

BG plc

A report under the Gas Act 1986 on the restriction of
prices for gas transportation and storage services



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**Presented to the Director General of Gas Supply
May 1997**

Members of the Monopolies and Mergers Commission as at 29 May 1997

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¹These members formed the Group which was responsible for this report under the chairmanship of Sir Graeme Odgers.

Note by the Director General of Gas Supply

In accordance with section 25(6) of the Gas Act 1986, the Secretary of State has directed the Director General of Gas Supply to exclude from the copies of the reports on references under section 24 of that Act to be sent to the Gas Consumers' Council and published under section 25(5) *(b)* of that Act, certain matters the publication of which appears to the Secretary of State to be against the public interest or the commercial interests of certain persons. These omissions are indicated by a note in the text.

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Part I

Summary and Conclusions

1 Summary

1.1. Under the reference (see Appendix 1.1) made on 14 October 1996 by the Director General of Gas Supply (the Director General), we are required to report on whether the continuation, without modification or cessation, or the cessation, of Special Condition 9C of the Public Gas Transporter Licence (the licence) of British Gas plc (BG)¹ operates or may be expected to operate against the public interest. Special Condition 9C restricts the price of BG's transportation and storage services, which are operated by Transco, a separate business unit of BG.

1.2. The reference followed the rejection by BG of proposals by the Director General in August 1996² to amend that charging condition. The Director General had proposed a reduction of 20 per cent in BG's transportation charges in 1997/98, to be followed by a requirement that charges increase by no more than the change in the retail price index (RPI) less 2.5 percentage points (referred to as RPI-2.5) from 1998/99 to 2001/02. During our inquiry, BG argued that it would need to increase charges by RPI-2.25, without any initial price reduction, in order to be able to finance the carrying on of its activities. In March 1997, during the course of our inquiry, the Director General suggested that the initial reduction in charges should be 29 per cent, but still subject to a restriction of RPI-2.5 thereafter.

1.3. The Director General also proposed a number of other amendments to the structure of the charging formula and other provisions of the charging condition, some of which were disputed by BG. We agree with the Director General's proposals that prices for storage should be separately regulated. We also agree that the structure of the transportation charges formula should be changed: that only 50 per cent of revenues should vary according to volume; that the charging formula should be based on a distinction between supplies to large and small users; and that the costs of non-daily meter reading be separately passed through in charges, subject to an economic purchasing requirement. Among various provisions which the Director General wished to amend but we have found not to operate against the public interest are that which allows BG to request full disapplication of the licence condition if a matter is not referred to the MMC; and that relating to the obtaining by the Director General of information about BG's capital investment and its publication.

1.4. In assessing the appropriate level of charges, we have concluded that a real, pre-tax cost of capital of 7 per cent should apply for Transco. This is consistent with the range of 6.5 to 7.5 per cent we put forward in a previous report on gas (the 1993 MMC report)³ but below

¹In February 1997, British Gas plc became BG plc. In this report, BG refers to British Gas plc or to BG plc as appropriate.

²1997 Price Control Review *British Gas' Transportation and Storage: the Director General's final proposals*, Office of Gas Supply, August 1996.

³*Gas: Volume 1 of reports under the Fair Trading Act 1973 on the supply within Great Britain of gas through pipes to tariff and non-tariff customers, and the supply within Great Britain of the conveyance or storage of gas by public gas suppliers*, HMSO, Cm 2314, August 1993. At the same time the MMC also reported on references made under the Gas Act published as *British Gas plc: Volume 1 of reports under the Gas Act 1986 on the conveyance and storage of gas and the fixing of tariffs for the supply of gas by British Gas plc*, HMSO, Cm 2315, August 1993. Two further volumes providing the supporting factual analysis and account of

that which BG thought appropriate.

1.5. Other important financial issues arise primarily from the fact that the market value of the shares in BG at privatization and thereafter represented a substantial discount to the balance sheet replacement cost of the assets. These issues include: how to value the assets for regulatory purposes, since to allow a full return on the replacement cost of assets would result in shareholders recovering significantly more than the value of their initial investment, and in prices to users higher than is necessary to enable Transco to finance the carrying on of its activities; how to apportion any discount on balance sheet replacement cost between different businesses; how depreciation should be treated, in allowed revenues and in rolling forward the assets-whether it should be based on the value of assets in the accounts, a value reflecting shareholders' investment, or the cost of actual replacement; how to roll forward (that is, update and revalue) the resulting value of the regulated business (on the basis of replacement cost, or a general indicator of inflation such as RPI) both to the start of the period under review and in future.

1.6. In the 1993 MMC report, in considering the cost of capital and the asset base to which it should be applied, the MMC took into account the ratio of the 1991 market value of BG's shares to the balance sheet value of its assets, referred to as the market to asset ratio (or MAR), and apportioned equally across BG's businesses. We believe that approach to the valuation of assets at December 1991 remains appropriate. Given that discount on book value, we accept the Director General's arguments that to allow full depreciation in revenues during the period under review may be expected to result in prices higher than necessary to finance the carrying on of Transco's activities, to the detriment of consumers of gas. We have concluded that for the period under review only MAR-adjusted depreciation should be allowed on pre-1992 assets and full depreciation on subsequent investment. We have also concluded that the regulatory value of assets from April 1997 should be rolled forward by reference to the RPI and not CCA replacement cost. This approach would in our view ensure that charges to users provide a reasonable return on shareholders' existing investment and on new investment by Transco thus enabling the company to finance the carrying on of its activities.

1.7. The Director General's published proposals in August 1996 were based on a regulatory value at April 1997 of £12.4 billion (at 1996 prices). In March 1997, during the course of our inquiry, the Director General proposed a lower figure of £10.9 billion (at 1996 prices). She did so because she was concerned that the full depreciation that had been allowed in revenues in the period up to 1997 had resulted in prices to customers higher than necessary to enable the company to finance its functions; full depreciation should therefore be deducted from assets for the period up to 1997 in order to rectify that. In our view, the effect on prices is likely to be offset by other factors, including the impact of holding losses on the 1997 regulatory value. We also believe it generally inappropriate to recover revenue allowed in a previous price control period when a regulator decides to change for the future the basis on which such revenues should be calculated. We have concluded that the appropriate regulatory value of Transco at 1 April 1997 is £11.6 billion (at 1996 prices) having taken into account BG's recent actual capital investment.

1.8. The appropriate level of revenues is significantly affected by capital investment and operating costs. The Director General's August 1996 proposals were based on investment of £4.0 billion (at 1996 prices) over the five years from 1997/98; she subsequently reduced this figure to £2.4 billion. BG proposed some £4.5 billion capital investment. We believe a figure of almost £4.1 billion would be appropriate subject to possible upward adjustment for mains

views submitted to the MMC were published as *Volume 2 of reports under the Gas and Fair Trading Acts*, HMSO, Cm 2316, September 1993, and *Volume 3 of reports under the Gas and Fair Trading Acts*, HMSO, Cm 2317, September 1993.

replacement expenditure if the proposed review by the Health & Safety Executive (HSE) requires this.

1.9. Whereas BG put forward operating expenditure of almost £7.7 billion (at 1996 prices) over the next five years, we believe a figure of almost £7.1 billion on an equivalent basis would be appropriate, reflecting greater manpower reductions and recent reductions in rates. (Recent reductions in the meter-reading activities undertaken by BG further reduce this figure to almost £6.7 billion.) This compares with £6.6 billion put forward by the Director General in her August 1996 proposals and £6.1 billion in her March 1997 proposals.

1.10. On the basis of our consideration of the above issues, we have concluded that the continuation without modification of the current charging condition may be expected to operate against the public interest, by generating revenues higher than necessary for Transco to finance its activities (see paragraph 2.182), contrary to the interest of consumers; cessation of the charging condition would also be expected to operate against the public interest (see paragraph 2.184). We have recommended separate charging conditions for transportation and storage to remedy the adverse effects, which would result in a 21 per cent initial reduction in charges (subject, as with the Director General's proposals, to adjustment for under-recovery of revenues from the previous period). Charges would subsequently be allowed to increase by no more than RPI-2.