

The background of the slide features a close-up, slightly blurred image of electrical components, possibly a circuit board or a power supply unit, with various connectors and components visible. The image is overlaid with a large, white, rounded rectangular box that contains the main title and subtitle.

# **Transmission Price Control Review (TPCR) Initial Proposals**

**Opening Remarks for IP Workshop, 5 July 2006**

**David Gray  
Managing Director, Networks**

The title of the presentation, "Transmission Price Control Review (TPCR) Initial Proposals", is centered within a large, rounded orange border. The background of the slide features a blurred image of electrical equipment, including a circuit breaker and a meter, with a blue and white color scheme.

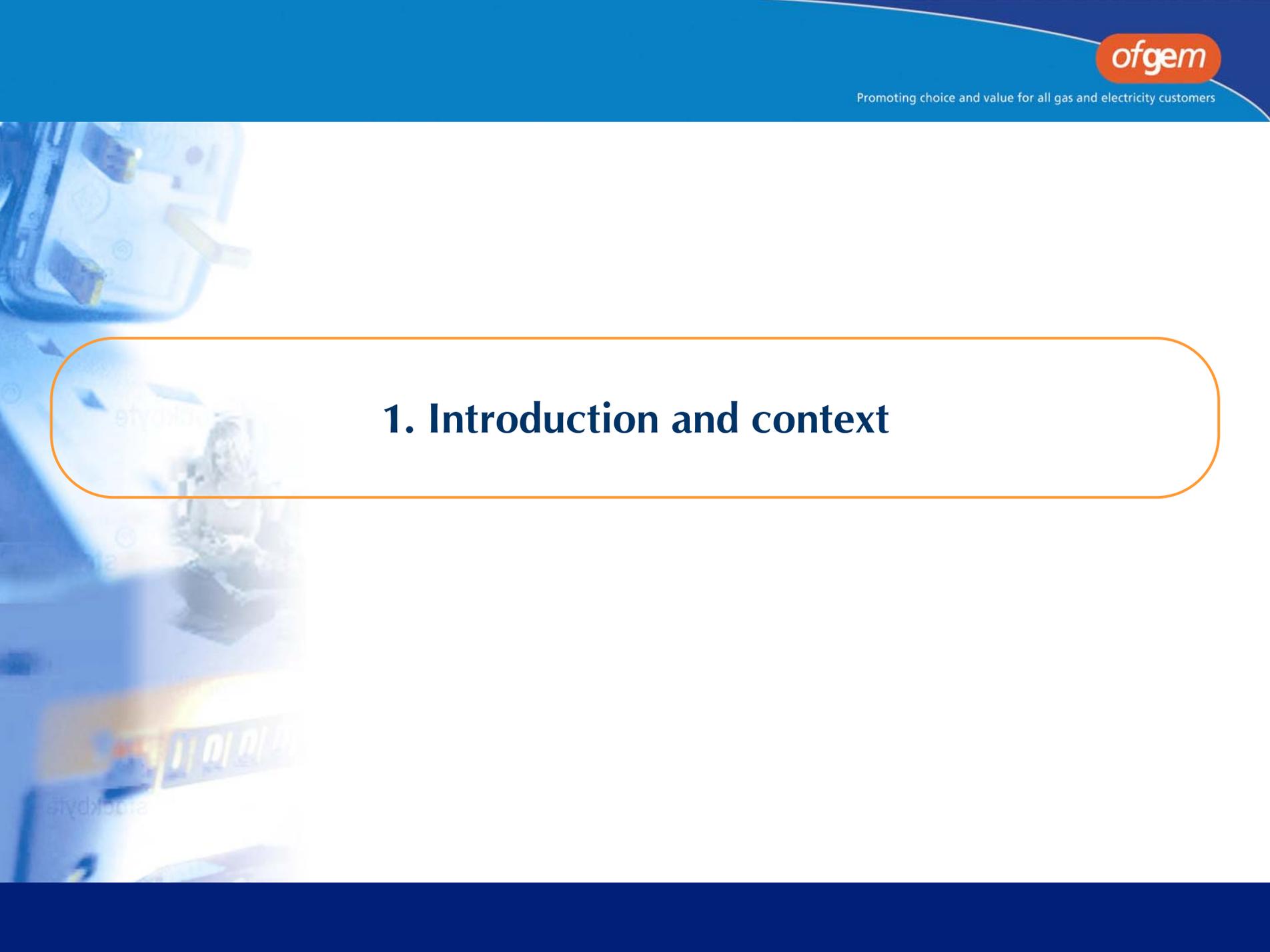
# **Transmission Price Control Review (TPCR) Initial Proposals**

**Presentation to IP Workshop, 5 July 2006**

**Robert Hull  
Transmission Director**

# Agenda

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

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# 1. Introduction and context

# Current stage in the process

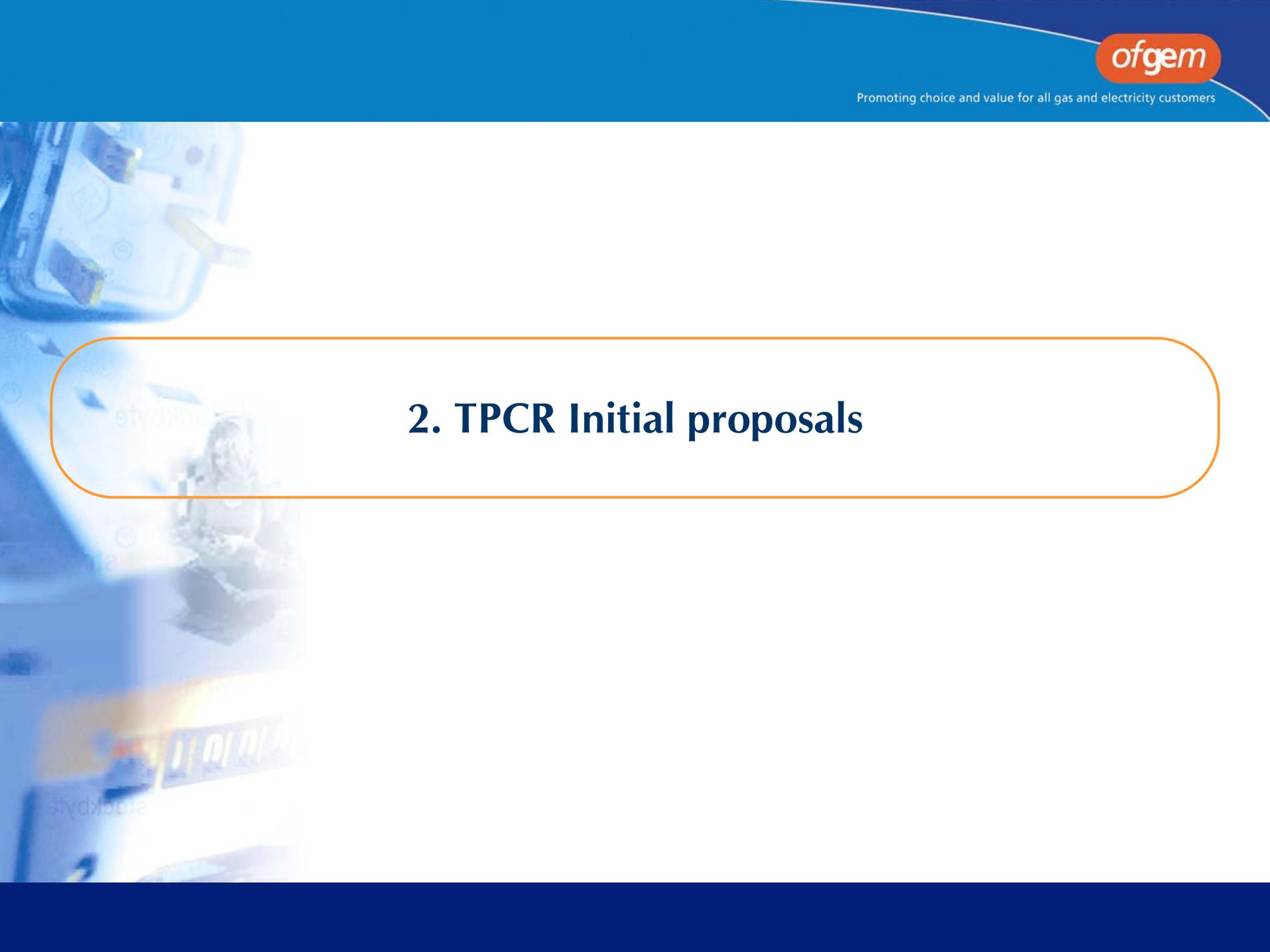
- **The June document sets out initial numbers for the four transmission companies; it focuses on**
  - initial cost assessment analysis for TO's
  - financial issues
  - price control incentive framework
  - modelling of potential revenue allowances
- **Access reform policies addressed earlier in the 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)

The background of the slide is a blurred, blue-tinted image of electrical components, including what appears to be a circuit board with various components and a connector. The text "2. TPCR Initial proposals" is centered within a white rounded rectangle with an orange border.

## 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

<b>Company forecast, 2007-12</b>	£3382m
Adjustments:	
Baseline definition	-£1252m
Other (chiefly unit costs)	-£257m
<b>Proposed baseline allowance</b>	£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

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

## Ofgem Initial Proposals on Baseline Capex

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

**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**

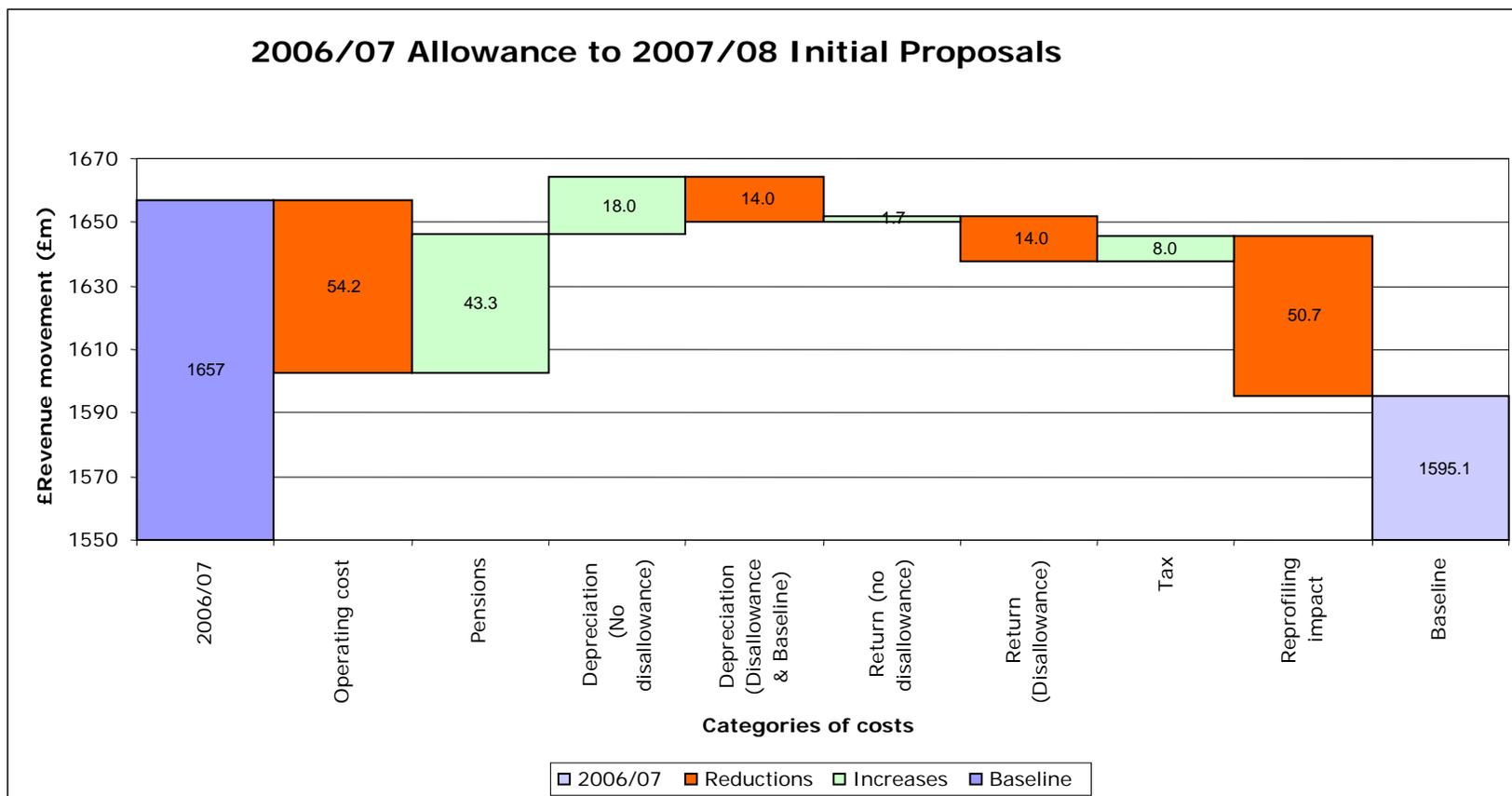
# Other Financial Issues

- **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

A blurred background image showing various electrical components, including what appears to be a circuit board with gold contacts and a component with a white plastic housing and a metal base.

## 3. Next steps

## Next steps

- **Deadline for responses 24<sup>th</sup> July**
- **Companies meet with Authority sub-committee – 26<sup>th</sup> 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**

A large, central version of the ofgem logo is positioned in the middle of the slide. It features the word "ofgem" in white lowercase letters on a red rounded rectangular background. The background of the slide is a blue-tinted image of electrical components, including a power outlet and a circuit breaker, which are slightly out of focus.

**Promoting choice and value for all  
gas and electricity customers**