Promoting choice and value
for all gas and electricity customers

DPCR5
Final Proposals

Analyst & Investor presentation

07 December 2009

Headline messages

Theme	Elements of DPCR5 Final Proposals
Networks	• £14bn total expenditure allowed – up from £12bn in DPCR4 • Bids cut by £1.3bn. But two DNOs with best track record given what they asked for
Customers	• Strong incentives to improve connections, network reliability and customer service
Environment	• New £500m low carbon fund to trial smart grid and other technologies
Finance	• Cost of capital: 4.7% vanilla (4.0% post-tax) • Higher returns available for companies that push on efficiency and deliver for customers and the environment
Pensions	• 15 year notional deficit repair period • Proportionate incentive to control ongoing costs

Our proposals are tough but fair

Headline figures

Headline figures	Initial Proposals	Final Proposals
Vanilla WACC	na	4.7%
Post-tax WACC	na	4.0%
RORE plausible range	na	3-13%
Total expenditure (07/08 £m)	13,326	14,016
Total revenue (07/08 £m)	21,515	22,192
Average annual X factor*	5.3%	5.6%
Closing RAV 2015 (07/08 £m)	18,416	18,817

*Annual X factors have been profiled to be constant year-on-year. For comparison, the unprofiled average X is 4.2%

NETWORKS

Total expenditure 20% higher than DPCR4

2007/08 £m	DPCR4	DNO bids	DPCR5 baseline	DPCR5 vs DPCR4	DPCR5 vs DNO bids
Total expenditure	11,703	15,303	14,016	20%	-8%
Allowed revenues	17,363		22,192	28%	

- £14bn allowed for expenditure on electricity networks in DPCR5
  - replace ageing assets
  - Reinforce “hot spots”
- £22bn allowed revenues in return for
  - meeting statutory obligations and licence conditions
  - achieving agreed output measures by end of 5-year period

DNOs allowed sufficient revenues to undertake work needed on the networks

Totex 8% lower than DNO forecasts

Total expenditure (£m 2007/08)	DNO bids	Initial Proposals	Final Proposals	FP vs DNO bids
CN West	1,322	1,101	1,173	-11.3%
CN East	1,288	1,124	1,189	-7.7%
ENW	1,246	1,033	1,128	-9.5%
CE NEDL	842	709	785	-6.8%
CE YEDL	1,128	928	1,032	-8.5%
WPD-South Wales	578	517	567	-1.9%
WPD-South West	823	733	813	-1.2%
EDFE LPN	1,137	1,023	996	-12.4%
EDFE SPN	1,174	1,027	1,036	-11.8%
EDFE EPN	1,724	1,449	1,475	-14.4%
SP Distribution	951	832	836	-12.1%
SP Manweb	1,135	1,018	1,028	-9.4%
SSE Hydro	578	523	567	-1.9%
SSE Southern	1,377	1,309	1,391	1.0%
TOTAL	**15,303**	**13,326**	**14,016**	**-8.4%**

- Largely agree with the volume of work proposed by DNOs but scrutinised unit costs.
- Best performing DNOs awarded allowance in line with their bid.
- Up to 14% cut for least efficient or least able to justify forecasts.
- WPD and SSE efficient in operating activities and in network investment activities.

Very thorough and detailed cost assessment

5.6% average annual increase in prices

Average annual X factor	Initial proposals unprofiled	Final proposals unprofiled	Final proposals profiled
CN West	4.8%	4.3%	4.3%
CN East	4.9%	4.3%	4.7%
ENW	7.2%	5.3%	8.5%
CE NEDL	7.0%	5.5%	7.7%
CE YEDL	5.6%	4.7%	6.5%
WPD-South Wales	5.0%	4.2%	6.2%
WPD-South West	6.3%	5.4%	7.5%
EDFE LPN	7.0%	5.5%	7.1%
EDFE SPN	8.6%	7.2%	8.8%
EDFE EPN	5.1%	5.2%	5.5%
SP Distribution	-4.3%	-2.3%	-4.3%
SP Manweb	8.6%	7.0%	11.1%
SSE Hydro	4.5%	2.7%	4.3%
SSE Southern	6.9%	2.6%	3.9%
TOTAL	**5.3%**	**4.2%**	**5.6%**

- Annual price increases do not follow DNO forecast expenditure profile.
- Price increases are profiled or smoothed out in a PV neutral way for constant X factor year-on-year.
- Unprofiled average X down to 4.2% from 5.3% at initial proposals.
  - lower cost of capital
  - lower pension costs
  - changes to cost assessment and modelling methodology
- SP Distribution: allowed revenues down due to lower depreciation and corporate tax allowances
- Final bills will be affected by new charging methodology

Very wide range of price increases across the country

Increased totex leads to 17% RAV growth

Regulatory asset value (£m 2007/08)	Opening RAV April 2010	Closing RAV March 2015	RAV % growth
CN West	1,380	1,652	20%
CN East	1,338	1,638	22%
ENW	1,212	1,417	17%
CE NEDL	827	992	20%
CE YEDL	1,057	1,296	23%
WPD-South Wales	669	715	7%
WPD-South West	914	1,069	17%
EDFE LPN	1,203	1,350	12%
EDFE SPN	1,008	1,303	29%
EDFE EPN	1,659	1,985	20%
SP Distribution	1,283	1,347	5%
SP Manweb	1,082	1,358	26%
SSE Hydro	838	853	2%
SSE Southern	1,653	1,843	11%
TOTAL	**16,123**	**18,817**	**17%**

RAV growth in spite of 20 year depreciation policy

CUSTOMERS & ENVIRONMENT

Must step up customer service and role in tackling climate change

Theme	Behaviours	Mechanisms
Environment	• Reduce DNOs' environmental impact • Enable customers to adopt low carbon or energy saving measures • Ensure DNOs prepare for change in network use	• £500m Low Carbon Networks fund • Losses incentive • Funding for undergrounding of lines • New obligations to report business carbon footprint and to provide local generators with better information
Customers	• Appropriate and efficient security of supply • Improve customer satisfaction • Improve connections service levels • Stimulate competition in connections • Be proactive in engaging with all stakeholders	• New interruptions incentive targets and incentive rates • Fund to improve service to the worst served customers • New incentive based on a broad measure of customer satisfaction • Guaranteed standards for connections • Margins on connections • Refocus annual customer service reward

Mechanisms in red give opportunity to boost returns

FINANCE

Cost of capital

WACC	Final Proposals
Cost of debt	3.6%
Cost of equity	6.7%
Gearing	65.0%
WACC (vanilla)	4.7%
WACC (post-tax)	4.0%

Figures in real terms

Cost of equity (6.7%)

- Long-term approach but recognise current uncertainty
- Potential and plausible risk lower in DPCR5 than DPCR4

Cost of debt (3.6%):

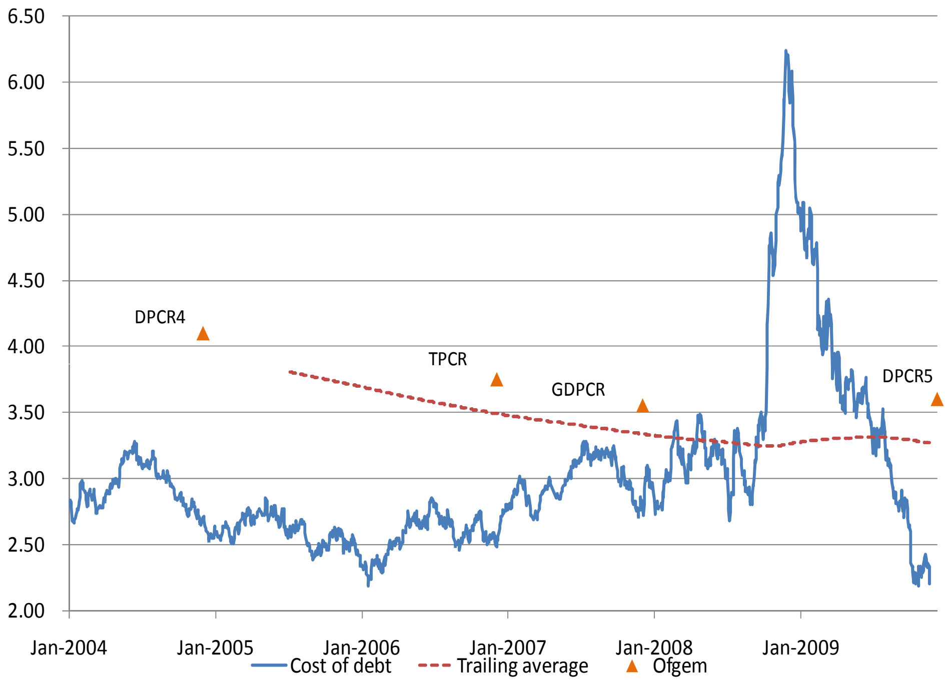
- 10yr trailing average is comparable with GDPCR (our last price control)
- LT average appropriately balances varied debt costs across DNOs.
- “Headroom” over trailing average

Gearing (65%)

- Consistent with a ‘comfortable’ investment grade credit rating.
- Some capital structures with gearing often higher than notional assumption

Recent market indicators

Ofgem analysis of real debt costs



Recent utility GBP issuance

Issuer	Month in 2009	Amount (£m)	Maturity (yrs)	Nominal Coupon (%)	Real Coupon (%) *
Northern Gas	June	200	10	5.875%	3.1%
ENW Finance	July	200	12	6.125%	3.3%
SSE	September	500	9	5.000%	2.2%
Enel	September	850	15	5.625%	2.8%
Enel	September	1400	31	5.750%	3.0%
Scotia Gas	October	300	9	5.125%	2.4%
EDF Energy	November	350	27	6.000%	3.2%
EDF Energy	November	300	22	6.125%	3.3%
EDF Energy	November	300	7	5.125%	2.4%
Weighted average (%)				**5.6%**	**2.8%**

* Estimated real coupon using deflator of 2.7% (average inflation forecast of City analysts)

Low risk companies such as DNOs can raise finance at proposed rate

Return on Regulatory Equity (RORE)

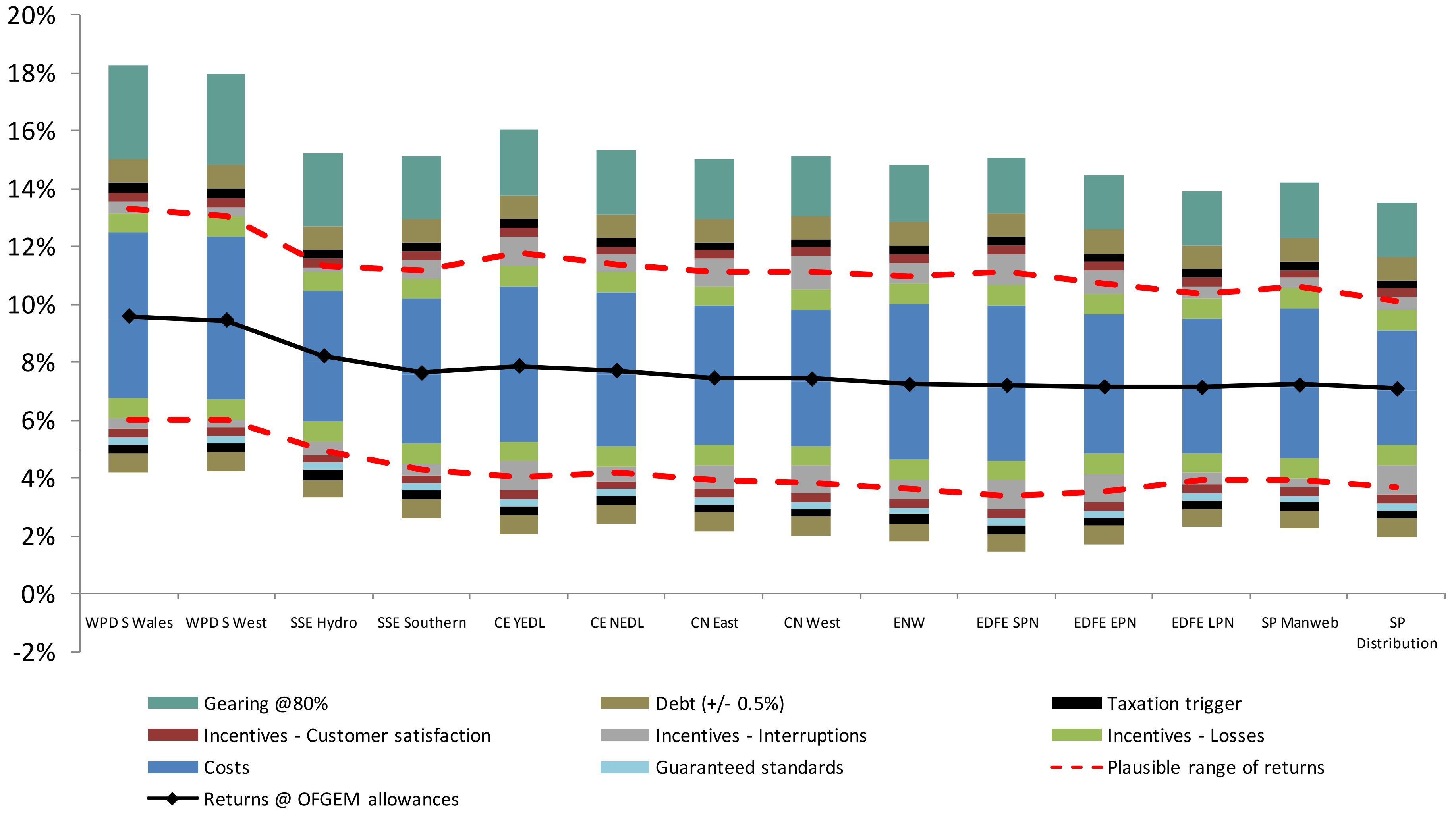
- Plausible returns range between 3% and 13%

- Up to 200bps for outperforming incentives
- +/- 250bps for out/underperforming cost allowances

- Further returns through financial engineering

Big rewards for companies that raise the bar on efficiency and excel in service delivery and on the environment

Potential equity returns (RORE)



PENSIONS

Pensions

£m,2007/8	Deficit repair	On-going costs	Total
Pensions	1,050	650	1,700

- Consultation to review of pension principles Aug08 to Nov09.
- DPCR5 new pensions approach:
  - Notional deficit recovery period: 15 years
  - Sharing incentives ongoing costs:
    - DPCR5: DNOs bear 20% downside and 50% upside
    - Future reviews: benchmarking
  - Efficiency trigger: Review by the Government Actuary's Department (GAD) at end of DPCR5
  - Valuation: 30 September 2009 – true up for 2010(A) in future

Pension costs are 10% of DNO cost base

OTHER

Proposal to review merger policy

- Ofgem advises the OFT or EC and can also propose conditions on merged entities through licence modifications.
- Existing merger policy only for electricity and gas distribution networks (separately).
- Proposing to suspend merger policy pending a thorough review applicable to all network sectors.

7 Dec 09
Proposal to suspend policy
(6wks consult.)

→

If decide to suspend pending review

→

1Q 2010
Propose revised policy
(12wks consult.)

→

Mid 2010
Publish revised policy

Existing policy applies

Case-by-case basis

New policy applies

Consultation letter published today

Proposal to review merger policy

Considerations for review	Options

• Include independent network operators in future policy?
• Value of loss in comparators as number of independent groupings changes?
• Minimum number of independent groupings?
• Issues with mergers between transmission and distribution network companies or between gas and electricity network companies?
	• Retain reduced future revenues approach
	  • set amount reflecting value of loss of comparator
	  • sliding scale depending on number of remaining comparators
	• Case by case basis approach
	  • publish set of principles as guidance

Last thorough review over seven years ago

RPI-X@20

- Root and branch review of future energy networks regulation
- Emerging Thinking consultation document expected January 2010
- Formally DPCR5 is outside of the scope of RPI-X@20
- DPCR5 ideas being considered as part of the RPI-X@20 project:
  - Should we have greater engagement with consumers and other stakeholders ?
  - Should we retain funding for innovation ?
  - Should we retain an customer satisfaction incentive ?
  - Should we make more use of output measures ?

RPI-X@20 to be fully implemented in DPCR6

Allowed revenues per DNO

Revenue over DPCR5 (£m 2007/08)	DPCR4	DPCR5 IP	DPCR5 FP	% change vs DPCR4
CN West	1,367	1,659	1,712	25%
CN East	1,390	1,706	1,745	26%
ENW	1,266	1,634	1,813	43%
CE NEDL	886	1,156	1,187	34%
CE YEDL	1,157	1,444	1,521	31%
WPD-South Wales	829	1,013	1,047	26%
WPD-South West	1,016	1,286	1,355	33%
EDFE LPN	1,294	1,697	1,752	35%
EDFE SPN	968	1,348	1,422	47%
EDFE EPN	1,653	2,036	2,122	28%
SP Distribution	1,663	1,540	1,550	-7%
SP Manweb	991	1,336	1,456	47%
SSE Hydro	962	1,163	1,188	23%
SSE Southern	1,923	2,496	2,323	21%
TOTAL	**17,363**	**21,515**	**22,192**	**28%**

Risk assessment – DPCR4 Vs DPCR5

RoRE Driver	Treatment in price control DPCR4	Treatment in price control DPCR5	DPCR4: WACC - 5.545% DPCR4 experience Min	DPCR4: WACC - 5.545% DPCR4 experience Max	DPCR5: WACC - 4.7% Ex-ante Min	DPCR5: WACC - 4.7% Ex-ante Max
-Op-ex (100% incentive rate)	*Uncapped*	*Uncapped*	-2.9%	2.9%		
-Cap-ex (23-40% incentive rate)	*Uncapped*	*Uncapped*	-0.8%	0.8%		
Totex (45-51% incentive rate)[1]	Uncapped	Uncapped	-3.7%	3.7%	-2.0%	2.0%
Sliding scale additional income	Fixed	Fixed	0.0%	0.5%	0.0%	2.7%
IIS[2]	Capped	Capped (d/s only)	-0.8%	0.8%	-1.0%	1.0%
Losses	Uncapped	Capped	-3.5%	3.5%	-0.7%	0.7%
Volumes (DP4) / re-opener (DP5)	Uncapped	Capped	-1.2%	1.2%	-0.8%	0.8%
Broad Measure	n/a	Capped	n/a	n/a	-0.3%	0.3%
Guaranteed standards	n/a	Capped	n/a	n/a	-1.00%	0.0%
Tax	Uncapped	Capped	-0.8%	0.8%	-0.4%	0.4%
Cost of debt[3]	Uncapped	Uncapped	-0.5%	0.5%	-0.25%	0.25%
Pensions[4]	Uncapped	Uncapped	~ 0%	~ 0%	-0.15%	0.30%
		Total	**-10.5%**	**11.0%**	**-6.6%**	**8.4%**

1: DPCR5 range is based on DPCR4 performance under the DPCR5 rules
2: IIS will be uncapped in DPCR5. The upside is assumed to be symmetrically opposite to the 1% collared downside.
3: The range of upside or downside is assumed to be lower than in DPCR4 given that the cost of debt estimate is lower.
4: We assumed that the upside from pensions is £5m upside and £2.5m on the downside (total DPCR5)

Recent WACC determinations

	Nov-04 DPCR4	Dec-06 TPCR	Dec-07 GDPCR	Nov-09 Ofwat-PR09	Dec-09 DPCR5
Pre-tax cost of debt	**4.1%**	**3.75%**	**3.55%**	**3.6%**	**3.6%**
Post-tax cost of equity	**7.5%**	**7.0%**	**7.25%**	**7.1%**	**6.7%**
Gearing (Debt:RAV)	57.5%	60.0%	62.5%	57.5%	65%
Vanilla WACC	**5.5%**	**5.1%**	**4.9%**	**5.1%**	**4.7%**
Post-tax WACC	4.8%	4.4%	4.3%	4.5%	4.0%

Promoting choice and value

for all gas and electricity customers