

ALISTAIR BUCHANAN
SPEECH AT SBGI - 6TH MARCH 2008

OFGEM'S "RPI at 20" PROJECT

SUMMARY

In 2010 electricity regulation will be twenty years old. It's a regime that has delivered so much in its time. It has taken us from the costly inefficiencies of the former nationalised industry to much lower network prices, better quality of service and substantial increases in investment.

Even so, the time is right for a review and that is why I am announcing today Ofgem's plan to review the regulatory regime for monopoly energy networks. Our review comes at a time when there is considerable interest in energy network regulation, across the board from academics to the companies themselves. There is a desire to analyse both the effectiveness and appropriateness of the current model. The latter being particularly relevant set against a new European regulatory agenda, continued focus on better regulation by the British Government, but especially the new renewables and carbon reduction agendas.

And now is a good time from a purely pragmatic operational perspective for the industry and Ofgem. For the past four years we have all been locked into delivering five sets of energy network price controls. Now we have a period of relative calm to enable us to consider the future.

We are acutely aware that the announcement of this review might stir up concerns.

By way of assurance I want to immediately flag up a key tenet of Ofgem's thinking: **consultation and involvement of interested parties is paramount.** So before any decisions are taken everyone with a stake in this industry will be able to take part.

If the review team recommends changes they will only do so after careful consultation and analysis.

This review will look at the big picture and the detail; and we believe will be a rewarding exercise in itself. Ofgem's primary role is to **promote and protect consumers' interests** and this "RPI at 20" project gives consumers both the opportunity for involvement (in what is 25% of their bill) and reassurance that Ofgem is continuing – on their behalf – "to kick the tyres".

THREE IMMEDIATE QUESTIONS

I think the first question that those close to the industry will ask will be **how is this review going to affect the next electricity distribution price control** scheduled to come into effect in 2009? This is something I know will particularly concern those in capital markets.

Companies and capital markets can assume that because the "RPI at 20" project will not report until 2010, the next price control will run its own course. That course will be broadly consistent with previous price controls and will be fleshed out shortly in the "DPCR5 First Consultation" document.

Indeed it is highly likely that the price control team will feed its findings into the project team's work. Consequently if there are changes recommended by the review then the DNOs would probably be unaffected until 2014/15. But please appreciate that this is only guidance and I cannot fetter Ofgem or GEMA's judgment on this at this stage.

And how will the review be managed?

A new team will be formed with its own Director, and this will report to Steve Smith, MD Networks Division. We plan to have this team in place by the summer. It will be assisted by a high level advisory panel Chaired by myself.

Initial soundings on joining the advisory panel from a number of senior representatives have been encouraging, and they will be joined by some non executive directors of Ofgem. Steve Smith's team will aim to report to Sir John Mogg and the Ofgem Board in summer 2010.

So what happens in 2010?

After the Board has considered the findings of the "**RPI at 20**" project we would seek to outline the "next steps". Essentially there would be three options: no change, major change or somewhere between the two. Either of the second two options would trigger consultation. So do not fear that your voice will not get a chance to be heard. Clearly any proposed change would have to be benchmarked against any potential loss of benefits that had been achieved to date. Certainly whichever option is chosen by the Board we would intend to publish our thoughts.

... PERHAPS THE BIGGEST QUESTION OF ALL – WHY CHANGE A WINNING FORMULA?

Standard business thinking says you should review a product regularly. But the pivotal importance of the energy networks to Britain means we can't engage in change for change's sake.

Stability in the regulatory regime has won much for customers by fostering confidence in the City to bring low cost of capital.


But stable and static are not necessarily equivalents. And the environment in which networks are operating is far from static. We are already a good way into a changing world of escalating importance in the environmental and social exclusion concerns that make up sustainable development. Those changes place new demands on the country's infrastructure operators.

The Government has just announced ambitious renewables targets for 2020 and this together with our 2004 sustainability duty, leads naturally to our asking the question: is the current regulatory regime still appropriate? New nuclear connections, heavy promotion of distributed energy solutions or smart grid developments all ask new questions of the infrastructure and therefore of the regulator.

Will the UK model fit in with the network regulation envisaged for Europe and expected to be managed by the new European Agency Regulatory body? How will it line up with Brussels' package of measures proposed for addressing vertical integration across European energy giants?

These questions and reasons make a compelling case for a review. And we consider the appetite for a review to be strong among interested parties.

Here are a few quotes that illustrate this:



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

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I would like to add to the case with a couple of particular interests of my own.

A few years ago I spoke at the Institute of Economic Affairs², on Better Regulation, and in that speech I referred to my worries over the increasing complexity of price controls.

Arguably the current approach to price controls struggles to meet the call for simplicity from the Better Regulation Commission (as was). For example it takes two years of extensive consultation to complete a price control.

This - even after 20 years experience when arguably the most debatable aspects of price controls have been thoroughly debated. While undoubtedly very clever, some schemes in our price controls, such as the IQI sliding scale, are virtually unfathomable to those outside the cognoscenti.

Secondly, I worry that we at Ofgem have not fully understood whether there has been a paradigm shift in financing. Maybe we should not be concerned about the rapidly rising valuations and that the markets will resolve such issues. Alternatively we could be misrepresenting consumers' best interests by arguing that the tried and tested financial parameters and tests that Ofgem uses are still suitable.

Whether there has been a shift in financial valuations or not there remains a spectre of what we do with company failures or requests for significant financeability hand-outs. Fortuitously Ofgem has not had to handle either so far.

Even still, I believe capital markets and companies would benefit from greater clarity about the adequacy of Ofgem's current "tool kit" of cash lock downs, special administration and so on. And I am concerned that our tool kit is more about cure than prevention. Generally, it provides fixes after a company failure rather than guidance on what a company might expect during a price control negotiation should it become apparent that financeability is a big issue.

WHAT WILL WE REVIEW?

The scope of this review is substantial: we want to look at the big picture and at the local detail.

The review team will want to take sightings from various vantage points to get its bearings for the big picture. These will include academic analyses, the perspectives of public bodies and other regulators.

Academic: Leading regulatory thinkers including Littlechild³, Doucet⁴ and Michael Pollitt¹ (Ofgem's in-house consultant) have been advocating quite different approaches to regulation recently. They have probed whether consumer advocate, public contest, easier settlement models are the next step for GB. Others have kept closer to the existing model. For example such as Derek Holt⁵ on financeability, and company failure through systemic risk, and Dieter Helm⁶ notably on split cost of capital, have been raising legitimate questions. Ofgem should also revisit the work done by Smithers⁷ and Co for the TPCR4 in the light of market movements.

Public bodies: We are interested in the ideas of the Parliamentary Select Committees. And the review gives us the opportunity to discuss issues with the public bodies that are closely involved to the price controls. For example does HSE have a particular view on safety tolerance levels in the future? or does the MOD think that RAV'able security costs could be charged at a different level from standard WACC?

Other regulators: Ofgem is always willing to listen and take on good ideas from other regulators. For example should we try to adopt more of the CAA's constructive engagement model or perhaps we could consider the approach taken by the Water Commissioners in Scotland, who have opted for an approach that looks beyond the current cycle into the next?

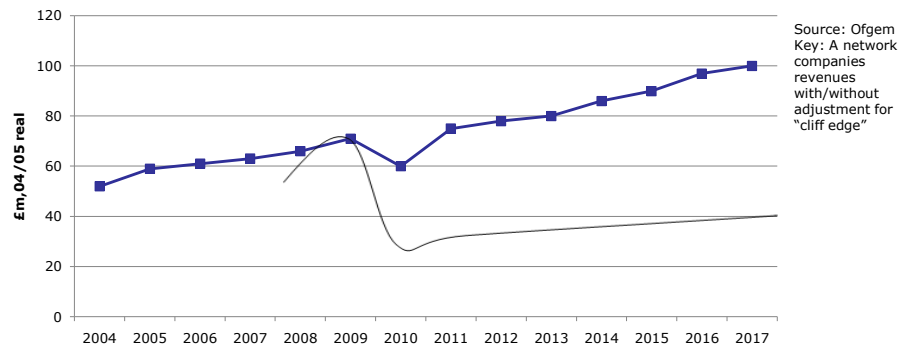
Our review should not be insular. As an active member of the European Regulatory bodies, CEER and ERGEG, we can review "best practices" from across the EU and also look more widely internationally.

At a more local level the review provides an opportunity for Ofgem to get under the bonnet and give the price control car an MOT. Some areas that could benefit from this I would suggest are:

- Pensions: should we specify now how we handle a surplus?
- Cliff edge depreciation: are we creating a problem for future regulators in our application of accelerated depreciation?
- Consistency on financial indicators: gearing ratios, credit ratios, and merger tax rules all fall into this category.
- Deferred tax: are we properly assessing the scale of upside for companies?
- Costing-in the shadow cost of carbon: are we doing this holistically?
- Does the Competition Commission appeal option still appear reasonable⁹?

THE IMPACT OF OF CLIFF EDGE DEPRECIATION

Revenues



ARE WE BUILDING UP A FUTURE PROBLEM?

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One critical factor of the review that straddles the macro analysis and the 'MOT' work is the thorny issue of risk and reward. We need to revisit the extent to which after 20 years the companies might be more comfortable with a low risk/low reward approach. This has particular resonance in the sustainability field as we should test the appetite for potentially quite significant reward as an incentive to assist the Government to meet its 2020 targets.⁸

Regulatory risk in company operations brings me neatly to the risks associated with a review.

HAVE WE CONSIDERED THE RISKS?

The capital markets and the companies are likely to fear a regulatory review if it seeks to claw back retrospectively; if there are sudden lurches in regulatory direction; and if the rumour mill creates instability.

Ofgem fully understands this – as does the Board. I can offer some comfort.

- We are insulating the next set of price controls for the electricity distribution companies. The **“RPI at 20”** project will report after they are completed.
- Capital markets and companies will be represented on Ofgem’s advisory panel.
- Most actions taken by Ofgem are appealable.
- Consultation is in our DNA - indeed we have already had fruitful conversations with other regulators and Government officials.

Today’s announcement is intended to be an ‘early warning’ that we are doing a review. Meanwhile it will be business as usual, and change (if there is change) will not come before a lot of consultation.

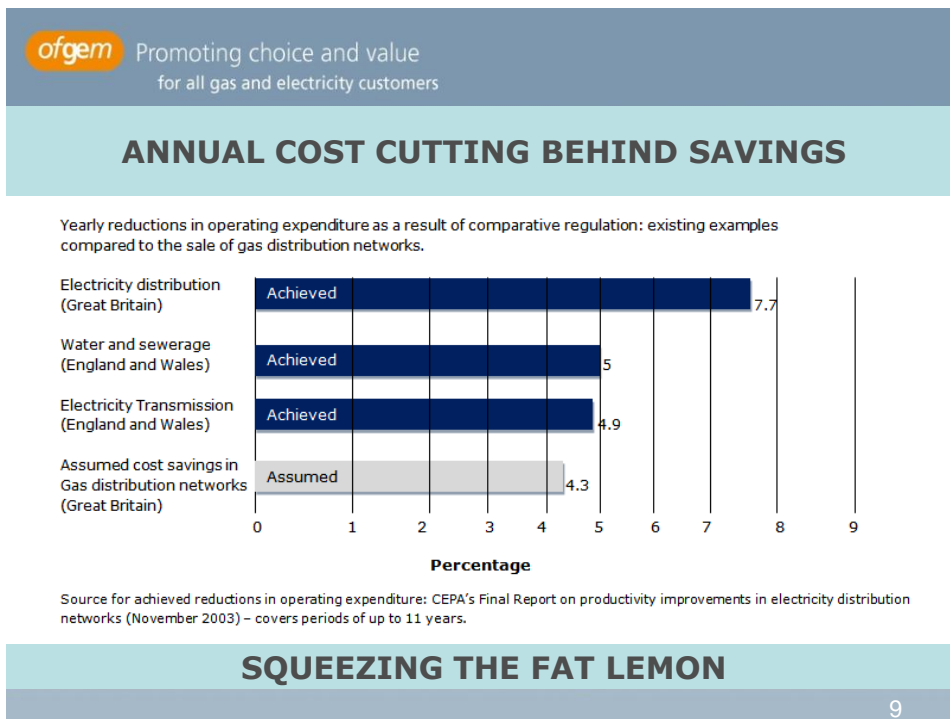
With regard to the ‘rumour mill’ I strongly urge those in the capital markets to contact our City liaison team (Charles Gallacher and/or Alex Lyon) if they are concerned.

THANKS TO A TRUSTY SERVANT

Before I leave you to take my seat on the review train I'd like to give you a brief account of how we have got this far. By almost any measure the incentive- and comparison-based price controls have been hugely successful.

Prices are down

Since 1990 the electricity distribution charges have been halved and transmission charges cut by 41%. The NAO showed that the DNOs cut annual operating expenditure (opex) by 7.7% in the 11 years to 2003, and even the local gas networks (who were not part of the competing ownership model until 2005) made 4.3% cuts in annual opex according to NAO estimations.



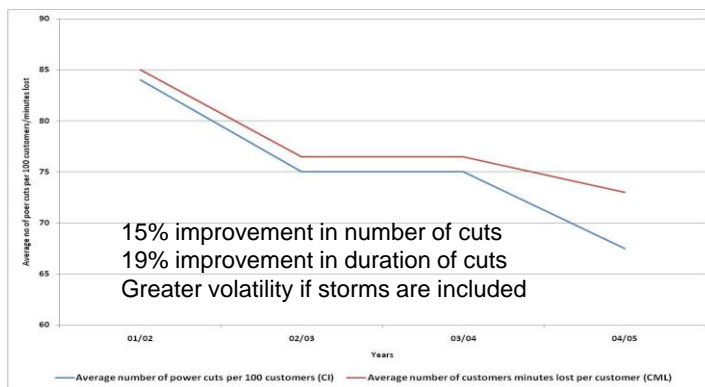
Quality is up

In the fifteen years to 2005 we saw 11% fewer power cuts and the duration of those interruptions fell 30%. The profile of quality of service in the price controls has grown. Poor performance in this respect can now cost companies up to 3% of their revenue. Quality of service indicators were introduced for the first time on the gas distribution networks in December 2007. In preparation for the next electricity distribution price controls, Ofgem is (in our already successful Consumer First project) looking at how we can tap into consumer expectations better than we have to date.

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QUALITY UP

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



1990-2005 POWERCUTS -11% DURATION - 30%

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Investment is up

The investment story is singularly impressive. Indeed, National Grid's reliability continues to be a world beater.

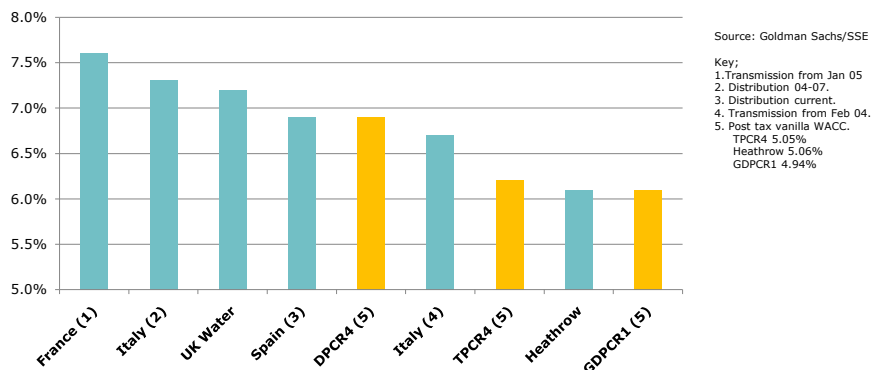
In its Energy White Paper DBERR (was the DTI) argued that only the Netherlands network has higher operational performance levels. In the fifteen years to 2005 investment was £0.4 billion a year and in its latest regulatory package, to run to 2012, that figure is £1.5 billion a year. This compared to just £0.25 billion a year 1984-1989. The figures for the DNOs are much the same: £3.8 billion 1986-1990 pre privatisation, 1990-2004 £15.5 billion and for 2004-2009 it will be £7.4 billion.

Cost of capital is down

Long gone are the days of the assumed 8.0% pre tax WACC of 1990. Ofgem has secured for GB customers rates now just hovering above the 6.0% pre tax level. This is not only competitive with other UK regulated concerns but also favourable by contrast to many energy network companies in Europe.

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SECURING A LOW COST OF CAPITAL



HUGE BENEFIT TO CONSUMERS FROM LOW WACC.

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In the recent transmission price controls Ofgem estimated that a 1% move on WACC was worth £125 million to the consumer. We believe that these low levels have been secured because of the consistent and stable regime adopted by energy regulators since 1990.

RPI-X HAS ACCOMMODATED CHANGE

The resilience of the price control package has accommodated substantial change in electricity supply and demand patterns since 1990. Overall about 30GW of new generation has come onto the system and 24 GW has left. The pattern was crudely gas-fired stations on; coal and nuclear off. Clearly a common feature has been large scale generation units.

Now the changes we are seeing are potentially taking price controls into territory that the current regime was not designed for.

Society's changing demands and priorities are bringing new challenges with the greatest, being the need for sustainable development. Included now in the price controls are an array of measures designed to promote and protect sustainability. On the environmental side there is a range of measures to reduce emissions while on the social side improvements include incentives for rural gas connections.

In meeting **society's changing demand and priorities** Ofgem has had to adopt a range of features to the price controls that have the effect of changing the original plans as laid down for RPI-X in 1990. Examples would include:

- Line base regulation rather than a holistic review of opex once every five years. As an example monies are set aside, in a straight line manner for the Innovative Funding (IFI) and Registered Power Zones (RPZ) initiatives.
- Individual capex settlements rather than just a holistic capex review once every five years. The most obvious examples being the allowances for funding four new transmission lines in Scotland to bring renewable power to England (the TIRG) and the Milford Haven gas pipeline.
- Generous incentives - particularly to promote sustainability based schemes, such as distributed generation.
- Differential cost of capital rather than one level fits all, such as for the TIRG schemes.

Clearly the direction and composition of the **RPI-X** formula has been stretched. Some would argue it has been pulled a long way from its intended role.

RPI-X - THE FINAL SUM

Clearly RPI-X has been a faithful and sturdy workhorse in delivering efficiency and investment for 20 years. We believe the time has come to consider its future application given the new demands placed on regulation by climate change in particular and more generally the need for sustainable development.

We know that one of the chief gains from having such a reliable regime has been the stability arising from it. So our decision to enter into a review has not been taken lightly and the argument for any change that might arise from the review will be hard tested through rigorous consultation.

We also have to acknowledge the “horses for courses” concept! As illustrated in the table and graph below the different potential savings from the GDN’s, who are at a different stage of the RPI-X cycle, from the DNO’s.

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IS THE LEMON SQUEEZED?

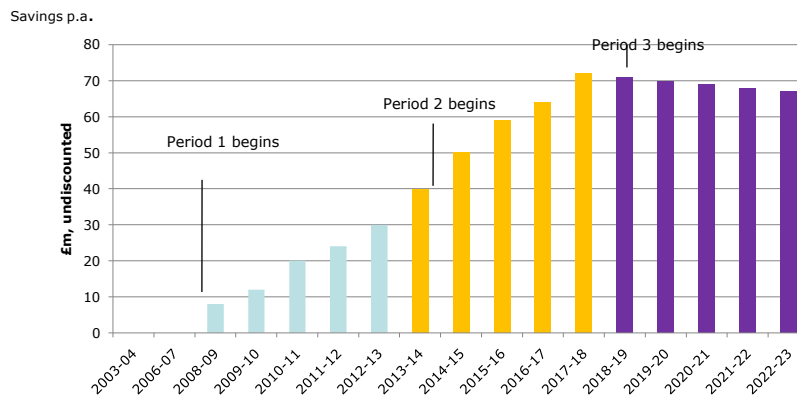
Electricity Distribution Charges

	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.

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CLASSIC BENEFITS OF RPI-X STILL TO COME ON GDNS



Source: NAO

ON GAS THE BIG SAVINGS EXPECTED POST GDPCR2.

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Stephen Littlechild commented in the 1990 electricity distribution company prospectus: “I recognise the importance of stability in the regime and would require a convincing case to be made before proposing radical change”. **I would reinforce this message with the observation that capital market trust is hard won and easy lost.** We enter this review fully aware of these cautionary lines and with a desire to maintain our reputation as a safe pair of hands. Reliable regulation brings benefits to all parts of the industry and, most importantly, to customers.

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KEY REFERENCE POINTS

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GLOSSARY

DPCR: Electricity Distribution Price Control Review.

TPCR: Transmission Price Control Review.

GDPCR: Gas Distribution Price Control Review.

GDN: Gas Distribution Network Company.

DNO: Electricity Distribution Network Company.

TO: Transmission Asset Owner Company.

NAO: National Audit Office.

IFI: Innovative Funding Incentive.

RPZ: Registered Power Zones.

TIRG: Transmission Investment for Renewables Generation.

WACC: Weighted Average Cost of Capital.

IQI: Information Quality Incentive.

RAV/RAB: Regulated Asset Value/Base.