

Gas distribution price control review 2008-13 Updated Proposals Analyst presentation

24 September 2007

The conference call, which this presentation accompanies, will be recorded.

To access this recording after the call dial [0800 358 9369](tel:08003589369) and enter the pin [136977#](tel:136977#)

The recording will be available until close of play on 1 October.

Disclaimer: The information contained in these slides is a summary of the proposals for the gas distribution price control. Full details of GEMA's initial proposals for the price controls are set out in the publication "Gas Distribution Price Control Review Updated Proposals". The information contained in these slides is intended to summarise some aspects of the key features of the initial proposals but neither GEMA nor Ofgem represent or warrant that the information contained in these slides constitutes an accurate or complete summary of the proposals.

Note: All figures quoted are in £m 05/06 real, unless otherwise stated

Key themes

- Developing upon work done at initial proposals
- Upward adjustment to allowances for opex and repex
- Capex marginally lower
- Cost of capital – have set out our thinking on risk relative to transmission price control – decision at final proposals
- GDN charges to increase by 1.3% per annum
- Work in progress, but closing in on final decisions

Operating costs - approach

- Benchmarking with 2006/07 as base year – actual costs lower than previously forecast
- Retained disaggregated benchmarking to set relativities
- Then uplifted so total opex across GDNs equivalent to a top-down upper quartile approach
- Real price effects of 1-2% p.a./ productivity assumption of 2.5% p.a.
- Regional factors where appropriate (London/extreme sparsity)
- Revenue driver to cover increased emergency services costs if metering contracts not retained
- No opex rolling incentive

Operating cost allowances (annual averages)

GDN		Actuals 2002-07	07-08 Allowances	2008-13 Initial proposals	2008-13 Updated proposals
NGG	East of England	109.5	109.8	95.7	93.9
	London	75.0	71.7	67.0	71.2
	North West	83.0	80.4	74.0	76.7
	West Midlands	60.8	59.9	54.0	58.1
NGN	Northern	77.8	77.3	73.0	75.1
SGN	Scotland	65.4	65.2	57.0	63.6
	Southern	108.9	105.5	105.4	113.6
WWU	Wales & West	79.7	82.7	71.9	75.9
Total		660.1	652.5	598.0	628.0

2005/06 prices. Figures include pensions but exclude shrinkage allowances and impact of loss of metering

Capex/Repex - approach

- Updated analysis based on 2006/07 actuals and new forecasts
- Updated opening RAV
- Benchmarking, RPEs, regional factors and efficiency improvements applied where appropriate
- Full analysis large capex projects
- GDN and Ofgem views compared using IQI (equivalent to sliding scale mechanism in DPCR4) - outputs include:
 - Capex/repex allowances as percentage of Ofgem's view
 - Incentive rate for under/overspend during control
 - Additional income

Capex/repex post-I QI

GDN		Total capex/repex allowances 2008-13	%age reduction from company forecast	Under/over spend incentive rate	Total additional income 2008-13
NGG	East England	700.2	-7.6%	35%	8.0
	London	676.1	-11.1%	35%	6.5
	North West	604.2	-15.8%	35%	7.0
	West Midlands	437.0	-5.5%	35%	5.2
NGN	Northern	613.4	-10.2%	33%	4.9
SGN	Scotland	444.5	-13.3%	30%	0.5
	Southern	1,064.2	-16.0%	30%	1.1
WWU	Wales & West	607.2	-18.5%	31%	0.8
Total		5,146.9	-12.9%		34.0

2005/06 prices

Indicative RAV

	NGG	NGN	SGN	WWU
Opening RAV 1 April 2008 per initial proposals	5,907.7	1,340.0	3,200.7	1,234.0
Updated opening RAV 1 April 2008	5,923.4	1,340.1	3,217.7	1,235.0
Capex/repex Additions	2,417.5	613.4	1,508.7	607.2
Less: repex expensed (50%)	-897.4	-199.0	-479.2	-179.7
Depreciation	-1,082.0	-245.1	-584.8	-224.1
Closing RAV 31 March 2013	6,361.4	1,509.4	3,662.5	1,438.3

£m, 2005/06 prices. Note that opening RAV has changed since our initial proposals due to updates to 2005-06 and 2006-07 actuals.

Cost of capital

- Risk analysis based on:
 - bottom-up review of operational risks
 - top-down review of global asset betas
- Results suggest gas distribution (under price control proposals) as least as risky as transmission (under price control)
- Implications
 - Possibly higher cost of equity
 - No direct impact on cost of debt due to commoditisation of utility bonds
 - No direct impact on gearing assumption – market evidence does not support finance theory conclusions that higher risk = lower gearing

Cost of capital

	TPCR Dec 2006	GDPCR model assumption
Cost of debt (real, pre-tax)	3.75%	3.55%
Cost of equity (real, post-tax)	7.0%	7.0%
Gearing (% debt)	60%	62.5%
Vanilla WACC	5.05%	4.84%

Other financial issues

- Maintaining policy of expensing 50% repex
- No change to depreciation (45 year straight-line)
- Current tax treatment of repex vs. regulatory treatment leads to regulatory tax losses for most GDNs
- No profiling – keeps allowances cost-reflective
- Financeability review does not raise serious concerns – weaknesses in some GDNs due primarily to penalties for capex overspend in 2002-07, so are a shareholder issue

Revenue allowances

GDN		Allowances 2007/08	Average annual Allowances 2008/13	Average annual % change
NGG	East England	427.2	420.4	-0.5%
	London	245.1	275.9	4.1%
	North West	285.5	292.0	0.8%
	West Midlands	217.8	226.0	1.2%
NGN	Northern	273.5	283.7	1.2%
SGN	Scotland	194.3	199.6	0.9%
	Southern	432.4	459.9	2.1%
WWU	Wales & West	252.0	262.6	1.4%
Total		2,327.7	2,420.1	1.3%

2005/06 prices

Outstanding items – may lead to material changes by final proposals

- Cost of capital
- Review of LTS capex requirements in light of updated demand forecasts
- Finalisation of incentive parameters for:
 - Capacity outputs incentive
 - Loss of meter work revenue driver

Next steps

- Responses to updated proposals due 22nd October
- Final rounds of meetings with companies in October/November
- Final proposals to be published 3rd December

The logo for Ofgem, consisting of the word "ofgem" in a white, lowercase, sans-serif font, centered within an orange rounded rectangle. The background of the slide features a collage of images: a solar panel array on the left, a close-up of a gas valve on the right, and a close-up of a gas meter at the bottom. A large white arrow points from the right towards the center, partially overlapping the gas valve and meter.

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