Independent Gas Transporters
and other interested parties

Promoting choice and value for
all gas and electricity customers

Your Ref:
Our Ref: 86/10
Direct Dial: 020 7901 7481
Email: Regulatoryfinance@ofgem.gov.uk

Date: 16 July 2010

Dear colleague,

Reasonable profits test under the provisions of Standard Licence Condition 4A - cost of capital review

The reasonable profits test is used to assess licensees' compliance with Standard Licence Condition 4A ('SLC 4A') of the Gas Transporters Licence which allows no more than a 'reasonable' profit. This condition is only relevant for independent gas transporters (iGTs) since the incumbent gas distribution network operators (GDNs) are subject to different price control arrangements.

The reasonable profits test methodology was introduced in 2003 and subsequent guidance issued in November 2004[1] noted that the cost of capital would be reviewed every five years. Hence it is now time to review the cost of capital used in the test to ensure that the charges subject to the reasonable profits restriction still represent good value for consumers.

Any assessment of the cost of capital for the reasonable profits test should take due account of the business risks associated with the operation of the 'legacy[2]' distribution sites to which the regime refers. Additionally it should reflect the actual financing costs faced by the IGTs concerned. On this basis it seems appropriate to consult with all interested parties to understand their views on an appropriate cost of capital going forward. We anticipate that this issue will be of particular interest to iGTs but views from all stakeholders are welcome. Therefore, we are now asking all interested parties, including iGTs, to give us their own assessment of the factors affecting the cost of capital relevant to legacy site operation. In particular we are interested in views on:

- The particular business risks associated with this type of network operation
- Factors affecting the ability of iGTs to raise debt or equity finance at competitive rates, especially with reference to any characteristics of legacy network sites
- Factors affecting iGTs gearing levels
- Equity Beta
- Financing issues affecting iGTs as relatively small businesses
- The risks associated with bad debts or loss of revenues on legacy sites

It should be noted that recent cost of capital assessments for other regulated businesses indicate that an appropriate cost of capital may be somewhat lower than the 8.5% pre-tax real cost of capital previously used for the reasonable profits test as shown in the table in appendix 1.

[1] See http://www.ofgem.gov.uk/Networks/GasDistr/IGTReg/Documents1/8828-condition4_15nov04.pdf
[2] Legacy sites are those which were built before the introduction of the relative price control mechanism in 2004. Hence new legacy sites can no longer be created although existing sites may be extended.

As recognised above, the larger regulated businesses which have recently been reviewed face a different risk profile to iGTs so the figures in the table do not necessarily imply what the cost of capital for iGTs ought to be, although for market wide factors (such as risk free rate) they may be relevant to some extent.

Post-migration revenue

The current arrangements for the reasonable profits test require that iGTs forecast their costs and revenues as far as 2023. All iGT legacy sites will have migrated to the relative price control (RPC) by no later than 2020 which means that all iGTs have up until now had to report some projected RPC revenues as part of the reasonable profits test. This might mean that licensees are being unequally treated since migration dates are licensee specific meaning that the extent to which the reasonable profits test outcome is affected by post-migration revenue will vary by licensee.

In order to address this issue it is proposed that in future the reasonable profits test be assessed over the period from 2000 to the migration date for each iGT. We seek views on this proposal from respondents.

Timetable

Reasonable profits test reporting is due by the end of each calendar year. Our objective is to implement the updated cost of capital and any methodology changes (such as eliminating post-migration revenue from the test) for the reporting due by 31st December 2010. In order to meet this deadline we plan to implement any changes to the reasonable profits test by 31st October 2010, subject to proper resolution of all issues raised during the consultation.

To achieve this deadline we are asking iGTs and other interested parties to respond to this letter by 20 August 2010 with a workshop around the start of August if there is sufficient interest. After this a consultation on our proposals will be held prior to implementation of any changes.

If you would like to discuss any aspect of this letter then please do not hesitate to contact Dan Rock[3].

Yours sincerely

Rachel Fletcher
Partner, Local Grids

[3] Dan Rock, Manager, Regulatory Finance; Telephone: 0207 901 7481; Email: daniel.rock@ofgem.gov.uk

Appendix 1 – Comparison of the cost of capital for the reasonable profits test with recent regulatory settlements

	Original consultation[4]		DPCR5	Competition Commission's Provisional Findings re: Bristol Water[5]	
	Feb-02		Dec-09	Jun-10	
	Low	High	Final	Low	High
Cost of debt:					
Risk free rate	2.75	2.75			
Debt risk premium	2	3			
Cost of debt	4.75	5.75	3.60	3.90	3.90
Cost of equity:					
Risk free rate	2.75	2.75		1.00	2.00
Equity risk premium for the market	3.5	3.5		4.0	5.0
Gearing	37.5%	37.5%	65.0%	60.0%	60.0%
Equity Beta	0.70	1.00		0.64	0.92
Small company premium	0	0.8		0	0
Post tax cost of equity	5.2	7.05	6.73	3.56	6.60
Taxation adjustment (multiplier)	1.43	1.43	1.39	1.39	1.39
Pre-tax cost of equity	7.4	10.1	9.3	4.9	9.2
Real pre-tax WACC	**6.4**	**8.5**	**5.6**	**4.3**	**6.0**
Vanilla WACC	**5.03**	**6.56**	**4.69**	**3.76**	**4.98**
8.5% set as cost of capital for reasonable profits test in 2002					

[4] See page 12 of http://www.ofgem.gov.uk/Networks/GasDistr/IGTReg/Documents1/397-20feb02.pdf
[5] See page N58 of http://www.competition-commission.org.uk/inquiries/ref2010/bristol/pdf/appendices_and_glossary_merged.pdf

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**