ofgem

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Dear Tim,

Ofgem has received a number of enquiries from interested parties regarding the environmental liabilities of Transco's regional gas distribution network businesses ("DNs"). In the interests of transparency, Ofgem has set out below, its preliminary views on the appropriate treatment of costs relating to such liabilities for purposes of future price controls. It will be appropriate to assess the level of any allowance for environmental costs to be taken into account in determining future price controls in the light of all relevant facts and circumstances relating to each particular case and in accordance with the Authority's duties.

It is important to make clear that this letter should not create any expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. The information and guidance in this letter is provided on an informal basis and should not be treated as binding on the Authority. Nothing in this letter is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statement made in this letter.

Environmental liability can be a complex matter. In the context of Transco's proposals to dispose of up to four of the DNs presently operated by it, this may present particular difficulty for both seller and purchaser. Nevertheless, it is a commercial matter for the parties to resolve. In particular, Ofgem expects purchasers of DNs to negotiate satisfactory commercial arrangements for the appropriate allocation of environmental liabilities as between Transco and the relevant DN company, in line with market custom and practice for comparable transactions. For this purpose, Ofgem expects that purchasers will undertake appropriate due diligence. It will be important that the arrangements which the parties conclude are transparent and provide clear accountability for the ongoing management of sources of environmental damage. It may be appropriate that they also provide for continuing mutual provision of appropriate technical advice and assistance, in order that information and best practice may be shared in the interests of minimising the overall costs borne by consumers.

For price control purposes, it has in the past been accepted that appropriate allowance should be made for the efficient level of costs of cleaning up contaminated land occupied for a purpose of the regulated business which are expected to be faced by a licence holder in the period of the control. Under this approach, any over- or under-spend, relative to the allowance made, in delivering equivalent outputs is for the licence holder's account (subject to the overriding requirement that no such costs should be funded more than once). Where under-spend results from delivery of fewer outputs it would be off-set against the cost of delivering the shortfall in future periods. This is consistent with the usual approach to costs necessarily incurred in the conduct of a regulated business.

In broad terms, Ofgem would expect to continue this policy at future price control reviews. Clearly, the level of costs associated with mitigation and remediation of environmental damage might change over time in response to changing environmental standards, changing technology, changing costs of disposing of contaminated materials, and so on. These would need to be assessed at the relevant time in the light of the best information then available.

Ofgem's preliminary view is that its approach should be based on the following principles:

1. there should be no discrimination between the NTS, retained DNs and independent DNs;
2. only efficiently incurred costs should be recoverable;
3. recovery would be based on Ofgem's view of where the liability giving rise to the costs lies in law; and
4. if necessary, adjustment(s) would be made to other relevant price controls to prevent any double counting of recoveries from consumers.

Where liability lies in law will be a function both of statutory provision and/or common law, on the one hand, and, where relevant, contractual arrangements on the other. For example, where two successive occupiers of the same land may under statute or common law both be liable for environmental damage arising out of activities conducted on that land, the parties may by contract establish the contributions each will make to settlement of claims adjudicated against any one of them and to the costs of remediation and reparation. In the absence of such arrangements, the court may adjudicate the respective contributions. Where either of the parties has become incapacitated, the whole of the liability could lie with the remaining party.

As noted above, Ofgem expects that NGT and DN purchasers will negotiate appropriate contractual arrangements to allocate environmental liabilities on a basis consistent with market custom and practice for comparable transactions. Ofgem intends to apply the principles set out above so as to ensure, as nearly as may be practicable, that the cost of discharging liabilities are recoverable, to the extent eligible, under the price controls of each affected company in accordance with their respective proportional contributions. Costs falling to Transco in respect of sites transferred to DNs that have been sold will, to the extent eligible, be recoverable under the NTS control. Ex ante allowances will be made on the basis of expected outcomes. Ex post adjustments will only be made in exceptional cases.

In assessing whether costs are efficient, Ofgem will be guided by all available evidence. Licensees will be expected to ensure that they are in possession of all information relevant to the assessment and management of environmental risks, to have in place efficient and effective strategies for this purpose, and to seek the least cost means of effective mitigation and, where

necessary, remediation. Consumers should not be expected to bear costs that could be avoided by prudent management action.

There are further issues raised by the possibility that a different level of costs might be incurred according to the specific change of use proposed for a given site. Ofgem's preliminary view is that consumers should only bear the costs required to achieve compliance with environmental standards applicable to use in the operations of the regulated business. To the extent higher standards are required because of change of use, Ofgem would expect the incremental costs to be met out of the development profit associated with the change of use. It would be open to the licensee in such circumstances to seek a contribution from the developer.

Moreover, Ofgem understands that, as envisaged by the MMC[1], Transco has in the past borne clean up costs in respect of the whole of so-called 'joint' sites (sites that contain both operational and non-operational areas). Nevertheless, the whole of the proceeds of disposal or redevelopment of non-operational areas has been retained by an affiliate (i.e. outside the regulated business). No adjustment has been made to Transco's regulatory asset value (RAV) to reflect these disposals, although such adjustments would have been consistent with the principle adopted by the MMC that the costs of decontaminating wholly non-operational sites should be financed from the proceeds of disposal with any uncovered balance being borne by shareholders. The MMC considered, however, that it was reasonable to allow for the total statutory decontamination costs of 'joint' sites to be recovered from revenues of the regulated business. In the light of this, and to the extent the disposals were consistent with the provisions of Transco's licence in force at the relevant time, however, it would not seem appropriate to make retrospective adjustments to the RAV.

In June 2003, Ofgem announced[2] that it will adopt a revised policy in relation to disposal of network assets, including property previously occupied by a regulated business. Under the revised policy, an adjustment will be made to the RAV five years after disposal to reduce the RAV by the amount of the disposal proceeds. This will still leave companies with an incentive to make efficient use of their assets, while enabling customers to share in the benefits of rationalisation on a similar basis to other savings in capital expenditure. In applying this policy to disposal of (formerly) contaminated land, the adjustment made to RAV should be consistent with the allocation of decontamination costs. Thus, to the extent decontamination costs have been borne by the company, and not by customers, they should be offset against disposal proceeds in determining the appropriate adjustment to RAV.

Yours sincerely

A Walker

Andrew Walker
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[1] Monopolies and Mergers Commission: BG plc, A report under the Gas Act 1986, The Stationery Office, May 1997

[2] Developing Network Price Controls: Initial Conclusions, Ofgem, June 2003