National Grid Presentation
5 July Ofgem Workshop

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Agenda

- Opex
- Capex
  - Load-related and adjustment and incentive mechanisms
  - Non-load
- Financial Issues
- Overall impact on consumers

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Opex

Electricity and Gas Opex
Ofgem's Initial Proposals

- NGET
  - 2004/05
    - 16% "Normalisation" reduction
  - From this revised 2004/05 base Ofgem then factor in
    - A further 9% reduction from 2007/08
    - Increasing to 17% by 2011/12
- NGGT
  - 2004/05
    - 6% "Normalisation" reduction
  - From this revised 2004/05 base Ofgem then factor in
    - A further 8% reduction from 2007/08
    - Increasing to 16% by 2011/12

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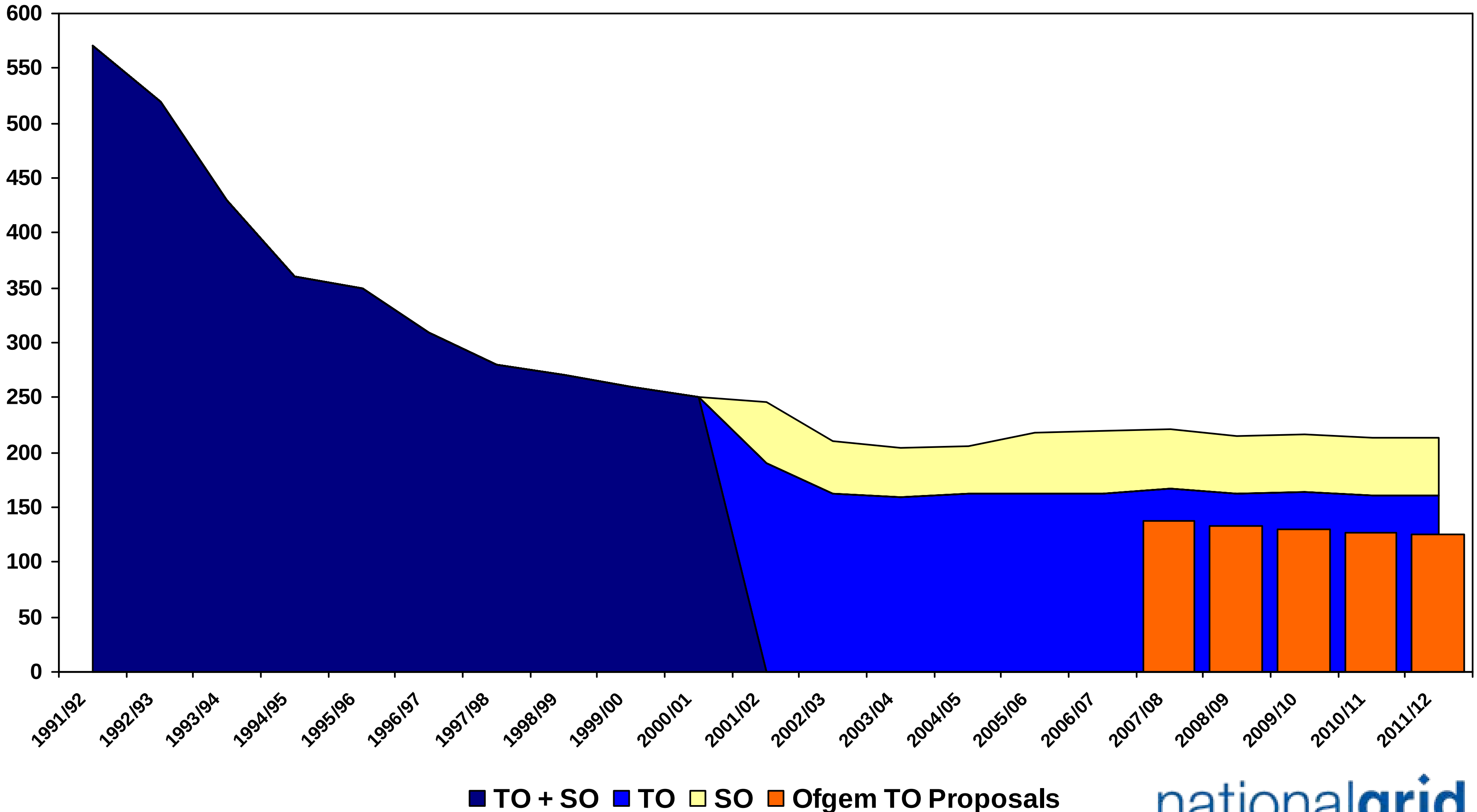
Electricity TO Opex
The Gap Between Us



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Why The Gap?

- "Normalisation" of 2004/05 is flawed
  - Normal costs deducted as if they were "abnormal"
- Projecting forward from 2004/05
  - Only partial recognition of "quasi capex"
  - No recognition of system expansion and asset condition upward drivers
  - No recognition of real pay growth in the economy
  - Future efficiencies contain overlap, error and arbitrary exclusions
- Reducing activity levels to align with Ofgem's targets would lead to reduced network reliability

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Load-related capex

Load-related capex in the round

- We agree on the desirability of using revenue drivers/adjustment mechanisms for ‘uncertain’ spend
- However, still need a baseline projection for load-related capex for
  - Financial modelling
  - As a baseline for adjustment
- Deal first with baselines and then with the adjustment/incentivisation mechanisms

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Ofgem’s proposals - electricity

- 2000/1-2004/5
  - Deemed efficient
- Deductions from our 2007/8-2011/12 plan
  - 13% “entry volume adjustment”
  - 2% “avoidable early replacement”
  - 4% “double counting”
  - 6% “scope for improved procurement” / above inflation unit cost increases for further review”
- 2005/6 and 2006/7
  - Treated as forecast years, thus deductions broadly consistent with Ofgem’s treatment of our 2007/8-2011/12 plan

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Ofgem's proposals - gas

- 2001/2-2005/6
  - £75m of investment re increased entry capacity at St Fergus deemed inefficient
- Deductions from our 2007/8-2011/12 plan
  - 58% "entry volume adjustment"
  - 8% "scope for improved procurement" / above inflation unit cost increases for further review"
- 2005/6 and 2006/7
  - Treated as forecast years, thus deductions broadly consistent with Ofgem's treatment of our 2007/8-2011/12 plan

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Our initial response (1)

- We need detailed feedback from Ofgem to comment on their assumptions
- 2005/6 and 2006/7 are completed/contractually committed and so PCR should update for this information
- Ofgem’s treatment of our procurement costs is hard to justify in the face of an inflationary market place
  - Steel costs
  - Pipeline build programme
  - Utility investment programmes
- As with non-load investment, need to reach agreement on likely future trend of unit costs

Our Initial response (2)

- We expect revenue drivers to deal with uncertainties but large proportion of load related investment is “validated”:
  - Capacity rights purchases through gas entry auctions
  - Agreement of ARCA for gas exit
  - Bilateral agreements and commitment to Final Sums for electricity entry and exit

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Adjustment mechanisms and incentives

Ofgem’s proposals

- Increased used of revenue drivers to deal with uncertainty
- Baselines set on the basis of actual system capability
- Simple or sophisticated UCAs
- Five year rolling incentives
- Assumption of interruption or capacity swap before investment
- Increased use of penal-only incentive schemes
  - Implicitly for new investment
  - Explicitly for electricity network reliability
- Question mark over extent to which investment purely and mechanically driven by user commitment

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Our initial response

- Supportive of overall approach but current package not acceptable, not least because
  - Gas baselines above actual system capability
  - UCAs lower than likely investment costs plus exposed to these for up to <u>two</u> price control periods
  - Proposed timing of incentive-driven cash flows could exacerbate financeability issues
  - Potentially huge downside on proposed gas investment incentive
- Overall
  - Proposals align poorly with our overall licence obligations
  - Downside dominates

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Non-load related capex

Ofgem's proposals - electricity

- 2000/1-2004/5
  - Deemed efficient
- Deductions from our 2007/8-2011/12 plan
  - 26% "lower level of asset replacement and refurbishment is required with more efficient unit costs"
  - 9% "scope for improved procurement" / above inflation unit cost increases for further review"
- 2005/6 and 2006/7
  - Treated as forecast years, thus % deductions are as for the 2007/8-2011/12 plan
- Ofgem's Initial Proposals (2005/06 – 2011/12):
  - *33%* cut in overhead lines investment
  - *27%* cut in switchgear investment
  - Further £128m cut in other plant types
  - Further procurement efficiency of £114m

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Our initial response

- Need detail on the basis for Ofgem's proposals but our own view is unchanged
- We are a responsible asset manager
  - Had to overspend to maintain reliability and to operate efficiently
    - Risk taking vs benefit of less asset replacement not economic to UK
- We have set out what we believe is required to maintain network performance
  - Based on robust, extensive asset condition information
  - In context with the scale and age of the network

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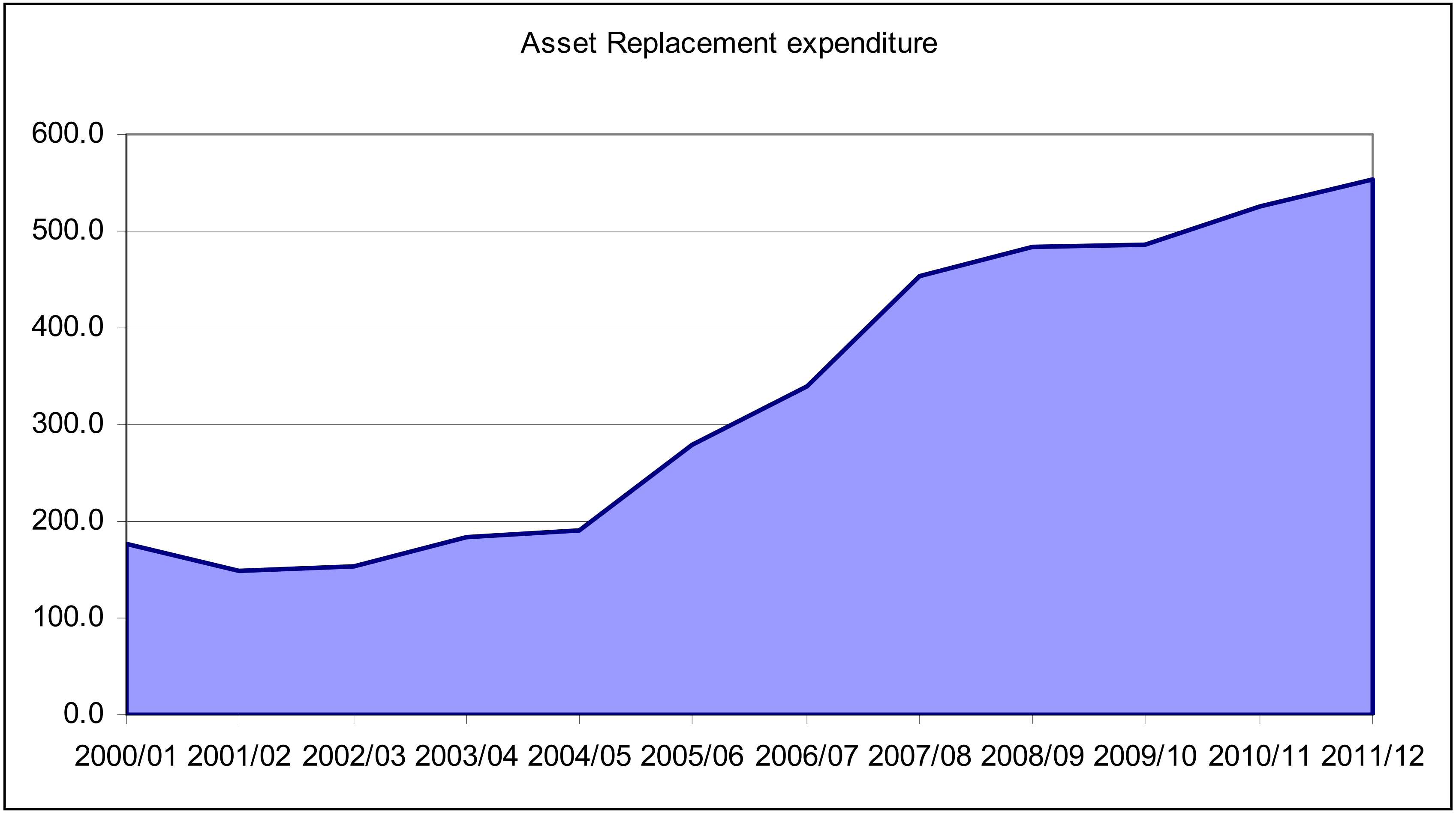
Asset replacement investment profile

Scale of expenditure forecast is large relative to the ***recent*** past…



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Asset replacement investment profile

… but **not** large in terms of the lifecycle and size of the network

Replacement cost of relevant part of network ≈ **£15.5bn**

Condition-informed weighted asset life of relevant network assets ≈ **46 years**

Majority of relevant assets installed between 1961 to 1970

- Replacement rates
  - Recent historical replacement rate ≈ **£150m p.a.**
  - Long-run steady state ≈ **£335m p.a.**
  - Installation rate ≈ **£900m p.a.**
  - Our plan ≈ **£500m p.a.**

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Why is our investment plan as it is?

- We understand
  - The condition of our assets and impact of assets failing
  - The drivers and rates of deterioration of those assets
- The asset replacement plan is based on assets being replaced just before the probability of failure becomes unacceptable
  - Assets replaced on the basis of **specific**, **detailed** condition information
  - Capital plan kept under constant review to reflect latest condition information
  - Replacement plans only identify sufficient replacement to **maintain** the existing performance of the network

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Short term consequences of spending less

- More assets at risk of failure
- Increased risk of loss of supply
    - Wide impact on consumers
    - Long time to replace or repair failed assets
- Increased risk of safety and environmental incidents

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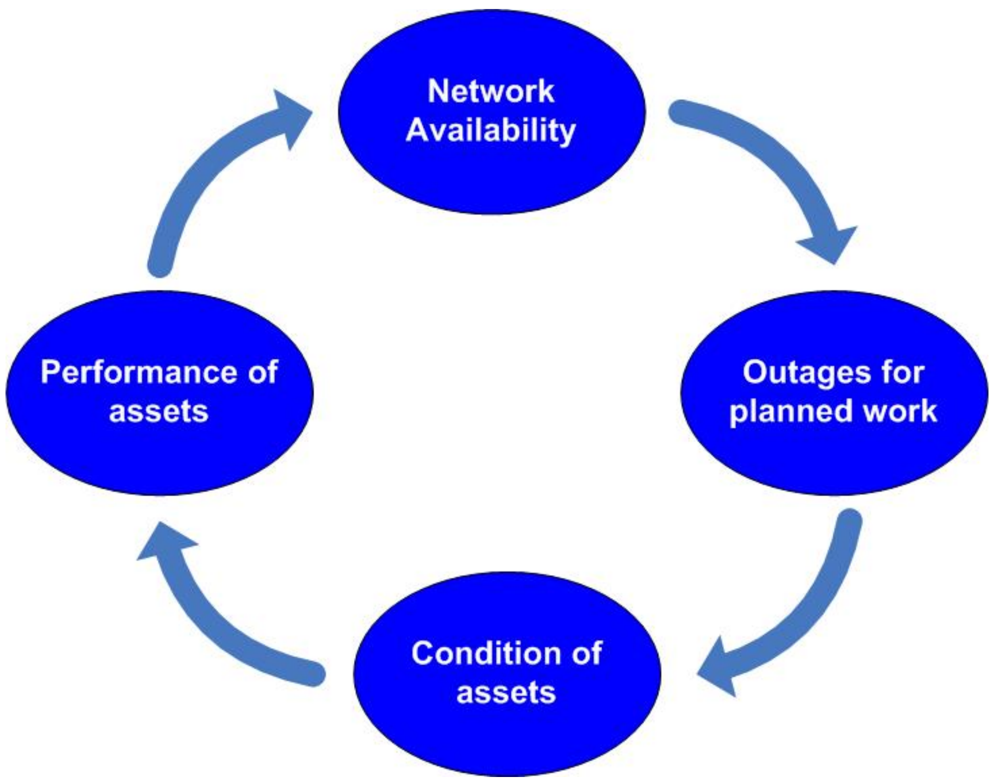
Long term consequences of spending less



- Increased asset failures
- More unplanned work
  - Increased opex and capex costs
  - Increased outage/ resource constraints
- Ultimately, deterioration of network beyond the point of recovery

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Ofgem's proposals - gas

- 2001/2-2005/6
  - Deemed efficient
- Deductions from our 2007/8-2011/12 plan
  - 30% of our emission reduction investment plan
  - 33% less asset replacement
  - 5% overall deduction for "scope for improved procurement"
- 2005/6 and 2006/7
  - Treated as forecast years, thus deductions broadly consistent with 2007/8-2011/12 plan

Our initial response

- Need detailed feedback but our own view is unchanged

- Our forecast sets out what we believe is required to
  - Meet legislative requirements with respect to emissions
  - Maintain the existing assets in serviceable condition to maintain security of supply

- Consequences of spending to Ofgem's plans
  - Loss of flexibility in network

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Financial Issues

Rate of return/financeability

- Early days on this
  - Main Ofgem RoR advice due for August
- Points to note at this stage
  - Pleased that Ofgem intend to deal with the NGET depreciation ‘cliff face’
  - DPCR4 RoR at top of relevant range because of the investment focus of the review - not obvious why this should not apply to TPCR
  - Major proposed break with DPCR4 (and with most other price reviews of the last ten years) on treatment of financeability – viz. any financeability issues assumed to be dealt with via equity injection
  - Issue of the implications of this for RoR, both
    - ‘Narrow’ transactional costs raised by Ofgem and
    - Potential wider impact on the nature of the National Grid investor base

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Pensions

- Proposals on ‘legacy’ pensions inconsistent with
  - Ofgas encouragement for Centrica divestment
  - Options available at the time on pension splitting
  - Practice at the time on risk sharing
- Proposals on ERDCs
  - Intrinsically unreasonable
  - Inconsistent with both the outcome of DPCR4 and the reasons given for that outcome
  - Appear to disincentivise honest and full provision of information to Ofgem

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Summary

Purpose of our spending plans

- Facilitate markets through network reinforcement and extension
- Maintain network reliability
- Maintain or improve the safety, physical security and environmental performance of the networks

while operating efficiently

Consumer cost and benefits

- Incremental price impact of our plan on domestic consumers
  - £2.20 p.a. for Gas consumers
    - Of which increased replacement capex = 10p
  - £1.25 p.a. for Electricity consumers
    - Of which increased replacement capex = 25p
- Benefits
  - A network that responds to market developments
  - The reliability that we believe customers expect
  - Responsible safety and environmental performance

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End