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Dear

## **GAS DISTRIBUTION PRICE CONTROLS – FURTHER CLARIFICATION**

Following the publication on 16 March 2004 of the open letter on Gas Distribution Price Controls it has become clear that there are a number of issues that would benefit from further clarification.

### **Non-Mains Related Replacement Expenditure**

The open letter explained that non-mains related replacement expenditure was capital expenditure that had been subject to accelerated funding. An important issue is the implication of this accelerated funding for the treatment of any overspends and the calculation of regulatory asset values. Given the benefits of transparency and certainty with respect to the calculation of RAVs there would seem to be clear advantages in clarifying the broad treatment of any overspend.

This accelerated funding was introduced at the last price control review in response to upward pressure on the total level of replacement expenditure created by the mains replacement programme. An incentive framework was put in place for mains related replacement expenditure by the introduction of a supplementary incentive mechanism. This was intended to deal with efficiency improvements, underspend and overspend for mains related replacement expenditure. With respect to the non-mains related replacement expenditure the intention in changing the price control treatment was to help ensure that Transco could finance its activities rather than change the incentives for efficiency improvements, underspend or overspend. In the light of these factors it would be inappropriate if decisions on funding had a significant impact on the incentives for overspend or underspend. Therefore, the intention is to treat any variances with the projections underlying the price control as variances against capital expenditure. The guidance set out in the letter of 16 March 2004 relating to capital overspends would apply to non-mains replacement expenditure overspends.

## **Transparency in the Calculation of RAVs and the Classification of Overspend**

At the next price control review any classification of overspend pursuant to the categories described in paragraph 5 of the 16 March 2004 letter would be a transparent process. This would allow the mapping of any overspend, on a year by year basis, to the RAV.

## **The Treatment of Shared Assets**

Transco has suggested that certain shared assets (including IS/telecoms systems, central stores and central furniture) are not direct assets for any particular distribution network, and that consequently, these assets and the RAV associated with them have been excluded from the sale process and will be retained by Transco, although they have been hypothecated between distribution networks in the calculations of RAVs underlying the separate price controls. Transco has estimated the net value of these assets at £121 million (out of a total RAV of £14.4 billion).

RAVs are an indicator of financial rather than operational capital therefore a change to a physical asset is neither a necessary nor a sufficient condition to trigger a change in a RAV. However, the RAV is calculated in a way that is designed to encourage efficient behaviour and it may, therefore, be appropriate to adjust a RAV for the disposal or transfer of assets. In making any adjustments to RAVs it will be important to ensure that consumers do not pay twice for any service and that the calculation of RAVs provides appropriate incentives for efficient investment. Where it is efficient to share assets then normal commercial arrangements would reflect this sharing and perhaps recover the cost of assets by recharging on the basis of usage. Consequently, at the next price control review it may be appropriate to make a revenue cost allowance for the iDNs to pay for the services provided by the shared assets that are retained by Transco (and make a compensating downward adjustment to the RAVs used to set the existing price controls). Within Transco's remaining price controls, it may be appropriate to either make a similar allowance for revenue costs or allow the assets to continue to be funded from the RAV. No adjustments would be made before the next price control review.

Yours sincerely

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