

The background of the slide features a blurred image of a power plug on the left and a person sitting at a desk working on a laptop in the center. The text is overlaid on a white rounded rectangle.

Transmission Price Control Review (TPCR) Initial Proposals

Opening Remarks for IP Workshop, 5 July 2006

**David Gray
Managing Director, Networks**

The background of the slide features a blue-tinted image. On the left, there is a close-up of a three-prong electrical plug. On the right, a person is seen from behind, sitting at a desk and working on a laptop. The image is faded and serves as a background for the text.

Transmission Price Control Review (TPCR) Initial Proposals

Presentation to IP Workshop, 5 July 2006

**Robert Hull
Transmission Director**

Agenda

1. Introduction and context
2. TPCR Initial Proposals
3. Next steps

A blue-tinted background image showing a close-up of electrical components, including a three-pin UK power plug and a circuit breaker or fuse strip, with some blurred text visible on the components.

1. Introduction and context

Current stage in the process

- **The June document sets out initial numbers for the four transmission companies; it focuses on**
 - initial cost assessment analysis for TO's
 - financial issues
 - price control incentive framework
 - modelling of potential revenue allowances
- **Access reform policies addressed earlier in the process are now being passed to industry for development under modification processes**
- **The June document presents our current 'soft' numbers that will need further analysis**
- **Next stage is to refine, and quantify proposals in detail:**
 - Update in September (including initial cost assessments for SO's)
 - Final Proposals in late November / early December

TPCR context - CAPEX (Licensee forecasts for 2007-12)

Historic Period			Forecast period 07/08 -11/12			
Company	RAV 04/05	Capex allowance (last 5yr review period)	Load Related	Non Load Related	Total	% Change from last 5yr review period
NGG	2443	889	898	468	1365	54%
NGET	5145	1453	1356	2485	3841	164%
SPT	739	152	350	367	717	371%
SHETL	269	71	778	56	834	1075%
Total	8596	2565	3382	3375	6757	163%

Note:

- The above totals exclude TIRG expenditure for NGET, SPT, and SHETL
- Milford Haven expenditure is included in the NGG total (split between historic and forecast periods)

A blue-tinted background image showing a close-up of electrical components, including a three-pin UK power plug and a circuit board with various electronic components.

2. TPCR Initial proposals

Key themes for this review

- **Efficient investment for infrastructure renewal and growth**
 - Baseline capital expenditure of £4.25bn
 - New load related investment will be funded using revenue drivers – potentially an extra £1.25bn based on company forecasts
- **Still scope for increased operating efficiencies**
- **Financial stability during period of increasing investment**
 - Pensions deficits being addressed in line with established principles
 - Cost of capital – consistent approach using longer-term historical averages

Capital Expenditure – Load Related

- Load related expenditure – driven by network users
- Allowance comprises
 - Baseline allowance
 - Revenue drivers to respond to additional requirements for capacity
- Gas entry
 - Baseline covers capacity available or committed on 1/4/07
 - All incremental capacity funded by revenue drivers
- Electricity entry
 - Baseline includes significant allowance for investment in anticipated network growth
 - Revenue drivers can flex up or down from baseline level

Capital Expenditure – Load Related

Company forecast, 2007-12	£3382m
Adjustments:	
Baseline definition	-£1252m
Other (chiefly unit costs)	-£257m
Proposed baseline allowance	£1873m
Alternative “possible” scenario	£2600m

Capital Expenditure – Non-load Related

- Non-load related expenditure – asset replacement
- Substantial step-up in activity allowed, but adjustments to:
 - Proposed volumes
 - Unit costs
 - Procurement efficiencies

Company forecasts 2007-12	£3375m
Adjustments – cost categorisation	-£101m
Adjustments – volume & unit costs	-£901m
Proposed allowance	£2373m

Ofgem Initial Proposals on Baseline Capex

Company	Load Related	Non Load Related	Total
NGG	454	282	737
NGET	1024	1766	2790
SPT	282	273	555
SHETL	113	51	164
Total	1873	2373	4246

Note:

The numbers above include TSS and Milford Haven costs in LRE and Excluded Costs in NLRE

- An illustrative case of the total allowed capex, if some of the drivers forecast by the companies materialise, could be as much as £5 billion.

Total Capex – Bids vs Allowance

	£m
Initial Licensee submissions	7,100- 9,200
Adjusted* Licensee submissions	6,750
Ofgem Baseline Allowance	4,250
Ofgem Potential Allowance**	5,500
Difference (submission – potential allowance)	1,250
Of which: load related	250
: non load related	1,000

***Adjustments include latest forecasts, removal of non price control and non TO capex**

**** If all load-related projects included in adjustments do go ahead**

RAV roll forward

- **Period to 2004/05**
 - No adjustments to electricity licensees
 - Consulting on potential £75m disallowance for NGG relating to excess investment in St. Fergus entry capacity
- **2005/06 & 2006/07 – Load related**
 - Some exclusions
 - Subject to further review
- **2005/06 & 2006/07 – Non-load related**
 - Consultants' assessment covered 2005-2012
 - Company profile applied to consultants' total figure
 - Some exclusions pending
 - Assessment of 2005/06 actual data
 - Further assessment of 2006/07 forecasts

Operating Expenditure

- **Four stage approach**
 - Normalise 2004/05 base year
 - Consider scope for efficiency improvement (items identified by consultants)
 - Consider specific upward cost pressures
 - Consider scope for continuing efficiency improvement
- **Treatment of non-op capex & quasi-capex**
- **Innovation Funding Initiative**

Cost of Capital

- **Post-tax cost of capital, with specific tax allowance**
 - Cost of debt 3.4%
 - Cost of equity 7.0%
 - Gearing (Net debt/RAV) 60%
 - Post-tax WACC of 4.2%
- **Continuing evidence of low real interest rates**
- **Strong evidence that UK utility equities exhibit risk which is significantly below market average**

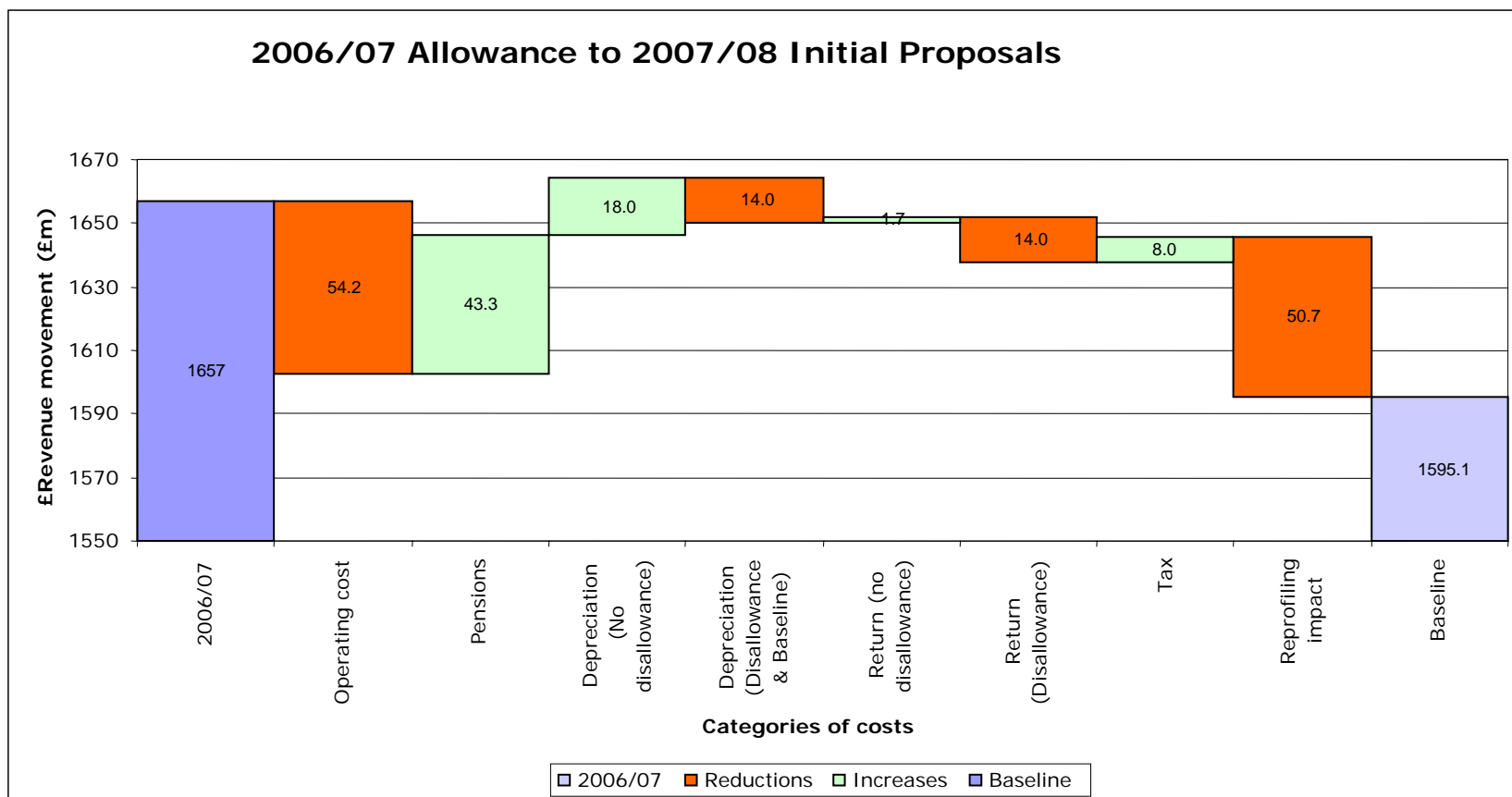
Other Financial Issues

- **Pensions**
 - ERDCs disallowed
 - “Centrica Liability” disallowed
- **Depreciation “cliff edge”**
 - Preferred approach is “depreciation tilting” – not yet applied in these proposals
- **Other “financeability” issues**
 - Potential strain caused by capex increases
 - Assume companies can raise equity (and allow for costs)

Proposed Revenue Allowances

	2006/07 allowance (£m)	Proposed 2007/08 allowance (£m), $X = 0$
NGET	1005	940
SPT	160	136
SHETL	51	49
NGG	442	471

2006/07 allowance to Initial Proposals



Incentive regime – position in June

- **RPI-X - Incentives over 5 year price control period**
- **Capex (Load related)**
 - TIRG expenditure (£560m) is already agreed and is outside this control
 - We have identified a level of baseline capital expenditure and are deriving a set of revenue adjustments ('revenue drivers') on a locational basis
 - We have signalled our consideration of a separate mechanism for dealing with some large, uncertain investments e.g. Western Isles, Shetland, possibly to make them subject to competitive bidding either on a merchant or price control basis
- **Capex (Non Load related)**
 - Sliding scale for non-load related expenditure i.e. reduced/increased return for over/underspend
 - Incentives for efficiency
- **Opex - Incentive to outperform allowances**
- **Performance incentives - Electricity reliability incentive, Innovation Funding Initiative**

Access reform - update

- **Electricity**
 - Options for user commitment approach have been developed in TPCR industry workshops, and published under open letter
 - National Grid are preparing proposals for triggering change to final sums for new entrants, commencing July (probably reducing final sums by 50%, and also making the amount more certain). These changes can be made outside the modification process
- **Gas entry**
 - Move from no baseline approach in March to an initial baseline with transparent mechanisms for change by NGG
- **Gas offtake**
 - Development of flex product currently under examination; impact assessment under way; set out proposals for revenue drivers and incentives
- **Modification process** – these changes will be led by industry and subject to Authority approval

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3. Next steps

Next steps

- **Deadline for responses 24th July**
- **Companies meet with Authority sub-committee – 26th July**
- **July/August – ongoing dialogue with companies**
 - publication of consultant reports/models
 - potential opportunity for licensees to rebid capex
- **September – Update document (including Ofgem's view on TO numbers and also SO internal cost numbers)**
- **Companies meet with Authority sub-committee – 18th October**
- **Final proposals – end November/early December**



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