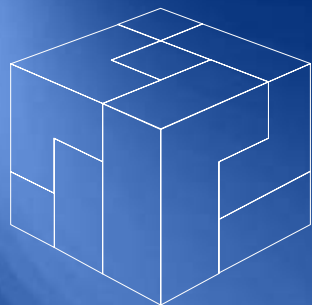


Regulation of UK Transmission: Which adjective should the agencies use now?



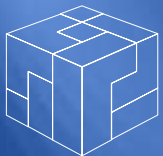
*Marc Watton
Utilities Analyst
BNP Paribas*



Corporate
and Investment
Banking

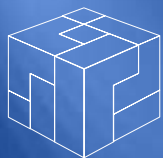
Description of Regulation – Through Several Iterations?

- **Antagonistic?**
- **Developing?**
- **Challenging?**
- **Supportive?**
- **Predictable?**
- **Stable?**



Why Does It Matter?

- **Debt Market is providing more than half of total capital employed and the cost of debt is in direct correlation to risk**
- **Debt Market looking for no surprises**
 - Predictability of cash flow
 - Sustainability of cash flow
 - Transparency of process
- **Regulatory reset is most important credit driver**
- **Bondholders increasingly comfortable with UK regulatory regime and understand building blocks of the review**



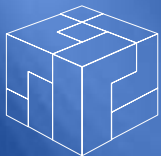
Regulatory Assumptions in Initial Proposals

- Note that these are 'initial' proposals and would expect both sides to give ground (as has been the case in previous reviews)
- We note the potential for additional revenues for required capex above the baseline as well as the incentive arrangements:
- Some concern about discrepancy between company capex plans and Ofgem initial proposal – but again that's not new
- While the cost of capital of 4.2% looks low in comparison with previous reviews, we understand the reasons for the reduction:



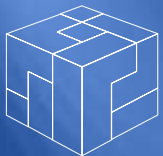
Regulatory Assumptions in Initial Proposals – Cont'd

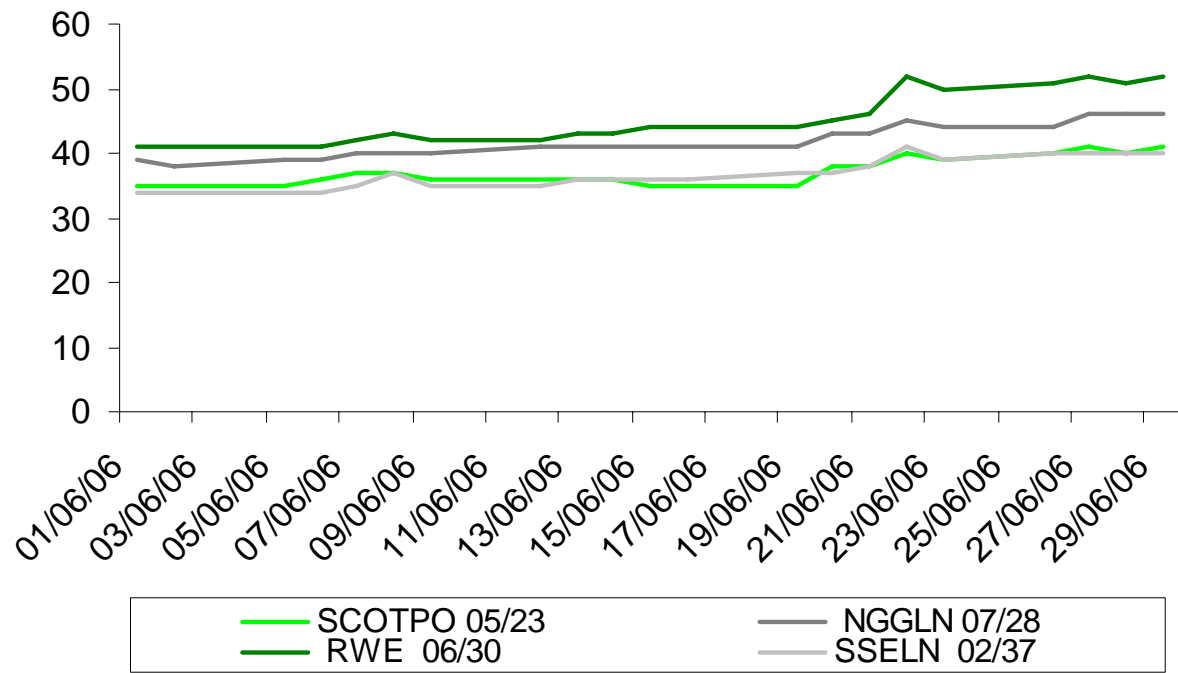
- The opening position in the proposal in respect of pensions and, in particular ERDC's, looks harsh and we would expect some closing of the gap
- Operating expenditure difficult to assess as outsider – looks quite tough
- Financeability – we applaud this clear approach. We felt that Ofwat's position was/is unsustainable. But will this approach work? Will equity markets deliver on request?
- Depreciation tilting – understand problem but worry about the transparency and general comprehension of this methodology.
- No surprises on RAV



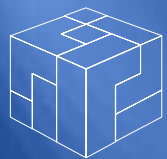
Conclusion

A picture is worth....





Source: BNP Paribas



Important Disclosures

Recommendation System:

Type	Terminology	Horizon
Credit Trend (1) Investment Recommendation (2)	Positive/ Stable/ Negative Buy/ Hold/ Reduce/ Sell (*)	6 months Up to 6 months

- (1) **Credit Trend** is based on underlying Credit fundamentals, business environment and industry trends;
- (2) **Investment Recommendation** is based on BNPP Credit Trend and Relative Value opinions.
- (*) **Buy**: Overweight exposure within industry sector, based on strong financial profile, conservative risk and/or solid relative value considerations, outperforming or demonstrating average performance within peer group;
- Hold**: Exhibits solid to strong credit fundamentals, but average total return characteristics within peer group;
- Reduce**: Credit exposure should be pared down based on weakening fundamentals and/or below average relative value characteristics within peer group;
- Sell**: Sell exposure largely based on deteriorating credit fundamentals and/or negative headline or event risk.



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