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OFGEM'S "RPI AT 20" PROJECT

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1. MAJOR ANNOUNCEMENT: “RPI at 20”.

MAJOR OFGEM PROJECT:"RPI AT 20"

- A two year project making its first report to Sir John Mogg and GEMA in summer 2010 – twenty years after DPCR1 started.
- A new team will be set up in Networks Division under leadership of Steve Smith, MD Markets … Director of Regulatory review TBA.
- The team will be assisted by a high level advisory panel … this will be chaired by Alistair Buchanan, CEO Ofgem … will meet once Ofgem team in place … will include NED's from GEMA.
- DPCR5 will run to its conclusion in December 2009 and if anything the DPCR5 team will feed into the "RPI at 20" team … therefore both companies and capital markets should approach DPCR5 as the fifth in a consistent process. (i.e. DPCR1 through to DPCR5).
- If there are macro/major changes recommended in 2010 then DNO's would probably be unaffected until 2014/15 review. (i.e. DPCR6).

CONSULTATION AND INVOLVEMENT PARAMOUNT

CHANGES WILL NOT BE TAKEN LIGHTLY

- Value of GB networks - £32bn.*
  - Electricity transmission £6.2bn.
  - Electricity distribution £13bn.
  - Gas transmission £2.4bn.
  - Gas distribution £10.5bn.

- Percentage share of networks in average domestic bill:
  - Electricity 24% (distribution 21%, transmission 3%)
  - Gas 21%.

(*: 2006 data shown)

JUST TOO BIG AND TOO IMPORTANT TO TREAT AS "AN EXPERIMENT"

2. RPI-X: A VERY SUCCESSFUL PRODUCT.

RPI-X: A VERY SUCCESSFUL PRODUCT

A 20 year "score card" would read:

- Major savings for consumers
- Quality – up.
- Investment – up.
- Innovation – encouraged.

A SAFER, MORE EFFICIENT, HIGHER INVESTED INDUSTRY

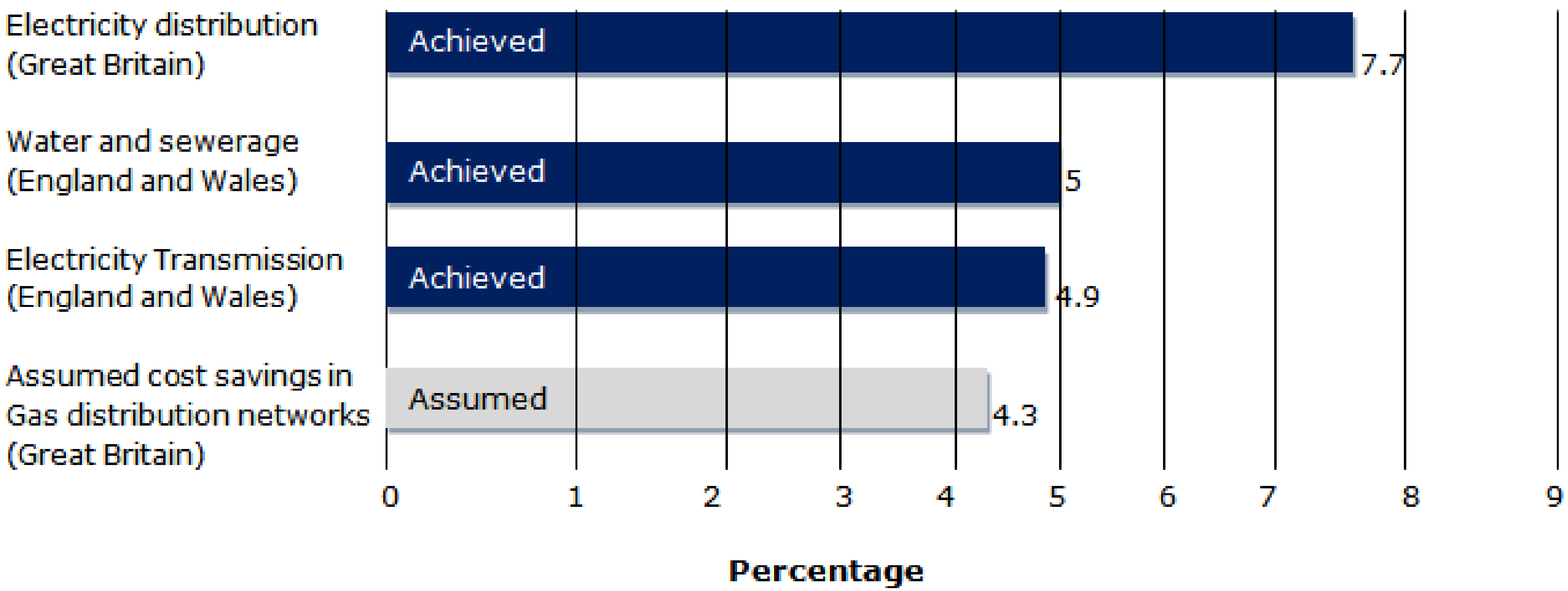
NETWORK CHARGES SINCE PRIVATISATION

The RPI-X approach has been very successful in encouraging efficiency, thereby reducing charges substantially in real terms.

- Electricity distribution – 50% since 1990.
- Electricity transmission – 41% since 1990.
- Gas transportation – 41% since 1994

ANNUAL COST CUTTING BEHIND SAVINGS

Yearly reductions in operating expenditure as a result of comparative regulation: existing examples compared to the sale of gas distribution networks.

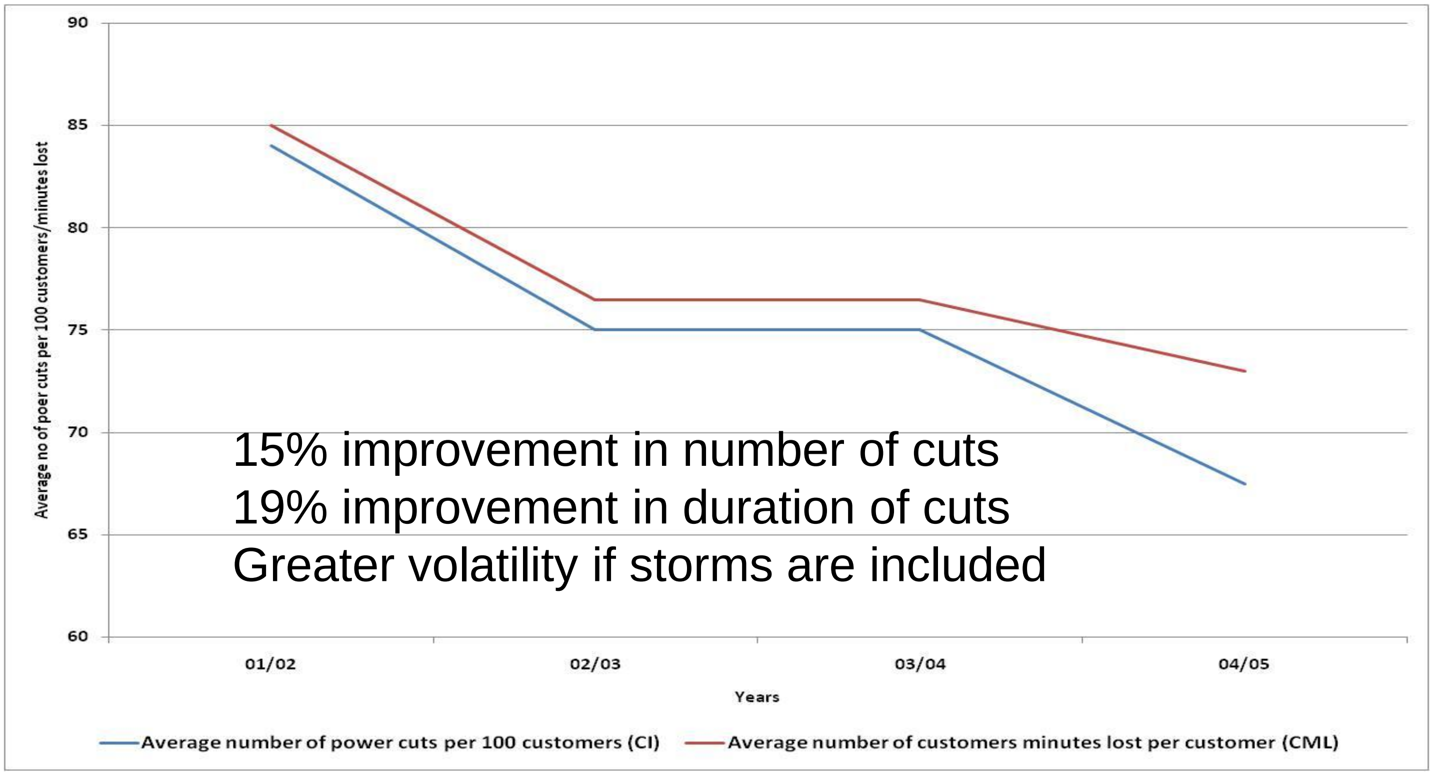


Source for achieved reductions in operating expenditure: CEPA's Final Report on productivity improvements in electricity distribution networks (November 2003) – covers periods of up to 11 years.

SQUEEZING THE FAT LEMON

QUALITY UP

Number and duration of power cuts (2001/2 to 2004/5) – excluding exceptional events.



1990-2005 POWERCUTS -11% DURATION – 30%

QUALITY OF SERVICE INCENTIVES 2005-10

- Tighter interruptions targets:
  - 4% average improvement in CIs.
  - 13% average improvement in CMLs.

- Stronger incentives to improve:
  - +/- 3% revenue exposure.

- Separate arrangements for storm events:
  - “Gates” defined in terms of number of faults.
  - Payment to customers for failure to re-connect within specified deadlines

- New package introduction for GDN’s in GDPCR1

OFGEM’S CONSUMER FIRST PROJECT LINKS PCR’S TO CONSUMERS

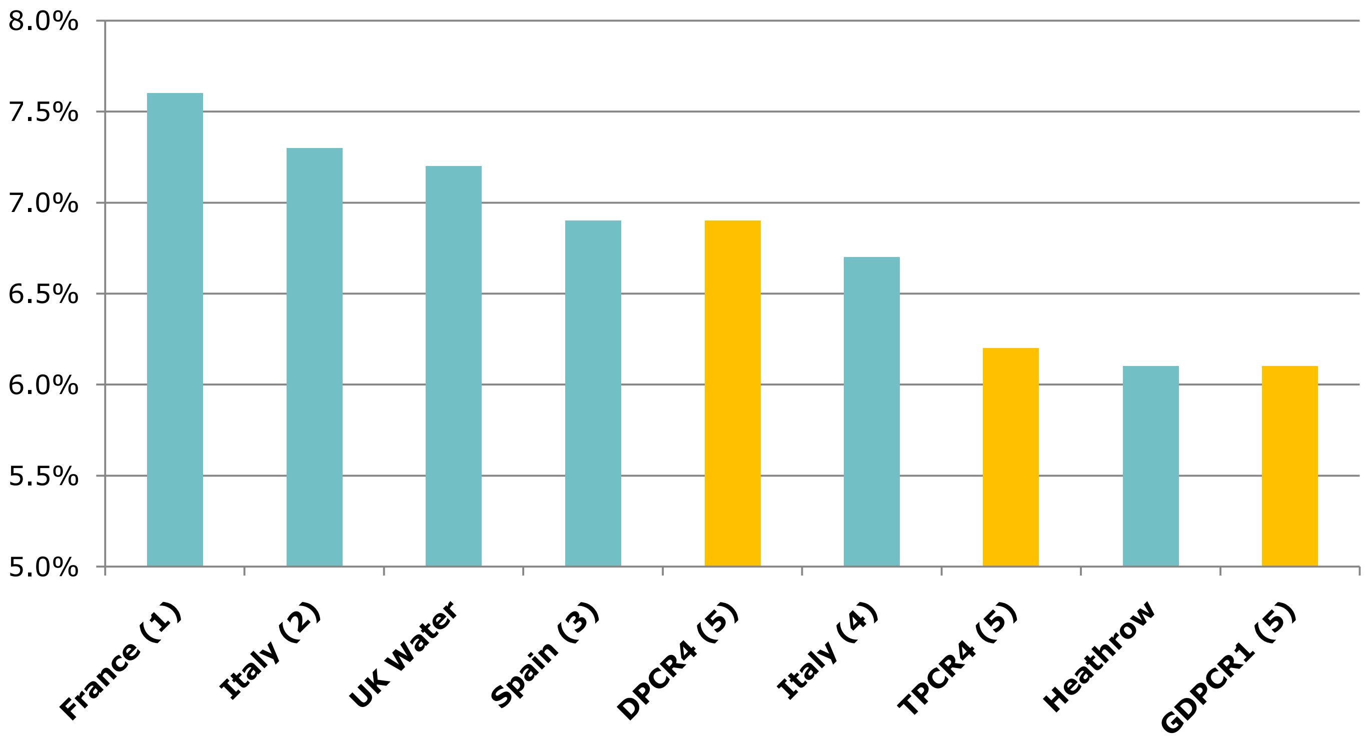
INVESTMENT UP

- Investment under CEGB.
  - Transmission networks £1.3bn in 1984 – 1989 (£0.25bn/year).
  - Distribution networks £3.8bn 1986-1990 (£0.75bn/year).

- Investment under price controls.
  - Electricity transmission networks £6bn 1991-2005. (£0.4bn/year).
  - Electricity distribution networks £15.5bn 1991-2005 (£1bn/year).
  - Projected electricity investment under DPCR4 £7.4bn (£1.5bn/year)
  - Projected transmission networks under TPCR4 at £5.7bn. (£1.14bn/year).
  - Capex overspend on GDN partially funded in 2006 and capex up £260m pa to £345m pa and repex increases from £492m pa to £772m pa under GDPCR1

UNDER RPI-X INVESTMENT HAS BEEN HIGHER THAN IN THE PERIOD BEFORE PRIVATISATION

SECURING A LOW COST OF CAPITAL



Source: Goldman Sachs/SSE

Key;
1.Transmission from Jan 05
2. Distribution 04-07.
3. Distribution current.
4. Transmission from Feb 04.
5. Post tax vanilla WACC.
TPCR4 5.05%
Heathrow 5.06%
GDPCR1 4.94%

HUGE BENEFIT TO CONSUMERS FROM LOW WACC.

RPI-X HAS BEEN FLEXIBLE ENOUGH TO EVOLVE

- **Sustainability challenge.**
  - DNO's: Losses, green reporting, IFI, RPZ,DG incentives
  - TO's: Losses, SF6 incentive, 4 projects get direct funding (called TIRG project).
  - GDN: Rural connection, gas quality incentive, shrinkage incentives.
  - Volume driver: Gone from GDN, TO – going from DNO.
- **Balancing "regulatory interrogation versus regulatory intrusion".**
  - Cost saving programme after DPCR4 saved £20millon more on RAV for consumers.
- **Meeting the changing patterns of supply and demand.**
  - Since privatisation 30GW of generation has connected and 24GW has left the system.

RPI-X = SAVE **TO** RPI-X = SPEND AND SAVE

HOW HAS THIS SUCCESS AND FLEXIBILITY BEEN ACHIEVED?

- **Regulatory framework has adapted.**
  - Line based regulation (IFI, RPZ).
  - Individual capex settlements (TIRG, Milford Haven).
  - Generous incentives (SD issues).
  - Shifted the intensity of focus on both incentive and comparative based regulation.
  - Outputs and quality have gone up the agenda.
  - Differential costs of capital (TIRG versus TPCR4).

- **While keeping the capital markets confidence… "hard gained but easy lost".**
  - Stability … based on RPI-X and set financial parameters.
  - Clarity … lots of consultation and regular communications.
  - Consistency … true to incentive and comparative based regulation.

CAN THIS APPROACH CONTINUE TO DELIVER?

3. WHY CHANGE WINNING FORMULA?

SO WHY REVIEW A WINNING FORMULA?

- **Good housekeeping.**
- **Fits in the regulatory cycles.**
- **Evidence available on DPCR4 initiatives.**
- **Align with European Regulators Agenda.**
- **Paradigm shifts? Renewables, better regulation, financials.**

RIGHT TIMING IS CRITICAL

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WHY REVIEW NOW – EXTERNAL INTEREST

- **“We are concerned about the direction of UK energy regulation signalled by recent PCR’s. As well as being by far the most complex price control framework we have seen since privatisation, we are concerned that the proposed approach is in our view suggesting a rapid movement towards a rate-based model … albeit with lower returns than such regimes usually enjoy” - CEO Company A.**

- **“For network utilities the game has changed substantially over the last few years and I believe that we have come to the end of the road on the “easy” opex savings. On climate change the key question is whether network utility regulation should be used as a wider tool – through network pricing or particular access priorities – to secure the climate change agenda” – MD Company B.**

- Lots of interest externally: SDC, Parliament etc.

THE COMPANIES GENERALLY SUPPORT A REVIEW

WHY REVIEW NOW – PARADIGM SHIFTS?

- **Better Regulation.**
  - What would the **framers of RPI-X say** now to a process that after 20 years takes 2 years of consultation, taking more data, and arguably starting to lose the ability to identify big differences between companies.
  - What do the **consumers** say to such excellent but horribly complex concepts such as sliding scale IQI regulation (see Appendix for example!).

- **Financial**
  - Do the prices paid for network companies suggest a paradigm shift in valuation and/or structure … or should we be mindful of Dot Com mania?
  - Are we valuing inflation linked networks properly.
  - In our concern to protect the consumer from network company failure (Ofgem's "tool kit" of cash lock down etc) have we:
    - Created a false optimism of protection for network owners whose finances are sloppy or worse fail?
    - Do we need to clarify how licence revocation would work?

- **Renewables**
  - Can we hit 33GW connected renewable power by 2020?

BIG QUESTIONS REQUIRE CONSIDERED RESPONSES

IS THE LEMON SQUEEZED?

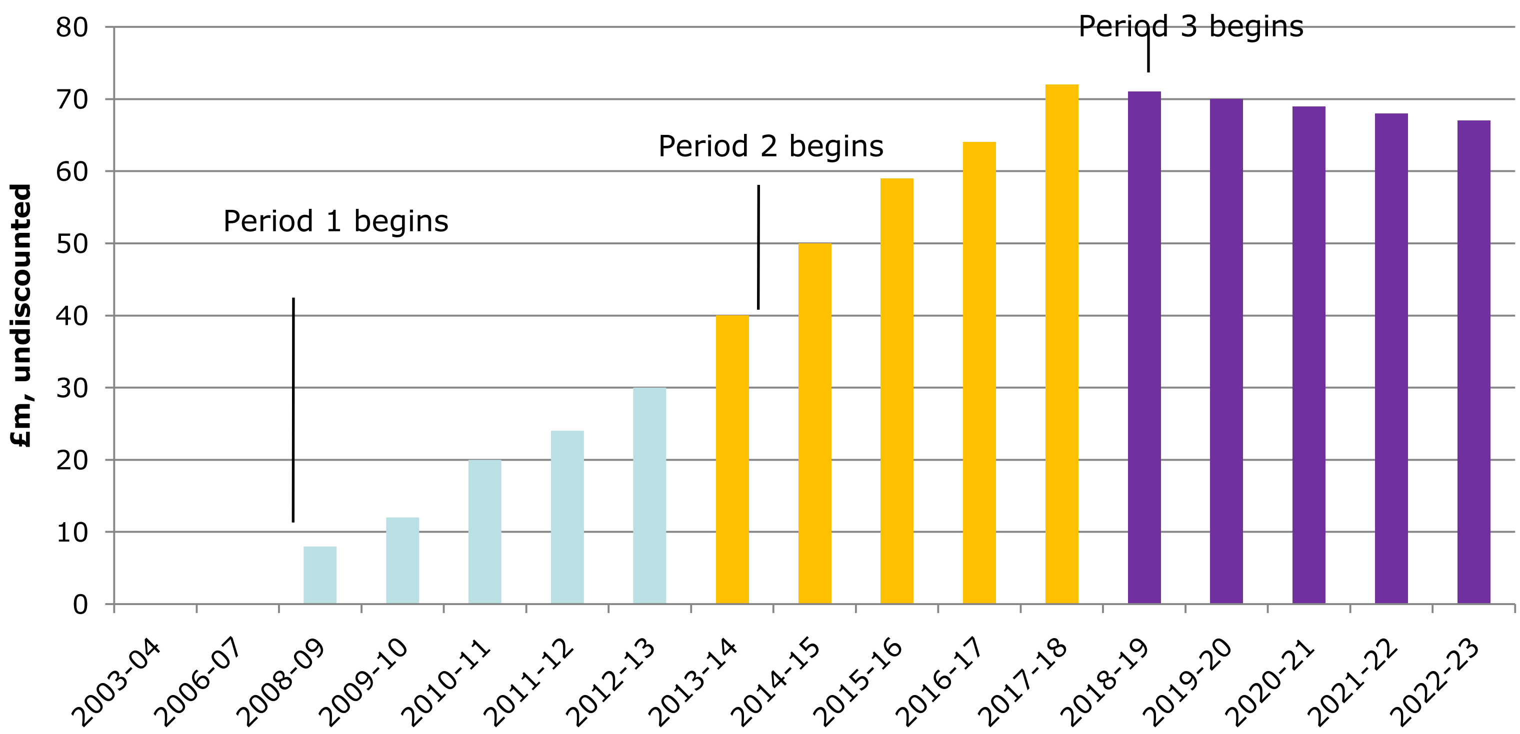
Electricity Distribution Charges

	Po Adjustment (average)	"X" Factor (p.a.)
1995 - 99	-25.5%	-3%
2000 - 05	-24.5%	-3%
2005 - 10	**+1.3%**	**0%**

MAYBE ON ELECTRICITY – NOT ON GAS.

CLASSIC BENEFITS OF RPI-X STILL TO COME ON GDNS

Savings p.a.



Source: NAO

ON GAS THE BIG SAVINGS EXPECTED POST GDPCR2.

4.The scope of Ofgem’s review.

THE SCOPE OF THE REVIEW: BIGGER PICTURE(1)

- Helm:
  - CAA has primary duty to encourage investment – should Ofgem?
  - 10 year price cap.
  - Split cost of capital.
  - Index cost of debt to market rates.

- Pollitt and Littlechild:*
  - Look at public contest model.

- Littlechild and Doucet:
  - Look at negotiated and unique individual settlements (with or without Consumer Advocate) … TPCR4 showed that 3 TO's were very different.
  - Settlements can stand for longer time periods.
  - Settlements in US context get rid of long regulatory litigation – could they in the UK get rid of long consultation process?
- Holt:
  - Ideas on protecting sectors from systemic default and financeability risks.

(* Dr Michael Pollit, Cambridge University is Ofgem's in-house academic advisor).

OFGEM MUST LISTEN TO IDEAS.

THE SCOPE OF THE REVIEW: BIGGER PICTURE (2)

- **House of Lords Science & Tech Committee:**
  - Provide indicative capex and rates of return for 5 years after formal 5 year review.
  - Index cost of debt to market rates.
- **Smithers:**
  - Revisit their Autumn 2006 report – Prepared for Ofgem.
- **CAA:**
  - "Constructive engagement" at Manchester airport etc.
- **Water Regulators in Scotland:**
  - "4plus 4 years" price control reviews

- **MOD/HMG**
  - Significant security costs put into RAV … worth examining the appropriate cost of capital for these assets?
- **HSE**
  - Could their role change with regard to safety tolerance levels, repex programme etc.

AT LEAST WE SHOULD SATISFY OURSELVES "WHY NOT" TO OTHER IDEAS.

THE MECHANICS OF THE PCR'S NEED AN MOT

A range of examples prove the point:

- **Pensions:**
  - What do we do with a surplus?
- **Cliff Edge Depreciation: (See pages 27 and 28)**
  - We have finessed the underlying revenue/asset relationship.
  - Will this cause the RPI-X regime a major problem in the future?
- **Consistency between reviews:**
  - Gearing ratios (57.5%, 60%, 62.5%), and choice of credit ratios.
  - Sliding scale (yes for DNO, and GDN but not TO).
  - Merger tax : needs a review.
  - Risk and return of T versus D – do we need greater clarity?

  Or should we be less consistent between sectors and companies?
- **Deferred Tax:**
  - Are we properly assessing the benefits that accrue to companies?

EVERY PCR ANORAK WILL HAVE THEIR OWN FAVORITE

THE MECHANICS OF THE PCR'S

- **Costing in Shadow Cost of Carbon etc:**
  - Are we fully capturing the value?
  - Why not a RPI-X + E?

- **Assessing the relationships of risk and reward:**
  - Are companies too easily reverting to lowest risk/lowest return approach?.
  - Does TO "lean" on SO's access to IAE etc.
  - Does the climate change agenda demand a greater incentive for companies to be rewarded for taking risks.

- **The final CC hurdle - does it still do the job?:**
  - Not an effective challenge – 1995 SHE v Ofgem – 13 years!

- **Does voluntary regulation work:**
  - Since DPCR4 DNO pricing methodology and EHV has been very "hard going".
  - Cost reporting not supported enough by a number of DNO's

AN "MOT" INVOLVES MANY OTHER PARTIES.

CLIFF EDGE DEPRECIATION

- **DPCR3 and DPCR4 set precedent to protect licensees revenues and financial ratios by reducing the regulatory life of post vesting assets … that protects the company from the "shock" when pre-vesting fully depreciated … so post vesting assets lives were dropped from 33 years to 20 years, and the difference smoothed over 15 years.**

- TPCR4 followed this precedent, but with "bespoke solution".

- **<u>Questions</u>**
  - Can we keep using this accelerated depreciation policy?
  - Should England/Scotland inter connector be included (currently not as it is subject to revenue driver).
  - Cliff edge helps tax position (allowances) – so differential treatment on accelerated depreciation could count twice.

MY ANORAK MOMENT!

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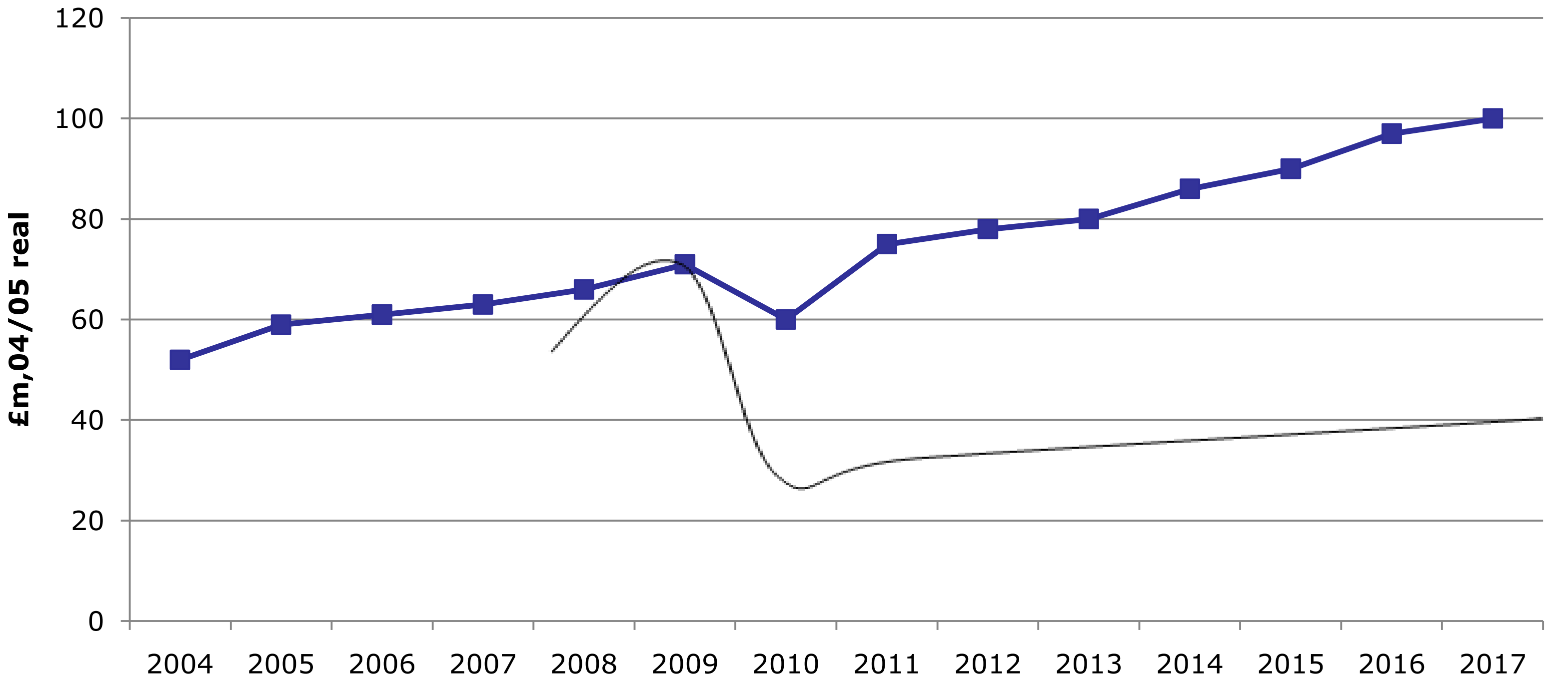
THE IMPACT OF OF CLIFF EDGE DEPRECIATION

Revenues



Source: Ofgem
Key: A network company's revenues with/without adjustment for "cliff edge"

ARE WE BUILDING UP A FUTURE PROBLEM?

5. THE RISKS TO THE REVIEW.

THE RISKS OF THIS REVIEW

- Capital markets will fear
  - Retrospective action.
  - Sudden announcements – new directions.
  - Rumour mill.
  - We fully understand this and it is “business as usual” unless changes (consulted upon) announced AND if in doubt call our City Liaison Unit (Charles Gallagher/Alex Lyon).

- Some comfort.
  - Insulating DPCR5
  - Capital markets will be represented on Ofgem’s advisory panel.
  - CC always a route for action.
  - Consultation is in our DNA.

COGNISCANT OF RISKS

OFGEM COMMITTED TO A CAREFUL APPROACH

- Guiding principles

  (1)“I recognise the importance of stability in the regime and would require a convincing case to be made before proposing radical change” Stephen Littlechild 1990.

  (2)“Capital market trust is hard won and easily lost” Alistair Buchanan – today.

CAPITAL MARKETS LIKE EARLY WARNINGS.