating rates of return and judging compliance with SLC 4

- 4.14 Taking into account responses to the 29 November 2002 letter and additional analysis of the cost of capital, Ofgem wrote again to all IGTs on 24 March 2003 setting out further proposals for the interpretation of reasonable profit under SLC 4A. This letter confirmed that returns above a real pre-tax cost of capital of 7.7 per cent would be a breach of SLC 4A and proposed some revisions to the guidelines for calculating rates of return and judging compliance with SLC 4.
- 4.15 Where capital expenditure is recovered through SLC 4 charges, two tests would *both* need to be satisfied to determine whether an IGT has complied with the reasonable profit requirement: a Net Present Value (NPV) test and a Return on Capital Employed (ROCE) test. Where no capital expenditure is recovered through SLC 4 charges, only the NPV test would need to be satisfied based on SLC 4 costs and revenues. The full guidelines for the monitoring of profits under SLC 4A are set out in appendix 4.

### ***Transco-equivalent charging***

- 4.16 A number of respondents to the 29 November 2002 letter suggested that IGTs should be allowed the option of setting transportation charges based on Transco-equivalent prices instead of being subject to the monitoring of profit levels. Several IGTs already set charges based on Transco-equivalent prices on a continuous basis. In addition, some IGTs said that they should be allowed the option of adopting the proposed RPC approach as their SLC 4 methodology.
- 4.17 There are significant advantages in this approach. It would allow the benefits of RPC to be realised while avoiding the administrative burden that would otherwise be involved in the profit monitoring regime. Ofgem consulted legal counsel and concluded that this approach would be acceptable under the current drafting of SLC 4A. Those IGTs that are prepared to charge no more than Transco-equivalent prices either on a continuous basis, or on the basis of RPC as set out in chapter three, will be considered to comply with the terms of SLC 4A, and will not be subject to the monitoring of profits discussed above.

## ***Options under SLC 4***

- 4.18 Each IGT will have to decide between the three options allowed under SLC 4. By 31 December 2003, IGTs charging under SLC 4 will be required to either:
- ◆ submit a report for 2002/3 demonstrating compliance with the ROCE and NPV tests; or
  - ◆ have adopted Transco-equivalent prices or RPC for all sites on a continuous basis as their SLC 4 methodology.
- 4.19 Any IGT that does not adopt Transco-equivalent or RPC prices in 2002/3 will face similar constraints and options in each subsequent year until all sites are migrated to RPC. Further details on the arrangements for the future migration of sites charged for under SLC 4 to RPC are set out in section 4.4.
- 4.20 Given that there are particular issues associated with I&C and domestic infill sites, there are specific circumstances where these sites may be excluded from the above arrangements. These issues are discussed below in section 4.5.

## ***Interaction between arrangements for SLC 4C and SLC 4 charges***

- 4.21 Where IGTs use both SLC 4 and SLC 4C for setting transportation charges, they will be subject to both sets of arrangements set out above. The combined SLC 4 and SLC 4C charges for transporting gas to individual IGT sites will be constrained by the SLC 4C Interim Arrangements. If the sites predate the Interim Arrangements and are not charging on a Transco equivalent basis or at RPC then the IGT will be required to ensure that all SLC 4 costs and charges (taken together) should result in no more than a reasonable profit.

## ***4.4 Migration arrangements for legacy sites***

- 4.22 The Draft Proposals identified the following options with respect to the migration of legacy sites into the new arrangements:

- ◆ avoid migration and retain existing charging arrangements for legacy sites, ring-fencing the costs and charges from new sites that will be subject to RPC;
- ◆ allow IGTs to migrate legacy sites to the new arrangements as and when they judge it to be appropriate; or
- ◆ provide a timetable for phasing in the new arrangements for existing sites.

### ***Summary of responses***

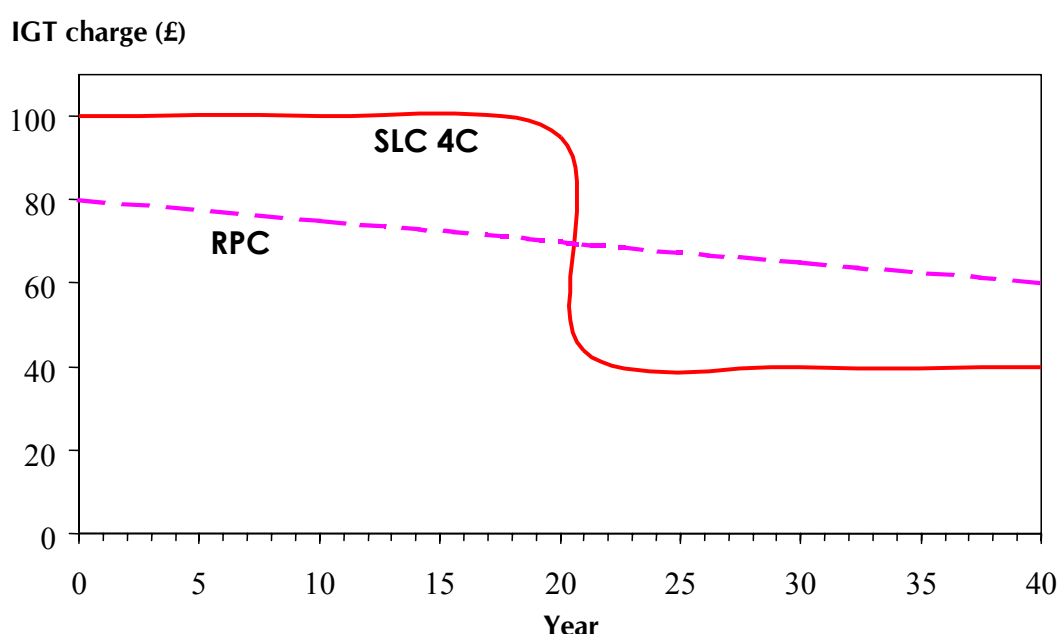
- 4.23 Five IGTs and three shippers / suppliers commented on the options for migrating existing sites into the new arrangements. All respondents recognised the benefits to shippers, GTs and consumers in removing disparities between charging arrangements.
- 4.24 Two of the shippers / suppliers suggested that the most suitable way of achieving this would be by specifying a timetable for phasing in the new arrangements. It was suggested that a five year period for migration would be appropriate. The IGTs that responded expressed a range of views. One IGT suggested that migration should occur on a revenue-neutral basis. Two suggested that migration should follow a piecemeal approach, with individual sites being migrated at a time of the IGT's choosing. One IGT said that SLC 4 sites should be migrated as soon as the new arrangements are implemented since these sites are not subject to any long-term approval of charges.

### ***Assessment of migration options***

- 4.25 The first option - maintaining the existing arrangements - would require IGTs, shippers and Ofgem to maintain all the existing charging arrangements in addition to the new arrangements. Based on discussions with IGTs and shippers, Ofgem considers this approach to be inefficient and costly to administer for all parties. Further, it is not clear that this approach would be consistent with the interests of consumers.
- 4.26 The second option - allowing IGTs to migrate legacy sites to the new arrangements at their discretion and on a site-by-site basis – is likely to lead to

higher prices in the longer term and not be in the interests of consumers. For example, IGT charges based on pre 7 December 2001 SLC 4C arrangements typically stipulate higher transportation charges for twenty or twenty five years, followed by significantly lower charges thereafter. If IGTs were given discretion as to when they could migrate these sites into the new arrangements, they may benefit from delaying migration until the end of the twenty to twenty five year period. This could then result in higher charges for consumers in the future. This situation is illustrated in Figure 4.1 below.

**Figure 4.1: SLC 4C charges and RPC**



4.27 The third option - providing a timetable for phasing in the new arrangements for existing sites - would encourage harmonisation of charging arrangements while delivering benefits to consumers. It would be in the interests of consumers and suppliers for all sites to move into the new arrangements at the same time. This would also facilitate a more straightforward migration process. Nevertheless, it will be important that the new arrangements do not have an unduly retrospective effect on any particular IGT.

4.28 In the light of this, Ofgem has undertaken analysis to assess the revenue effects of migration arrangements, based on a sample of pre-December 2001 SLC 4C sites. The results suggest that most IGTs could be migrated into the new RPC arrangements on a revenue neutral basis within a five-year period from the

introduction of RPC, although exceptionally there may be certain IGTs for which revenue neutral migration might not take place until ten years. Several IGTs have already indicated that they would be willing to migrate within this timeframe.

- 4.29 Given that there is no long-term approval associated with the charges for SLC 4 sites, it might be reasonable to expect these sights to migrate to the new charging arrangements sooner. This would enable the benefits of unified charging structures to be realised at an earlier stage. However, for the purposes of simplifying the migration process, the same treatment will apply to the migration of both SLC 4 and SLC 4C sites.

### ***Proposed migration arrangements***

- 4.30 Within sixty days of the implementation date of the new arrangements, each IGT will provide a report to Ofgem setting out its proposed migration date and evidence that such a date produces a revenue-neutral outcome. In particular, the IGT will need to provide:

- ◆ a single date for the proposed migration of charging arrangements for *all* existing sites (possibly excluding certain I&C sites and domestic infill sites as discussed below) into the new arrangements. In most cases, Ofgem will expect this date to be within five years from the implementation date of the new arrangements;
- ◆ analysis showing the IGT's forecast revenue stream by year based on the IGT continuing with the legacy arrangements for all existing sites (including SLC 4C and SLC 4-only sites);
- ◆ analysis showing the IGT's forecast revenue stream by year based on the IGT migrating all existing sites under the legacy arrangements to RPC at the date of implementation of the new arrangements; and
- ◆ assumptions used to derive the two sets of forecast revenue streams and the proposed migration date, in sufficient detail to enable Ofgem to replicate the IGT's analysis.

- 4.31 Ofgem would consider the reports provided by IGTs and either accept the migration date proposed by each IGT or direct it to make a modification to the proposed date. In making this decision, Ofgem would seek to ensure that IGTs would not gain a financial benefit from postponing migration beyond a reasonable date.

## ***4.5 Migration arrangements for I&C and domestic infill sites***

### ***Proposed arrangements for I&C sites***

- 4.32 As discussed in chapter three, charging arrangements for all new I&C sites should be based on RPC from the date the new arrangements are implemented. However, Ofgem understands that some I&C sites on IGT networks are based on charges that are higher than the Transco-equivalent, and that some of these arrangements have been specifically agreed with the I&C consumers concerned and are reflected in charges levied by certain suppliers.
- 4.33 In the light of these factors, existing charges for I&C consumers at legacy sites can be maintained if the IGT can demonstrate that each I&C consumer has agreed to the particular charging arrangement. In cases where this can be demonstrated, there are advantages in moving from the current arrangements - which often lack transparency - to an arrangement where the premium over the Transco-equivalent charge is explicit and crystallised at an agreed level.
- 4.34 For those I&C sites where agreement with the consumer can be demonstrated, the IGT serving that consumer must identify the premium over the Transco-equivalent charge that the charging arrangement equates to. Within sixty days of the implementation of RPC, Ofgem will require evidence of the consumer's agreement to the charge and the size of the premium. Subject to Ofgem's approval, charging for that site can then continue on the basis of RPC plus the agreed premium.
- 4.35 Those I&C sites that meet the above terms can be excluded from the profit monitoring arrangements set out in section 4.3 and the provisions for migration set out in section 4.4.

## ***Proposed arrangements for domestic infill sites***

- 4.36 As with I&C sites, there may be particular circumstances associated with existing domestic infill sites that may justify an IGT retaining its level of charges beyond the introduction of RPC.
- 4.37 For existing domestic infill sites, the IGT must identify the premium over the Transco-equivalent charge that the charging arrangement equates to and notify Ofgem. Notification of the premium must take place within sixty days of the implementation of RPC. Subject to Ofgem's approval, charging for that site can then continue on the basis of RPC plus the agreed premium.
- 4.38 Those domestic infill sites that meet the above terms can be excluded from the profit monitoring arrangements set out in section 4.3 and the provisions for migration set out in section 4.4.

## ***4.6 Summary and way forward***

- 4.39 This chapter has discussed the various legacy arrangements that currently apply to IGT charges, and sets out how these will be migrated into the new arrangements.
- 4.40 The next steps that need to be taken in this process are as follows:
- ◆ modifications to GT licences will be required in order to put RPC and the migration arrangements into effect. Consultation on the modifications will take place following the publication of this document. More detail on this process can be found in chapter six;
  - ◆ Ofgem will consider responses to the proposal for SLC 4C revised interim arrangements set out in the 2 May letter, and will publish conclusions later in July;
  - ◆ for those SLC 4 sites not adopting Transco-equivalent or RPC charging, profit monitoring will be enforced with submissions to Ofgem in December 2003, the details of which are set out in appendix 4;

- ◆ for all legacy domestic sites, within sixty days of the implementation date each IGT is to inform Ofgem of its proposed migration date together with supporting information as set out in section 4.4;
- ◆ for I&C consumers, within sixty days of the implementation date IGTs are to inform Ofgem of the premium above the Transco-equivalent charge that existing charges equate to, and provide evidence to Ofgem that such charges have been agreed by the consumer and should be maintained; and
- ◆ for domestic infill sites, within sixty days of the implementation date IGTs are to inform Ofgem of the premium above the Transco-equivalent charge that existing charges equate to.



## 5. Financial ring-fencing of IGTs

### *5.1 Introduction*

- 5.1 The Draft Proposals set out initial views on the financial ring-fencing of IGTs through the possible introduction of standard licence conditions in their licences. Financial ring-fencing provisions currently apply to licensed electricity distribution companies, electricity transmission companies and Transco. These conditions restrict the activities of licence holders and the use of financial resources and protect the licensee from financial pressures that might arise elsewhere in its group.
- 5.2 The financial ring-fencing conditions within Section C of the GT licence, which at present only apply to Transco, were summarised in the Draft Proposals and set out in full in appendix 6 of that document. These are:
- ◆ SLC 43 – restriction on activity and financial ring-fencing;
  - ◆ SLC 44 – availability of resources;
  - ◆ SLC 45 – undertaking from ultimate controller;
  - ◆ SLC 46 – credit rating of licensee; and
  - ◆ SLC 47 – indebtedness.
- 5.3 Financial ring-fencing of monopoly businesses provide important safeguards for the financial stability of licensed companies and offer two advantages for consumers:
- ◆ they should provide protection from certain events that might otherwise lead to the insolvency of the licensee and so protect consumers from the associated uncertainty and possible disruption; and
  - ◆ they should allow the licensee to retain access to financial markets on reasonable terms and so facilitate the funding of future investment programmes.

- 5.4 IGTs have significant monopoly power in providing gas transportation services to consumers connected to their gas networks. At present IGTs are smaller than Transco or licensed electricity distribution network operators with fewer consumers connected to their networks. Regulatory arrangements for IGTs should appropriately reflect these differences but should be no less effective in protecting consumers' interests.
- 5.5 Since the publication of the Draft Proposals the DTI has published a consultation paper on Proposals for a Special Administrator Regime for Energy Network Companies (16 April 2003). These DTI proposals could strengthen the protections offered to consumers if an IGT were to go into administration. Nevertheless, proposals for special administrators can be thought of as complementary to arrangements for financial-ring fencing rather than as arrangements that might supersede the conditions described in this chapter.

## ***5.2 Summary of responses***

- 5.6 The Draft Proposals asked whether:
- ◆ financial ring-fencing provisions should apply to IGTs;
  - ◆ the existing financial ring-fencing provisions set out in SLCs 43 to 47 would be appropriate given the circumstances of IGTs;
  - ◆ SLC 46 should be modified to reflect the circumstances of smaller companies;
  - ◆ the suggestions for 'keep well' agreements, or other alternative financial arrangements, would be appropriate; and
  - ◆ there should be any other changes to financial ring-fencing provisions for IGTs.

Ofgem received eight responses that dealt with these matters, five from IGTs and three from shippers / suppliers.

- 5.7 No IGTs supported the proposed licence conditions for financial ring-fencing. One IGT offered conditional support for the objectives of a number of licence

conditions but raised concerns over the implementation of those conditions. A number of IGTs questioned whether such provisions were necessary given the current financial circumstances of IGTs and the fact that no business failures have occurred. Some IGTs suggested that further consultation should be undertaken to consider how to deal with the problems that financial ring-fencing conditions are intended to address.

- 5.8 One IGT proposed that Ofgem should consider developing alternative arrangements, such as a transporter of last resort in cases where insolvency or other circumstances mean an IGT cannot operate a gas network, rather than attempting to impose financial ring-fencing conditions. It is not clear how such proposals might work or whether Ofgem would have the statutory powers to introduce such arrangements. Therefore, it will not be appropriate to proceed on this basis.
- 5.9 An IGT and a supplier suggested that a trigger point, relating to the size of an IGT, should be reached before the proposed licence conditions should take effect. It was said that in the electricity distribution sector an operator can provide use of system services to around 2,500 domestic consumers and remain exempt from the licensing regime and financial ring-fencing arrangements. There is some merit in these arguments and it will be appropriate only to impose the new arrangements on existing licence holders serving more than a predetermined number of consumers.
- 5.10 Of the shippers / suppliers, one fully supported the proposals for financial ring-fencing with the remaining respondents offering conditional support.
- 5.11 Relatively few respondents made specific comments on each of the proposed licence conditions, although one IGT has subsequently made further and more detailed representations on the impact of financial ring-fencing. Views of respondents and Ofgem's proposals in respect of each of the above licence conditions are set out below.

#### **SLC 43 – Restriction of activity and financial ring-fencing**

- 5.12 This condition would restrict the business activities of licence holders to gas transportation and related activities. It was generally opposed by IGTs, although

there was some support for the principle that IGTs should focus on gas transportation and related activities. One IGT stated that the proposals would restrict its ability to exploit skills and capabilities across other business activities and therefore constrain overall profits. The proposals were not felt to promote competition or put downward pressure on prices. Further evidence on the regulatory burden of these proposals was requested by shipper/suppliers.

- 5.13 SLC43 prevents a licensee from investing in any activity other than gas transportation, with the exception of *de minimis* activities, unless the Authority consents otherwise. Transportation encompasses network ownership, operation, connections and metering activities. Engaging in business activities other than gas transportation will tend to expose the licensee, and potentially consumers, to additional business risks. The activities of affiliates where the GT holds no investments would not be affected by this condition. The condition should therefore neither prevent skills from being exploited nor constrain the overall level of profits, provided an appropriate corporate structure is put in place.
- 5.14 No evidence has been provided that suggests this condition would lead to significant additional costs. Given that this condition is an essential component of the financial ring-fencing arrangements and in view of the comments above, it is proposed to introduce these arrangements for IGTs.

#### **SLC 44 – Availability of resources**

- 5.15 This condition would require that the licensee secures sufficient resources to carry on its licensed activities. A shipper / supplier stated that this condition was appropriate for all IGTs.
- 5.16 One IGT stated that there would be additional costs associated with obtaining a report from its auditors consistent with paragraph 5 of this condition, particularly given the timing of the report. In view of the limited scope of this report it is not clear that this would necessarily involve significant additional costs for a licensee. However, regard will be given to increasing flexibility of reporting dates during the licence modification process.
- 5.17 An IGT questioned why a certificate, consistent with SLC 44 (6), would be required before dividend payments are recommended or made in addition to

obligations under the Companies Act 1985. The obligations within SLC 44 (6) are an important element of the licence condition, providing incentives to ensure that the financial ring-fencing conditions are fulfilled and enabling Ofgem to receive the information necessary to carry out its functions.

- 5.18 As consumers rely on the GT for the provision of a monopoly service it seems reasonable to place an obligation on the licence holder to secure sufficient resources to carry on its licensed activities. It is therefore appropriate for this condition to apply to IGTs.

### **SLC 45 – Undertaking from ultimate controller**

- 5.19 This condition requires that a licensee obtains an undertaking from its ultimate controller with respect to compliance with its licence and other statutory obligations. An IGT questioned whether an undertaking between the IGT and ultimate controller would be effective in cases where enforcement action against the licensed company itself had failed. In addition, the respondent felt it was not clear what ultimate controller meant in all circumstances and expressed concern that it would restrict the ability of an unlisted company to raise finance. Additional representations included concerns that this condition would discourage investors and raise finance costs. Furthermore, it was stated that those willing to invest in the IGT would be likely to require some form of audit to determine their obligations arising from the undertaking.
- 5.20 The ultimate controller of a company is defined in condition 1 of the GT licence and includes any person in a position to control or exercise significant influence over the policy of the licensee by virtue of rights granted to them through contracts or ownership. Where groups of companies are concerned, consumers should not face risks arising from decisions made by a controlling company or person. An undertaking by a controller to refrain from any actions that would be likely to cause the licensee to breach its licence or other statutory obligations should reduce this risk.
- 5.21 At present, a number of regulated businesses are subject to financial ring-fencing conditions, which include requirements similar to SLC45. Typically, these conditions reduce risk for investors. Where investors exercise significant influence over a licensed business they should reasonably be expected to refrain

from action that may cause a breach of the licence holder's obligations. The obligations include those arising under the Gas Act 1986 (as amended) and the licence itself. The requirements of SLC 45 take into account the level of control exercised by investors.

- 5.22 It is important to protect consumers of essential gas transportation services from actions that may prejudice their best interest and so it is appropriate for this condition to apply to IGTs.

#### **SLC 46 – Credit rating of licensee**

- 5.23 SLC 46 requires that a licensee uses all reasonable endeavours to retain an investment grade issuer credit rating. An IGT stated that it would be expensive or impossible to achieve the requirements of this licence condition. A shipper / supplier suggested that modification to this condition to allow alternative financial arrangements to be accepted would be sensible.
- 5.24 This condition imposes an independently measured requirement which should generally promote financial security. The independent measurement of investment ratings makes them a preferred method of security over individually negotiated arrangements between a GT and Ofgem. However, obtaining an investment grade credit rating for a number of existing licence holders may be unduly expensive. In the water industry, credit rating conditions only apply to groups of companies serving in excess of 200,000 consumers.
- 5.25 It would be disproportionate to impose credit rating conditions on smaller existing licence holders where these would be costly and difficult to comply with. In these circumstances it is proposed to modify existing SLC 46 to allow Ofgem to give derogations to smaller licensees from the obligation to retain an investment grade credit rating.

#### **SLC 47 – Indebtedness**

- 5.26 This condition would restrict the ability of an IGT in creating mortgages, charges or other forms of security other than on certain specified terms and for a permitted purpose without the prior written consent of the Authority. It also prevents a licensee from entering into cross-default obligations. In broad terms, the condition requires IGTs to enter into commercial arrangements, necessary to

conduct their permitted purpose, on normal commercial terms. An IGT stated that this condition would restrict its ability to contract with other companies in its group and unnecessarily restrict its commercial freedom.

- 5.27 IGTs, and consumers connected to IGT networks, should be protected from the potential impact of inappropriate financing arrangements. In particular, a licensee should not engage in activities outside of their permitted purpose which introduces additional risk to the GT or its assets necessary to distribute gas to consumers. These restrictions should not unduly constrain an appropriately structured GT business. It may be possible for a GT to demonstrate alternative financial arrangements that satisfy the condition or its underlying principles.
- 5.28 Overall, this condition requires a GT to enter into business transactions on normal commercial terms. This is not considered to be an unduly onerous requirement and given the level of protection this condition affords consumers it is appropriate that this condition is applied to IGTs.

### ***5.3 Final proposals and way forward***

- 5.29 Overall, two key issues were raised by respondents. First, there was concern that the current drafting of the proposals reflected the circumstances of larger companies, particularly those which formed part of large groups. Second, that the regulatory burden of the proposals would be disproportionate in relation to the level of protection they give to consumers. Relatively few respondents explained in detail how financial ring-fencing conditions would materially effect the efficient operation of gas transportation services or quantified any increased regulatory burden.
- 5.30 It is appropriate to ensure that the costs of regulatory proposals are proportionate in relation to the benefits they deliver. Some of the financial ring-fencing conditions could impose significant costs on existing licensees. Therefore, it is proposed to introduce financial ring-fencing conditions for existing licensees if a licensee serves more than 30,000 consumers. The requirement for an investment grade credit rating will only be triggered when a licensee serves more than 300,000 consumers. This follows the precedent set in the water industry, where the credit rating conditions do not apply to smaller companies. These thresholds would apply to the total number of consumers served by a

group of companies, regardless of the number of GT licences it held. It is not the present intention to extend these derogations to new licensees.

- 5.31 It may be appropriate for transitional arrangements to facilitate the implementation of the financial ring-fencing arrangements. This may include the granting of specific derogations in respect of particular conditions for a defined period of time. Such derogations may be granted if it can be demonstrated that they would not expose consumers to additional risk, and are necessary to comply with the objectives of the conditions in a proportionate manner.
- 5.32 These issues will be taken into account during the licence modification process. The licence will be modified to move SLCs 43 – 47 from Section C of the GT licence to Section B and modify the conditions to allow the threshold derogations described above. These ring-fencing conditions would then apply to all licensed GTs.



## 6. The way forward

### **6.1 Introduction**

- 6.1 Chapters three to five set out Ofgem's final proposals for the regulation of IGT charging and financial ring-fencing. The final proposals follow over twelve months of consultation on the scope and form of regulation of IGT charging. A number of detailed discussions have been held with relevant stakeholders, including IGTs, shippers and consumer representatives. These proposals have been developed in the light of those discussions and modified where appropriate to ensure they meet Ofgem's statutory objectives in a reasonable and proportionate manner.
- 6.2 The final proposals offer a package of measures for the future regulation of IGT charges. The combination of measures should ensure consumers are appropriately protected by regulating charges for gas transportation services levied on shippers while at the same time ensuring that IGT's are not exposed to unnecessary business risk.
- 6.3 A number of steps are required in order to implement these proposals. These include:
- ◆ modification of existing licence conditions;
  - ◆ introduction of new licence conditions; and
  - ◆ dealing with migration arrangements.

### **6.2 Licence modifications**

- 6.4 Section 23 of the Gas Act 1986 (as amended) sets out the process and requirements to modify licences with agreement of GTs. To introduce the final proposals Ofgem intends to modify the existing standard licence conditions and possibly introduce special licence conditions. Transco has a number of amended standard licence conditions, including amended SLC 4 and 4A. It is for consideration as to whether these conditions will need to be modified as part of the above process.

- 6.5 Draft licence conditions will be prepared and sent to licensees for comment. This will be followed by the issuing of a statutory notice proposing to modify the licences and setting out the proposed modification. The notice should set out the effects of the licence modification, the reasons for the modifications and the date by which representations and objections may be made. Ofgem will consider carefully any representations made in response to the statutory notice and decide whether to proceed with the licence modifications.
- 6.6 If Ofgem is unable to proceed with the licence modification process because licensees do not consent to the modifications then it may be appropriate to make a reference to the Competition Commission pursuant to section 24 of the Gas Act.
- 6.7 The drafting of the proposed conditions will allow some discussion of the detail of the modifications, but the objective is for such details to reflect the broad proposals set out in this paper. At this stage it is envisaged that the licence modification should cover the following:
- ◆ introduction of RPC in the licence conditions for all new sites in accordance with the policy set out in chapter three of this paper;
  - ◆ arrangements for new infill sites. This will reflect the policy proposals to be published later in July or August on these matters;
  - ◆ migration arrangements for existing sites regulated by SLC 4, 4A and 4C, as set out in chapter four; and
  - ◆ financial ring-fencing conditions as discussed in chapter five.

### ***6.3 Structure of charges review***

- 6.8 Following publication of this document Ofgem also intends to initiate a review of Transco's structure of distribution charges. This will consider whether Transco's charges for distribution services are cost-reflective and provide appropriate signals for users of those services. The review will cover a range of issues including the balance of charges between end users and CSEPs, and the boundary between connection and ongoing use of system charges. The full

scope of the review will be discussed in an initial consultation document due for publication later this year.

- 6.9 If the outcome of the structure of charges review is not acceptable to IGTs they will be able to apply for a disapplication of the relevant RPC licence conditions – effectively rejecting the proposals set out in this document. In this instance Ofgem would have the opportunity to refer the matter to the Competition Commission for determination.

## ***6.4 Implementation timetable***

- 6.10 The intended timetable for implementation of the final proposals, along with other key dates, is set out below. The activities listed will run in parallel with the review of Transco's structure of distribution charges, which will begin following the publication of this document.

### ***Proposed timetable***

- July 2003: responses received and the final decision published on the revised SLC 4C Interim Arrangements.
- July / August 2003: Ofgem publishes an annex to this document setting out final proposals for the future regulation of domestic infill sites.
- September 2003: licensees consulted on the drafting of licence conditions.
- November 2003: Ofgem publishes statutory notice and initiates the statutory process necessary to allow the modification of licences.
- December 2003: licensees report on compliance with existing SLC 4.
- January 2004: target date for implementation of RPC.

# **Appendix 1 : Respondents to the December 2002 Draft Proposals**

British Gas Connections Ltd

British Gas Trading

East Surrey Pipelines

Gas Transportation Company

Independent Pipelines

Innogy

London Electricity

Scottish Power Gas

Scottish Power Retail

Scottish & Southern Electric Pipelines

Transco

United Utilities

## Appendix 2 : NExA AQ table

2.1 The NExA table is a standard matrix of AQs based on domestic property type and location. As the table shows, AQs are split into seven property bands for each of the three geographical regions.

**Table 2.1: NExA AQ (kWh) Table**

Domestic property types	South	Rest	North
1Bedroom	9,173	9,964	10,756
2BFlat, 2BTerrace	11,137	12,104	13,071
2BSemi, 2BDetached, 3BTerrace, 3BFlat	12,338	13,423	14,507
3BSemi, 2BBungalow	13,950	15,152	16,353
3BDetached, 3BBungalow	17,115	18,610	20,105
4BDetached, 4BTerrace, 4BSemi	20,720	22,508	24,296
5BDetached, 5BSemi, 6BDetached	31,447	34,172	36,898

2.2 The regions are:

- ◆ South (SW, NT, WS and SO);
- ◆ Rest (WN, SE, NW, EA, EM, WM and NE); and
- ◆ North (SC and NO).

## Appendix 3 : An example of RPC

3.1 This appendix illustrates how RPC will operate taking Transco's charges in Scotland as an example. It assumes that the initial difference between the CSEP and SSP charge is £40. The charging levels and caps and collars are all shown at 2003 price levels.

3.2 **Stage 1: Determine path of projected gas distribution charges for each region over twenty years** (from Table 3.1 in chapter 3)

Indexed start point (year 1 charges)	71.27
Indexed end point (year 20 charges)	64.62
% change in charges from year 1 to 20	9.33%
Annual equivalent % adjustment	0.49%

3.3 A decrease of 9.33% is equivalent to applying a factor of 0.91. The 20<sup>th</sup> root of this factor gives the annualised factor (i.e.  $\sqrt[20]{(0.91)} \approx 0.9951$ ). Therefore, the floor and ceiling decrease by **0.49%** each year

3.4 **Stage 2: Define initial floor and ceiling charge for each property**

Property SSP 'all the way' charge	60
Property CSEP charge	20
SSP less CSEP initial charge	<b>40</b>
Ceiling / floor band (+/-)	5%
Initial ceiling (40 * 1.05) =	42
Initial floor (40 * 0.95) =	38

3.5 **Stage 3: Generate floor and ceiling path for each property by applying % change annually**

3.6 Table 3.1 shows the floor and ceiling decreasing each year by 0.49%.

**Table 3.1: Floor and ceiling path**

Year	1	2	3	4	5	6	7	8	9	10
<b>Ceiling</b>	42.00	41.82	41.64	41.46	41.28	41.10	40.92	40.75	40.57	40.39
<b>Floor</b>	38.00	37.84	37.67	37.51	37.35	37.19	37.03	36.87	36.71	36.55

Year	11	12	13	14	15	16	17	18	19	20
<b>Ceiling</b>	40.22	40.05	39.87	39.70	39.53	39.36	39.19	39.02	38.85	38.68
<b>Floor</b>	36.39	36.23	36.08	35.92	35.76	35.61	35.46	35.30	35.15	35.00

**3.7 Stage 4: IGT calculates the Transco equivalent charge each year for each property**

In Year t=1 IGT charge equals initial charge. In year t=2 then:

**A:** Take starting SSP less CSEP charge in Year t=1 (i.e. 40 in the above example)

**B:** Adjust A by the proportional movement in the SSP 'all the way' charge between Year t=1 and Year t=2 (based on the average SSP charge of the different exit zones in each region)

**C:** If B lies within Ceiling and Floor for that year, then charge equals B

**D:** If B lies below Floor for that year, then charge equals Floor

**E:** If B lies above Ceiling for that year, then charge equals Ceiling

**3.8 For example:**

- ◆ Assuming the SSP charge in year t=2 decreases (based on the actual decrease in the average SSP charge of the different exit zones) to 59.07 from 60 in year t=1

- ◆ The new IGT charge in year t=2 would be calculated as follows:

$$\mathbf{IGT}_{t+1} = (\text{SSP}_{t+1} / \text{SSP}_t) * \text{IGT}_t$$

$$\mathbf{39.38} = (59.07/60) * 40$$

- ◆ The IGT would adopt the new IGT charge (**39.38**) as it lies between the new floor and ceiling for year t=2.

**3.9 Assuming the SSP charge moves in line with the expected movement in Transco's regional distribution charges, then the IGT charges would be as shown in Table 3.2:**

**Table 3.2: Projected decrease in the IGT charge**

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
<b>IGT charge</b>	40.00	39.38	38.76	38.16	38.07	37.98	37.89	37.80	37.71	37.62

<b>Year</b>	<b>11</b>	<b>12</b>	<b>13</b>	<b>14</b>	<b>15</b>	<b>16</b>	<b>17</b>	<b>18</b>	<b>19</b>	<b>20</b>
<b>IGT charge</b>	37.53	37.45	37.35	37.27	37.18	37.10	37.01	36.93	36.85	36.76



# Appendix 4 : Reasonable profit test for SLC 4 charges

## *The NPV and ROCE tests*

- 4.1 Where capital expenditure is recovered through SLC 4 charges, two tests would both need to be satisfied to determine whether an IGT has complied with the reasonable profit requirement: a Net Present Value (NPV) test and a Return on Capital Employed (ROCE) test. These two tests are summarised below.
- 4.2 Where no capital expenditure is recovered through SLC 4 charges, only the NPV test would need to be satisfied.
- 4.3 The NPV test would be based on each IGT's portfolio of projects that are charged for under SLC 4 and on out-turn costs and revenues in the preceding three financial years and the current financial year, plus forecast costs and revenues for the following twenty years. Using a discount rate equal to the maximum nominal cost of capital then:
- NPV of (turnover - operating costs excl depreciation + terminal asset values - capital expenditure)  $\leq 0$ .
- 4.4 The ROCE test would require that the average ROCE in the preceding three or more financial years would not exceed the maximum nominal cost of capital. The average ROCE is calculated as the sum of the last three years' operating profit divided by the sum of the last three years' average regulatory net asset value.
- 4.5 Ofgem may exceptionally give a derogation to allow the ROCE test to apply to a shorter period.
- 4.6 In situations where the NPV starts to become positive (for example in the case where the growth of an IGT business has slowed or ceased), Ofgem would consider a history of ROCE below the maximum nominal cost of capital as a mitigating factor.

## ***Determining costs and revenues***

- 4.7 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.
- 4.8 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.
- 4.9 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. For any sites charging under SLC 4 after 1 August 2003 it will be assumed that a reasonable proportion of costs are recovered through SLC 4B charges. It is the present intention to assume that as a minimum the cost of the service is recovered in this way, representing costs and revenues of £200 to £300 per connection.
- 4.10 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.
- 4.11 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.
- 4.12 Treatment of asset values and terminal values of assets at the end of the time period would require the application of straight-line depreciation over the accounting lives.

## ***Accounting treatment***

- 4.13 For the purposes of reporting costs, treatment should follow UK GAAP, unless otherwise directed by Ofgem. The following guidance covers the treatment of certain costs where Ofgem has previously prescribed specific accounting policies.

### **Capitalisation policy**

- 4.14 *Capitalisation of mains / services work*: all expenditure, meeting the definition of capitalisation in FRS15 "Tangible Fixed Assets", on mains and services shall be capitalised. Any arbitrary bases of assessment, such as value or the length of mains/services shall not be used as criteria for deciding whether expenditure should be treated as capital or revenue.
- 4.15 *Capitalisation of small tools and equipment*: all expenditure greater than £1,000 on individual items of small tools and equipment is to be capitalised.
- 4.16 *Capitalisation of interest*: all interest is to be recognised in the profit and loss account as incurred.
- 4.17 *Subsequent expenditure*: for subsequent expenditure incurred in replacing or restoring an existing asset (or component of an existing asset) to be capitalised:
- ◆ there has to be an assumption that there is a defined programme of overhaul and maintenance being carried out to maintain the standard of performance of the asset over its estimated useful economic life; and
  - ◆ it should provide an enhancement of the economic benefits of the existing asset in excess of the previously assessed standard of performance; or
  - ◆ relate to a major inspection or overhaul that restores the economic benefits of the asset that have been consumed by the entity and that have already been reflected in depreciation; or
  - ◆ where an existing asset (or a component of an existing asset) that has been treated separately for depreciation purposes and depreciated over its individual useful economic life, the carrying

amount shall be clearly identifiable and written out of the balance sheet.

- ◆ In accordance with FRS 15, expenditure to maintain an asset to its original safety standard, or to maintain its previously assessed standard of performance, would be an integral part of a defined maintenance programme and shall be recognised in the profit and loss account as incurred.

### **Asset lives**

4.18 Asset lives are assumed to be a minimum of twenty years.

### **Common, group and joint costs**

4.19 A method governing each IGT's respective common / joint / group cost allocation must be submitted together with the annual reports. The following high level principles have been identified as being appropriate when allocating common / group / joint costs:

- ◆ Consistency – where practicable all attributions, allocations and inter-business recharging of common / joint / group costs shall be consistent from year to year.
- ◆ Objectivity – attributions and allocation of common / joint / group costs shall be performed on an objective basis and not unduly benefiting the regulated business or any other business or company.
- ◆ Cost causality – common / joint / group costs shall be attributed or allocated in accordance with the activities which cause the costs to be incurred.
- ◆ Transparency – All methods used in the attribution or allocation of common/joint/group costs shall be transparent.

### ***Small company premium***

4.20 The February 2002 cost of capital consultation 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. As set out in chapter five Ofgem is proposing that larger IGTs should be required to comply with the financial ring-fencing licence conditions. In view of this, it is appropriate for the small company premium to be included in the allowed rate of return when assessing reasonable profits for these IGTs.

- 4.21 Ofgem's estimate for the cost of capital for IGTs is no more than a real 7.7 per cent plus a possible small company premium of 0.8 per cent.

### ***Other requirements***

- 4.22 SLC 4A(3) stipulates 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'. However, Ofgem would accept a report received in each calendar year that covered another 12-month period that had been agreed in advance with Ofgem.