

Summary of Letter of Comfort

This memorandum sets out the terms of the letter and accompanying Memorandum, dated 23rd October 2001, from the Chairman of the Gas and Electricity Markets Authority, to Sir John Parker, the Lattice Group Chairman, in connection with Transco's acceptance of Ofgem's Final Proposals for Transco's Price Control Review from 2002.

The Memorandum referred to was a note circulated to members of the Authority setting out topics covered and points made in meetings between senior Ofgem personnel and senior Lattice executives.

The note drew the Authority's members attention to:-

1. The potential for charges for lane rentals under the New Roads and Streetworks Act 1991.
2. The Health and Safety Executive Fundamental Review of Gas Safety.
3. The Energy Review
4. The treatment of tax in relation to replacement expenditure.
5. The position on pensions.

All members of the Authority whom the Chairman had been able to contact had confirmed that they were content with the points made to Transco in connection with the issues, subject to one point of clarification regarding pensions.

In relation to lane rentals and the HSE Fundamental Review of Gas Safety, the general philosophy that Ofgem would adopt in respect of adverse changes in these areas would be that if the impact was not material on Transco's ability to finance its activities, it would not propose to take any action. However, if there was a material impact, Ofgem would be prepared to re-open the Price Control to ensure that Transco's revenues increased to reflect the additional costs. Ofgem would want to ensure that these were efficiently incurred.

As regards the Energy Review, Ofgem considered that it was difficult to see how additional costs might be imposed though it was possible that moral pressure might be felt. However, if the Energy Review resulted in a mechanism that imposed additional material costs on Transco, affecting its ability to finance its business, Ofgem would be prepared to re-open the Price Control.

As regards any potential change in tax treatment of replacement expenditure, Transco had expressed concern about the potential cash flow impacts of Ofgem's position as set out in its letter of 5th October to Lattice Group's Director of Regulation and Corporate Affairs. This was because, should Transco lose the case against the Inland Revenue at first instance, it might be well advised to make a payment of tax due, while continuing to appeal, in order to minimise costs. The Authority, having reconsidered the matter, was of the view that, if Transco received professional advice,

with which Ofgem were happy, that it would be cheaper to make an interim payment while continuing to fight the case, Ofgem should consider whether to re-open the Price Control as opposed to waiting until the case is finally lost. If Ofgem did re-open the Price Control where no definitive tax ruling had occurred, it would need to guard against giving Transco a new Price Control only to find that the decision eventually went in Transco's favour. It would want to explore with Transco the alternatives to revising the Price Control while the tax situation remained unclear. One position would be to increase Transco's short term gearing. This is different from the position which would arise under a definitive tax ruling when Ofgem accepted the need to re-open the Price Control without any further consideration of gearing levels.

As regards pensions, Ofgem's view was that additional pension costs were a normal business risk and the automatic re-opening of the Price Control for a material change would not be appropriate. However, Ofgem would be happy to discuss with Transco any problems associated with the pensions shortfall, should that occur, and would be prepared to consider re-opening the Price Control, but would not guarantee so doing in those circumstances.