

GAS DISTRIBUTION PRICE CONTROLS

1. This letter sets out Ofgem's present thinking on the:
 - separation of Transco's gas distribution price control;
 - calculation of regulatory asset values, the use of rolling incentive mechanisms and the treatment of any capital overspends at the next gas distribution price control review;
 - the calculation of the five year supplementary cap on replacement expenditure; and
 - the extension of the existing gas distribution price control by one year.

2. In the calculations underlying the 2001 Transco price control proposals, all non-mains replacement expenditure, including the replacement of gas distribution service pipes (the small diameter pipes connecting customers' premises with the mains) was treated as network capital expenditure, albeit with accelerated funding, so at the next price control review it will be appropriate to adjust regulatory asset values for this expenditure. These adjustments will be designed to ensure that only efficiently incurred capital expenditure is included in regulatory asset values and should be based on the guidelines set out below in paragraphs four and five. In making these adjustments, it will be necessary to bear in mind that a substantial number of distribution service pipes are replaced by the contractors Transco uses to carry out its mains replacement programme. Given that there are different incentive arrangements applying to capital and replacement expenditure, it may be necessary to give particular attention to the cost allocation and capitalisation policies applying to services and replacement expenditure, respectively, to ensure these are consistent with the approach adopted in setting the price control.

3. In June 2003 Ofgem published proposals for the separation of Transco's distribution price control into eight separate regional price controls. The licence modifications designed to put these proposals into effect were published pursuant to section 23 of the Gas Act in February 2004. In formulating the licence modifications, some small amendments have been made to the calculation of each regional network's regulatory asset value to reflect the best available information on separating the existing price control revenue allowances. These revised regulatory asset values are summarised in table one below. It should be noted that these are based on the projections of capital expenditure made at the time of the last price control review and at the next price control review they will be subject to the updating process described below in paragraphs four and five. With the exception of this updating no further changes to regional network regulatory asset values are currently envisaged. Appendix one sets out the regional network revenues consistent with the regulatory asset values in table one below.

Table 1: Regulatory Asset Values for Gas Distribution (£ millions, 2000 prices)

Regional network	RAVs at 1 st April 2002	RAVs at 1 st April 2007
Scotland	670	707
North England	1,072	1,108
North West	1,137	1,134
East England	1,865	1,791
West Midlands	903	909
Wales & West	915	947
London	1,024	1,000
South England	1,789	1,785
Total	9,376	9,382

4. At the next price control review adjustments to the values in table one will be made:
- to take into account variances (and the reasons for these variances) from the capital expenditure projections made at the last review; and
 - if there is clear evidence of inefficiency.

For each year of the period 2002/03 to 2007/08 these adjustments will be made on the basis of each of the individual network areas described in table one, depending on the pattern of any over and under spend within each of the network areas and the reasons for these variances. The treatment of variances is described in more detail below.

5. Ofgem's present thinking on appropriate incentives for operating and capital expenditure efficiencies were discussed in the December 2003 consultation on electricity distribution price controls. At this stage Ofgem expects similar principles to those described in the December 2003 consultation paper to apply to regional gas distribution networks from 1 April 2003. These changes would be put in to effect at the next gas distribution price control review. The principles are likely to include the retention of the benefits of efficient under spend for a period of five full years, in line with the arrangements that will be finalised as part of the electricity distribution price control review. Where capital overspend is concerned, Ofgem would expect to classify and treat the overspend as follows:

- if there is clear evidence of wasteful and unnecessary spending then this will not be included in a licensee's regulatory asset value;
- if costs are higher than allowed at the last price control review but are nevertheless consistent with efficient spending, in general there will be a symmetrical treatment of under and over spend. Therefore a licensee could expect to have to meet at least the return element of financing costs of overspend for a full five year period, after this full five year period had elapsed the amount of the overspend would be added to its regulatory asset value;
- where costs are higher, consistent with efficient spending and this spending can be clearly shown as providing significant benefits to consumers, such as in terms of being essential for security of supply, Ofgem would consider allowing the licensee to recover the regulatory depreciation and or return from the year the expenditure is incurred. For example, where additional spending arises from a government requirement not taken into account at the price control review and the spending is

efficiently incurred, Ofgem would consider allowing the licensee to recover the regulatory depreciation and return from the year the expenditure is incurred.

In conducting the next gas distribution price control review it will be appropriate to consult widely on these principles and establish whether they remain appropriate to the circumstances pertaining at that time.

6. The June 2003 proposals for the Separation of Transco's Distribution Price Control noted that alongside the mains replacement expenditure incentive mechanism is a requirement on Transco that will cap its outturn price control allowance for mains replacement expenditure over the five year period to the total of the price control projection for mains replacement expenditure made at the last price control review. In creating the regional price controls it was decided to retain this constraint on each individual network price control, but these would be relaxed if developments in either Transco's risk model or HSE requirements created a material loss of equivalence (that is having separate distribution price controls would reduce Transco's regulated revenue compared to a single price control). In the circumstances where Transco sells a regional network that network's five year mains replacement cap will be relaxed if the HSE require the network operator to increase the level of mains replacement activity in the relevant region beyond the level of activity envisaged at the last price control review. The calculation of the mains replacement caps for individual networks is described in appendix two.
7. In November 2003 Ofgem issued a press statement and open letter consulting on the possible extension of the gas distribution price controls by one year, suggesting that the controls would be in force from 2002/03 to 2007/08 (inclusive). Respondents to the consultation generally supported the proposals and as the reasons given for extending the price controls remain valid it is intended to proceed on this basis. These reasons include providing a balanced workload for companies and Ofgem, and, allowing gas distribution and transmission issues to be treated separately. In deciding how to extend the price controls it will be necessary to consider carefully respondents' views on matters such as the treatment of mains replacement expenditure and consult further on these issues. Nevertheless, the work associated with extending the price control will need to be proportionate to a one year interim arrangement and so where appropriate assumptions underlying the present price control will be extended or updated in a straightforward way to cover 2007/08.

Andrew Walker

Director – Regulation & Financial Affairs

Table 2: Regional network revenues (£ million, 2000 prices)

	Scotland	North England	North West	East England	West Midlands	Wales & West	London	South England
2002/03								
Opex*	94.6	133.4	128.2	179.2	99.8	120.0	112.8	183.1
Deprc	23.5	37.6	39.9	65.5	31.7	32.1	35.9	62.8
Return	42.5	67.9	71.2	116.6	57.3	58.0	64.2	111.9
Total	160.6	238.9	239.3	361.3	188.8	210.2	213.0	357.7
2003/04								
Opex*	90.8	123.8	128.4	169.2	89.7	114.3	107.9	176.6
Deprc	24.0	38.4	40.1	65.8	32.4	32.9	36.2	63.1
Return	43.5	68.8	71.2	116.1	58.0	59.1	64.2	111.8
Total	158.4	231.0	239.7	351.0	180.1	206.3	208.4	351.5
2004/05								
Opex*	92.2	124.6	124.6	171.5	89.6	115.4	102.1	174.5
Deprc	24.4	38.6	40.3	65.6	32.5	33.2	36.3	63.3
Return	44.0	68.9	71.0	114.9	57.6	59.4	63.8	111.8
Total	160.7	232.1	235.9	352.1	179.7	207.9	202.2	349.6
2005/06								
Opex*	90.8	124.8	127.5	167.5	89.4	113.2	103.3	178.5
Deprc	24.6	38.9	40.3	65.5	32.5	33.3	36.2	63.6
Return	44.2	69.0	70.8	113.8	57.1	59.3	63.2	111.6
Total	159.7	232.7	238.6	346.8	179.0	205.8	202.8	353.7
2006/07								
Opex*	88.6	122.4	129.0	165.8	88.1	109.9	102.2	179.6
Deprc	24.8	39.1	40.5	65.4	32.5	33.5	36.2	63.8
Return	44.2	69.1	70.9	112.6	56.9	59.2	62.7	111.5
Total	157.6	230.6	240.4	343.8	177.4	202.6	201.1	354.9

* includes 50% repex

Table 3: Regional network price controlled revenues (£ million, 2000 prices, X = 2%)*

	Scotland	North England	North West	East England	West Midlands	Wales & West	London	South England
2002/03	164.3	240.4	246.1	362.3	186.9	213.1	212.2	364.4
2003/04	161.9	236.9	242.5	356.9	184.1	210.0	209.0	359.0
2004/05	159.3	233.1	238.6	351.2	181.2	206.6	205.7	353.3
2005/06	156.4	228.7	234.2	344.7	177.8	202.8	201.9	346.7
2006/07	153.6	224.7	230.0	338.6	174.7	199.2	198.3	340.6

*the values in table 3 have the same present values as the totals in table 2, but have been sculpted using the X values in the price controls

Appendix 2

Transco's price control final proposals document described a supplementary incentive mechanism relating to mains replacement. This mechanism included a constraint such that over the five-year period of the aggregate total of the mains replacement 'price control allowances' would be no more than the aggregate of the 'price control projections'.

Although separate Network formulae only apply to the last three years of the price control period, this constraint will continue to be applied over the five years of the price control period. The aggregate total of Transco's two-year 'price control allowances' combined with the separate Network replacement three-year 'price control allowances' will be no more than the aggregate of the five-year 'price control projections' as set out in the table below.

Table 4: Mains Replacement Cap

Price control initial projection allowance (J_{it}) (£m 2000 Prices)	Formula year t				
	T = 1	t = 2	t = 3	t = 4	t = 5
i = 0	342	263			
i = 1			23.0	22.9	22.2
i = 2			35.0	37.7	37.4
i = 3			43.4	50.0	56.1
i = 4			47.4	42.9	43.6
i = 5			29.3	30.1	30.0
i = 6			28.2	27.0	25.4
i = 7			31.0	34.8	35.4
i = 8			50.4	58.4	63.4

If the aggregate total of Transco's two-year 'price control allowances' does not equal the aggregate of Transco's two-year 'price control projections', then the difference will be allocated to the total Regional Networks aggregated three-year 'price control projections'.

The difference will be allocated to the Regional Networks by prorating according to the Regional Networks aggregated three-year 'price control projections'.

The three-year constraint will be applied to the aggregate of the Regional Networks owned by each Licensee.