

ofgem

Transco Price Control Review

Transco price control review

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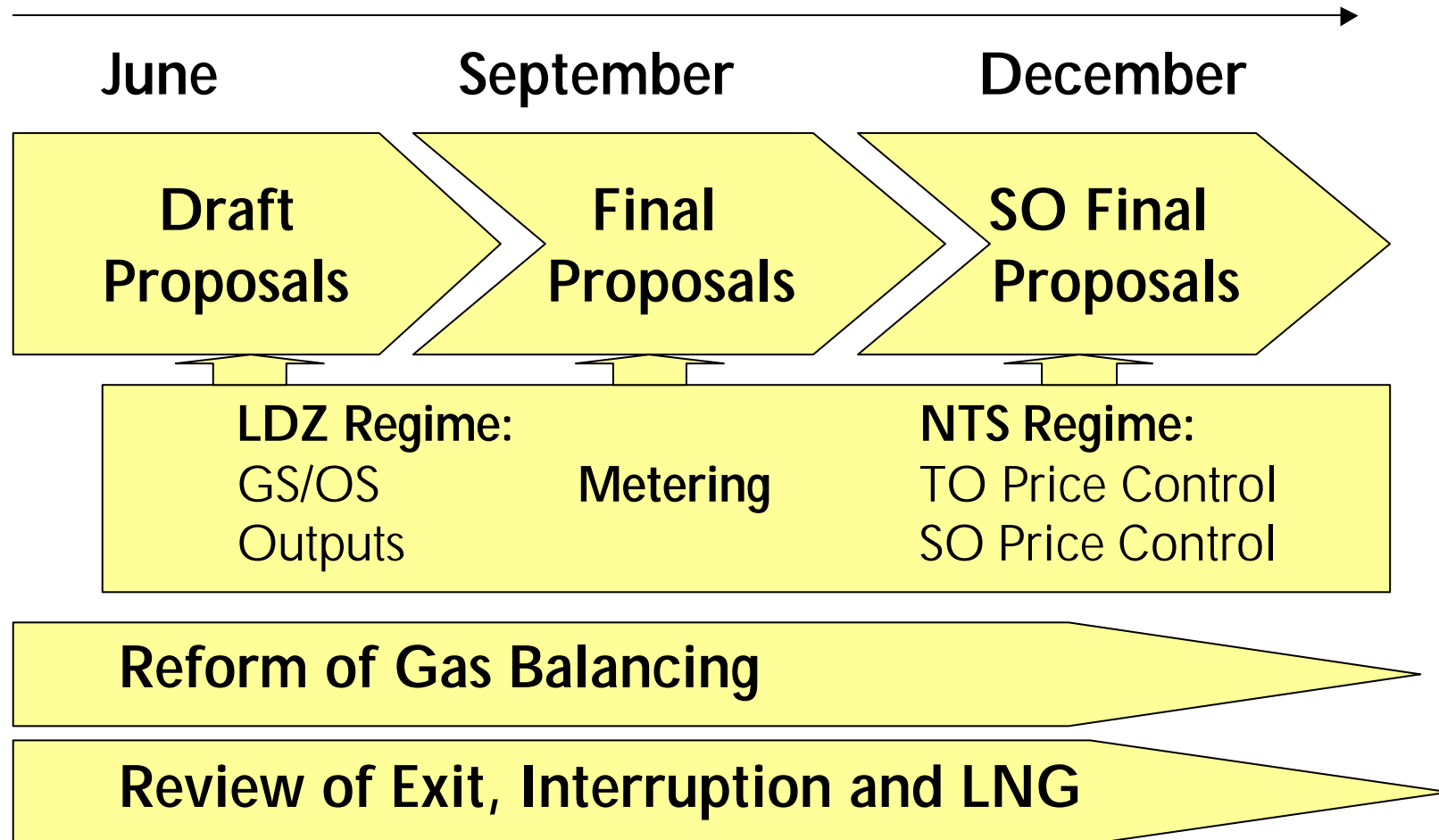
Key issues in this review

- Focus on outputs, not just inputs
- Flexibility to handle uncertainties (e.g. NTS investment, replacement expenditure)
- Transco's changing role and structure

Overview

- Process and timetable
- Scope and form of controls
- Opex, Capex and Repex
- Regulatory value
- Cost of capital
- Ofgem's base case

Process going forward



Scope of Controls

- Separate controls for:
 - NTS: TO and SO controls
 - LDZs: single aggregate control initially
 - metering: retained subject to the development of competition
 - meter reading: remove for non-daily metered customers, retain for daily-metered customers

NTS Controls

- TO:
 - RPI-X total revenue control
 - Based on defined levels of entry and exit capacity
 - Draft proposals June, Final proposals September
- SO:
 - Cost sharing
 - Draft proposals September, Final proposals December

NTS Outputs

- Outputs based on entry and exit capacity
- Levels will be defined in September
- Transco will retain revenues from sales of capacity above these levels
- Transco will incur buy-back costs if it fails to deliver them
- Incentive on Transco to react to the market

LDZ Controls

- RPI-X control
- Revenue driver reduced from 50% to 35%
- Outputs:
 - financial incentives linked to level and duration of interruptions
 - Guaranteed and Overall Standards

LDZ Outputs

- Number and duration of interruptions:
 - up to 2% of revenue, symmetrically
 - to apply from 2004
- Guaranteed and Overall Standards:
 - revised compensation payments
- Costs of these proposals are reflected in operating cost projections

Metering

- Tariff caps for individual services:
 - domestic credit meters
 - pre-payment meters
 - meter reading at daily-metered sites
- Non-discrimination requirement for other services
- Actual revenues depend on how well Transco competes

Expenditure analysis

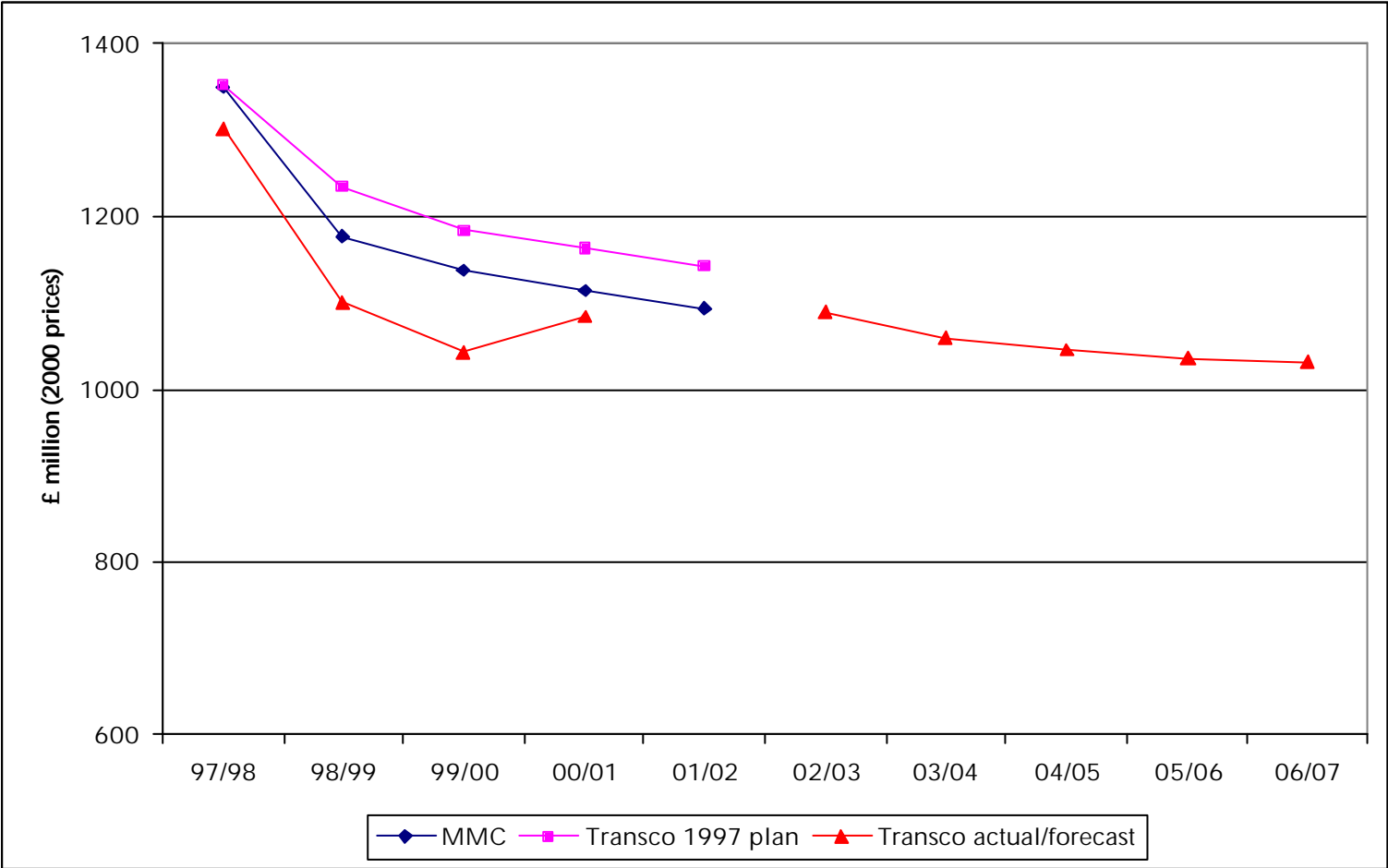
- Transco completed a Business Plan Questionnaire in December
- Assessed by Ofgem's advisers - their draft reports have been shared with Transco
- Mixture of "bottom-up" and "top-down" analysis
- Transco's Strategic Business Plan is currently under consideration

Total Operating Expenditure

<p>Transco 1997 plan (1997/98 – 2001/02)</p>	£7,309m
<p>MMC (1997/98 – 2001/02)</p>	£7,062m
<p>Transco BPO forecast (2002/03 – 2006/07)</p>	£6,426m
<p>Ofgem's projections (2002/03 – 2006/07)</p>	£5,320m

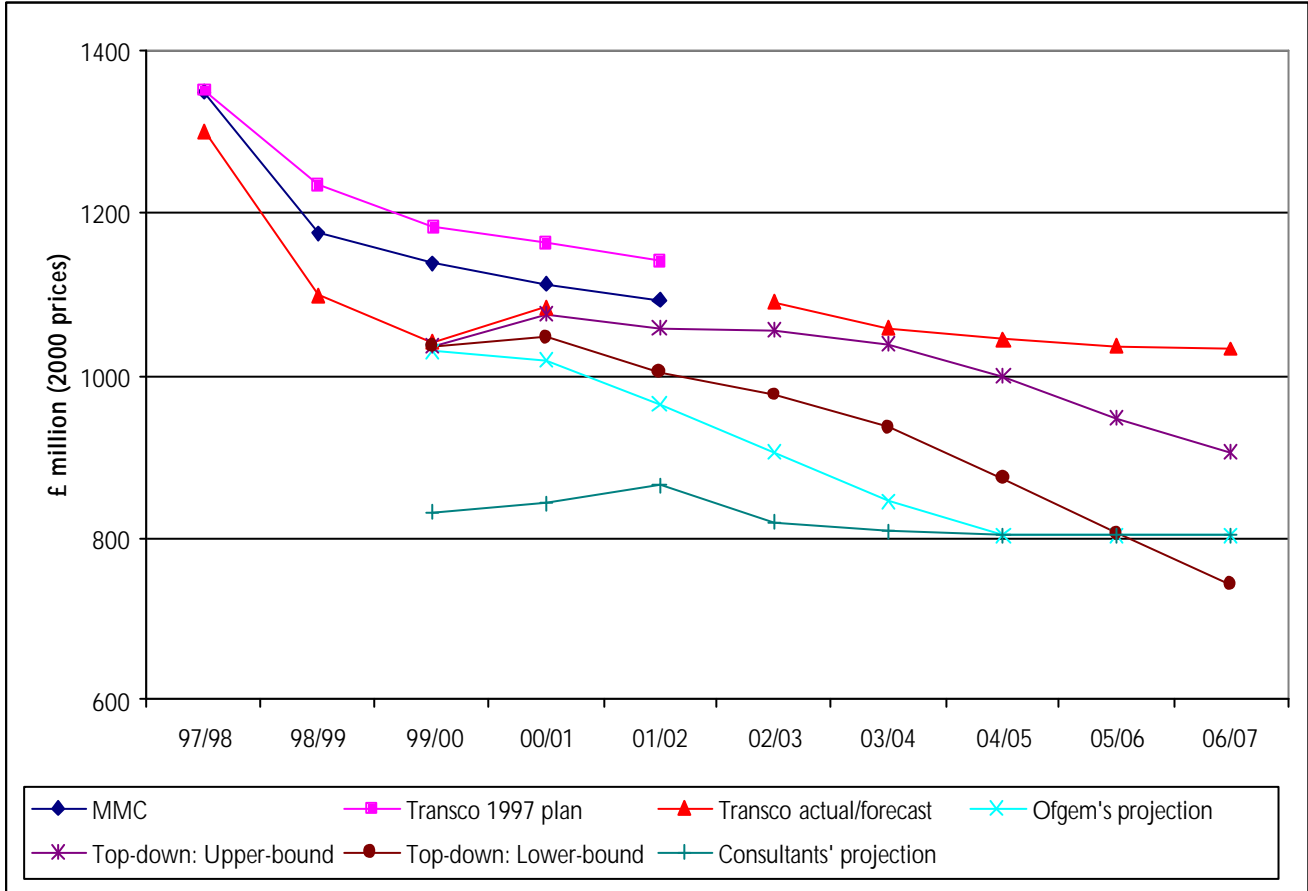


Controllable Operating Expenditure (1997-2007)





Controllable Operating Expenditure (1997-2007)

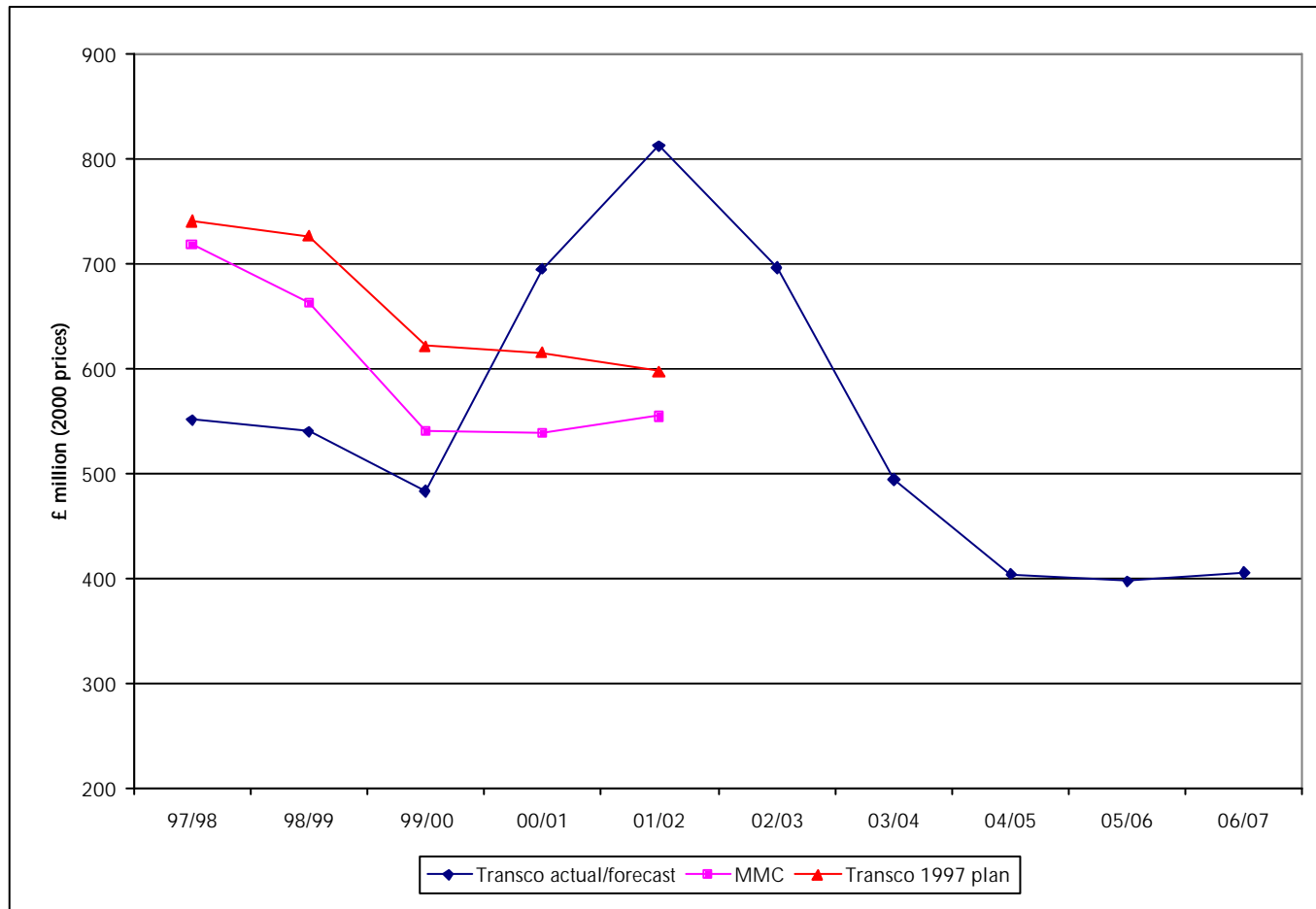


Controllable Opex Annual Reductions

<p>Transco 1997 plan (1997/98 – 2001/02)</p>	4.1%
<p>MMC (1997/98 – 2001/02)</p>	5.1%
<p>Transco BPO forecast (1999/00 – 2006/07)</p>	0.1%
<p>Ofgem's projections (1999/00 – 2006/07)</p>	3.5%



Capital Expenditure (1997 to 2007)





Capital Expenditure (1997-2007)



Total Capital Expenditure (excluding replacement)

Transco 1997 plan (1997/98 – 2001/02)	£3,305m
MMC (1997/98 – 2001/02)	£3,018m
Transco actual/forecast (1997/98 – 2001/02)	£3,087m
Transco BPO forecast (2002/03 – 2006/07)	£2,402m
Ofgem's projections (2002/03 – 2006/07)	£1,920m

Replacement Expenditure - Current position

<p>Transco 1997 plan (1997/98 – 2001/02)</p> <p>MMC (1997/98 – 2001/02)</p>	<p>£1,688m</p> <p>£1,502m</p>
<p>Transco BPO forecast (2002/03 – 2006/07)</p> <p>Ofgem's projections (2002/03 – 2006/07)</p>	<p>£1,996m</p> <p>£1,654m</p>

Replacement Expenditure - Future Position

Transco BPO forecast	£1,809m
SBP Low Case (35 years)	£2,471m
SBP High Case (25 years)	£3,812m

- Ofgem will reflect impact of HSE decision
- May need to reconsider capitalisation of repex

Regulatory Asset Value

- Issues
 - Ernst & Young report on focussed value
 - Consistency
 - Views of customers and investors
 - Views of MMC
- Conclusion
 - Maintain unfocused approach
 - Substantial reduction in uncertainty

Cost of Capital

Component	Low %	High %
Risk-free rate	2.75	2.75
Debt risk premium	1.50	1.90
Cost of debt	4.25	4.65
Equity risk premium	3.5	3.5
Gearing	62.5	62.5
Equity Beta (value)	1.0	1.0
Post tax cost of equity	6.25	6.25
Taxation adjustment (multiplier)	1.43	1.43
Pre-tax cost of equity	8.9	8.9
Pre-tax WACC	6.0	6.25

Ofgem's Base Case (1)

	Transco BPO proposals	Ofgem base case
Regulatory Value	Unfocused	Unfocused
Cost of capital	At least 7.0%	6.1%
Total operating expenditure (five year total)	£6.4 billion	£5.3 billion
Controllable operating expenditure: annual reduction (1999/00-2006/7)	0%	3.5%

Ofgem's Base Case (2)

	Transco BPO proposals	Ofgem base case
Capital expenditure (five year total)	£2.4 billion	£1.9 billion
Replacement expenditure (five year total)	£2.0 billion	£1.7 billion
Po cut		14%
X		2%

Customer Benefits

- Improved security of supply on NTS
- Output targets and standards in LDZ
- Resources to invest in a safe network
- Initial price reduction of 14 percent, subject to further discussions and agreement on repex programme
- Ongoing reduction of 2 percent per annum

Transco's Requirements

- Clear outputs Transco is expected to deliver
- Flexibility to respond to uncertain market conditions
- Incentives for good performance, compensation for inadequate service
- Agreed capital base and adequate return on capital