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## Further guidance on reasonable profit tests under SLC 4

1 As you will know, Ofgem has previously issued guidance in relation to the interpretation of reasonable profit under Standard Licence Condition (SLC) 4. This guidance has included:

- A consultation paper on 'Independent Gas Transporter charges and the cost of capital' published in February 2002;
- A letter on 'Recovery of payments to developers through transportation charges' sent on 22 April 2002;
- A letter on 'Definition of reasonable profit for Condition 4 transportation charges' sent on 29 November 2002;
- A further letter on 'Definition of reasonable profit for SLC 4 transportation charges' sent on 24 March 2003; and
- 'Final proposals for the Regulation of IGT Charging' published in July 2003.

2 All of these documents are available from Ofgem's website (www.ofgem.gov.uk) under the 'IGT Regulation' area of work.

3 This guidance has resulted in the definition of two reasonable profit tests that will be applied each year. As part of this process, those IGTs who continue to charge under SLC 4 are required to submit an annual report to Ofgem demonstrating their compliance with the reasonable profit tests. The first such submissions were made during 2003/4.

4 In the light of the submissions received, we thought it would be helpful to provide some further guidance on some of the key requirements of the reasonable profit tests. This should lead to a more straightforward procedure for both the production and validation of reasonable profit submissions in future years.

### *Summary of reasonable profit tests*

5 A summary of the reasonable profit tests is provided below, and the full guidelines are set out in Appendices 1 and 2 to this letter:

- Where capital expenditure is recovered through SLC 4 charges, two tests would both need to be satisfied to determine whether an IGT 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;

- The NPV test is based on cash flows from the previous three financial years and the current year, together with the forecast for the next 20 years. When discounted at the maximum allowed cost of capital, the NPV must not be positive;

- The ROCE test requires that the average ROCE based on the previous three financial years is less than the maximum nominal cost of capital. In general, the average ROCE is defined as the sum of the last three years operating profit divided by the sum of the last three years average regulatory net asset value;

- The current maximum real cost of capital is 7.7% (excluding the small company premium). Since Ofgem has indicated that it intends to introduce financial ring-fencing provisions for IGTs, an additional small company premium of 0.8% has also been allowed. This translates into a maximum nominal cost of capital of 11.21%, assuming an inflation rate of 2.5%; and

- Compliance with the reasonable profit tests will not be required if an IGT adopts Transco-equivalent charging (either continuously or on the basis of RPC) for *all* sites.

### *Further guidance on reasonable profit tests*

6 In the light of the reasonable profit submissions received from IGTs during 2003/4 we consider that it would be helpful to set out some more guidance of the form and content of future submissions. This should make for a more effective process in subsequent years.

*Real versus nominal values*

7 It is important to clarify how each component of the reasonable profit tests should be stated in submissions to Ofgem. In general terms, items other than regulatory depreciation should be expressed as they appear (or are expected to appear, in the case of forecasts) in licensees' statutory accounts. That is, they should appear in nominal (money of the day) terms and be prepared on a historic cost basis.

8 Submissions should include a table shown in Appendix 2 (shown for a submission made in time $T_0$) with all values expressed in nominal terms. For the avoidance of doubt, the following should be observed:

- Capital expenditure – capital expenditure should be included on a nominal basis (eg. fixed asset additions are included as spent);

- Gross asset values – should be expressed on a historic basis (eg. not inflated in future years);

- Regulatory depreciation – should be calculated on a straight line basis with an assumed 20 year asset life, and should be calculated as 1/20 of opening gross asset value in each year;

- Net asset values – should be modelled on a historic cost basis (eg. not inflated in future years);

- Closing Regulatory net asset values – should be calculated as the difference between the opening regulatory net asset value and regulatory depreciation;

- Terminal asset value – should be calculated as the closing regulatory net asset value in year 20; and

- Profits – other components of profit (turnover, opex etc) should be included in nominal terms.

9 To perform the NPV test, all values should be discounted back to the values applicable in the first reported year (ie. year $T_{-3}$ in Appendix 2). This will ensure consistent treatment of values across all years.

*Supporting documentation*

10 The reasonable profit submission should include a table as specified in Appendix 2 to this letter including a forecast for the next 20 years (this is based on the format provided in the 29 November 2002 letter). A short note on each item should be included with the submission. This needs to specify the approach taken in deriving the figures, and set out clearly all assumptions that were made, including the assumed connection profile (the number of connections assumed in each year of the 23 years of analysis).

11 A summary of the calculations used in carrying out the NPV and ROCE tests should also be included.

12 The latest available sets of both statutory and management accounts should be included in the submission, together with a reconciliation of key values to those presented as part of the reasonable profits analysis.

*Timing of submissions*

13 Unless agreed otherwise with Ofgem, reasonable profit submissions need to be received by 31 December in each year and cover the twelve months preceding 1 October of that year. In some cases Ofgem has agreed submissions to be made on a different timetable.

14 Submissions should be sent in electronic format to samanta.padalino@ofgem.gov.uk .

If you have any questions relating to the points raised in this letter, you can contact me on 020 7901 7072 or Samanta Padalino on 020 7901 7033.

Yours sincerely

Frances Warburton
Head of Gas Networks Regulation

# *Appendix 1: Reasonable profit test for SLC 4 charges*

## General

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.

2. Where no capital expenditure is recovered through SLC 4 charges, only the NPV test would need to be satisfied.

3. The NPV test would be based on each IGT's portfolio of projects that are charged for under SLC 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. The ROCE test would generally require that the average ROCE in the preceding three 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.

5. In situations where average returns based on the method described above start to exceed the maximum allowed cost of capital (for example in the case where the growth of an IGT business has slowed or ceased), Ofgem would consider using a longer historic time period in calculating the average ROCE. Hence, a history of average returns below the maximum cost of capital may be considered as a mitigating factor.

6. Ofgem may also exceptionally give a derogation to allow the ROCE test to apply to a shorter period. For example, by 31 December 2004, IGTs will be required to report the ROCE for 2003/4, and the average ROCE for 2002/3 and 2003/4 would be required not to exceed the maximum nominal cost of capital.

7. 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.

8. While the SLC 4 arrangements remain in place, the maximum real pre-tax cost of capital and the small company premium would be reviewed every five years. The current maximum real pre-tax cost of capital (7.7%) and small company premium (0.8%) would be applicable from 2002/3 to 2007/8.

9. Compliance with the reasonable profit tests will not be required if an IGT adopts Transco-equivalent charging (either continuously or on the basis of RPC) for *all* sites.

## Small company premium

10. The February 2002 cost of capital consultation paper suggested that a small company premium of 0.8% might be appropriate for IGTs. Since Ofgem has indicated that it intends to introduce financial ring-fencing provisions for IGTs, an additional small company premium of 0.8% has also been allowed.

11. Ofgem's current estimate for the maximum real cost of capital for IGTs is 7.7 per cent plus a small company premium of 0.8 per cent.

## Determining costs and revenues

12. 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.

13. 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.

14. 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.

15. 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.

16. 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.

17. 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

18. 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

19. 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.

20. Capitalisation of small tools and equipment: all expenditure greater than £1,000 on individual items of small tools and equipment is to be capitalised.

21. Capitalisation of interest: all interest is to be recognised in the profit and loss account as incurred.

22. 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.

23. 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

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

## Common, group and joint costs

25. 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 interbusiness 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.

## Real versus nominal values

26. Submissions should include a table shown in Appendix 2 (shown for a submission made in time T0) with all values expressed in nominal terms. For the avoidance of doubt, the following should be observed:

- Capital expenditure – capital expenditure should be included on a nominal basis (eg. fixed asset additions are included as spent);

- Gross asset values – should be expressed on a historic basis (eg. not inflated in future years);

- Regulatory depreciation – should be calculated on a straight line basis with an assumed 20 year asset life, and should be calculated as 1/20 of opening gross asset value in each year;

- Net asset values – should be modelled on a historic cost basis (eg. not inflated in future years);

- Closing Regulatory net asset values – should be calculated as the difference between the opening regulatory net asset value and regulatory depreciation;

- Terminal asset value – should be calculated as the closing regulatory net asset value in year 20; and

- Profits – other components of profit (turnover, opex etc) should be included in nominal terms.

27. To perform the NPV test, all values should be discounted back to the values applicable in the first reported year (ie. year T-3 in Appendix 2). This will ensure consistent treatment of values across all years.

## Supporting documentation

15 The reasonable profit submission should include a table as specified in Appendix 2 to this letter including a forecast for the next 20 years. A short note on each item should be included with the submission. This needs to specify the approach taken in deriving the figures, and set out clearly all assumptions that were made, including the assumed connection profile (the number of connections assumed in each year of the 23 years of analysis).

16 A summary of the calculations used in carrying out the NPV and ROCE tests should also be included.

17 The latest available sets of both statutory and management accounts should be included in the submission, together with a reconciliation of key values to those presented as part of the reasonable profits analysis.

## Timing of submissions

28. 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.

## *Appendix 2 – submission of reasonable profits (in year $T_0$)*

**(£000 money of the day)**

| | $T_{-3}$ | $T_{-2}$ | $T_{-1}$ | $T_0$ | $T_1$ | $T_2$ | $T_n$ |
|---|---|---|---|---|---|---|---|
| Turnover | x | x | x | x | x | x | x |
| Opex (excluding depreciation) | x | x | x | x | x | x | x |
| Regulatory depreciation | x | x | x | x | x | x | x |
| Regulatory operating profits | x | x | x | x | x | x | x |
| Capital expenditure | x | x | x | x | x | x | x |
| Opening gross asset value | x | x | x | x | x | x | x |
| Closing gross asset value | x | x | x | x | x | x | x |
| Regulatory depreciation | x | x | x | x | x | x | x |
| Opening regulatory net asset value | x | x | x | x | x | x | x |
| Closing regulatory net asset value | x | x | x | x | x | x | x |
| Average regulatory net asset value | x | x | x | x | x | x | x |
| Terminal asset value | | | | | | | x |
| Average ROCE | | | | x | | | |
| NPV | x | | | | | | |