Scottish and Southern Energy

Transmission Price Control

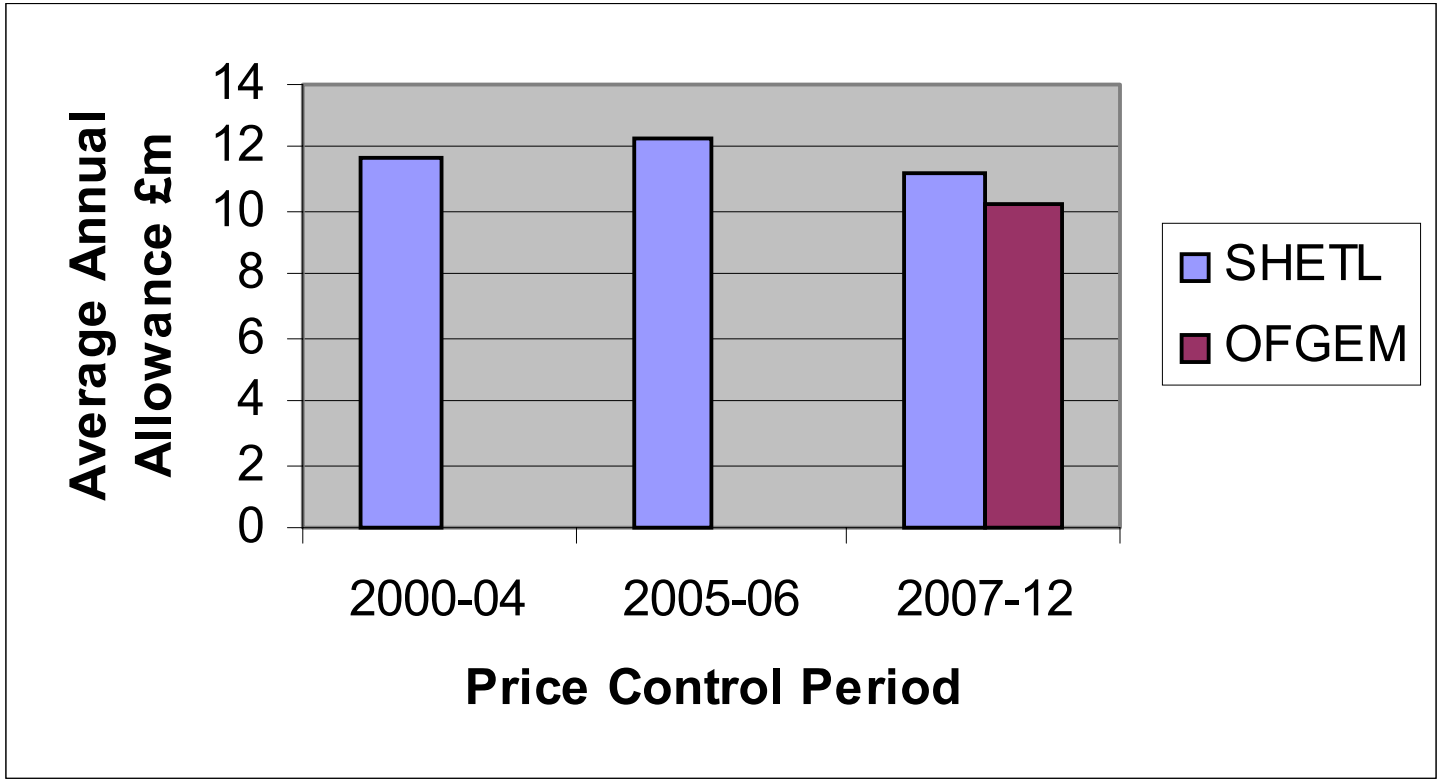
Initial Proposals Workshop

5th July 2006

Key Issues

- Capital Expenditure
  - Non Load Related
  - Load Related
  - Revenue Driver mechanisms
- Financing Issues
- Incentives
- Summary

Non Load Related Capex



Load Related Capex

Local Infrastructure

SHETL Forecast	£122m	
Connection Design	-£13m	NGET Charging
Volume Adjustment	-£26m	Revenue Driver
Baseline	£83m	

Deep Infrastructure

SHETL Scenario	£878m	
of which	£260m	already approved
and	£618m	Revenue Driver

Islands: Separate mechanism required

Connection Design

- "Plugs" methodology removed incentive on generators to opt for most economic connection design
- Ofgem has
  - asked NGET to look at ways of restoring the economic signal
  - assumed that generators will respond to the signal when introduced
  - disallowed £13m SHETL capex in these proposals
- However
  - our figures suggest cost-reflective reduction of £4/kW TNUoS
  - NGET proposal for Nodal Security Factor gives 16p/kW discount
- Some way to go to restore the economic signal

Revenue Drivers

- Agree that ex-ante allowance not appropriate for capex with significant uncertainty
- Might be able to deal with local infrastructure through a revenue driver
  - Large number of small projects
  - Needs to have appropriate balance of risk
  - Needs to ensure funds released at the right time to finance the investment
- Number of problems to resolve with “deep” revenue driver

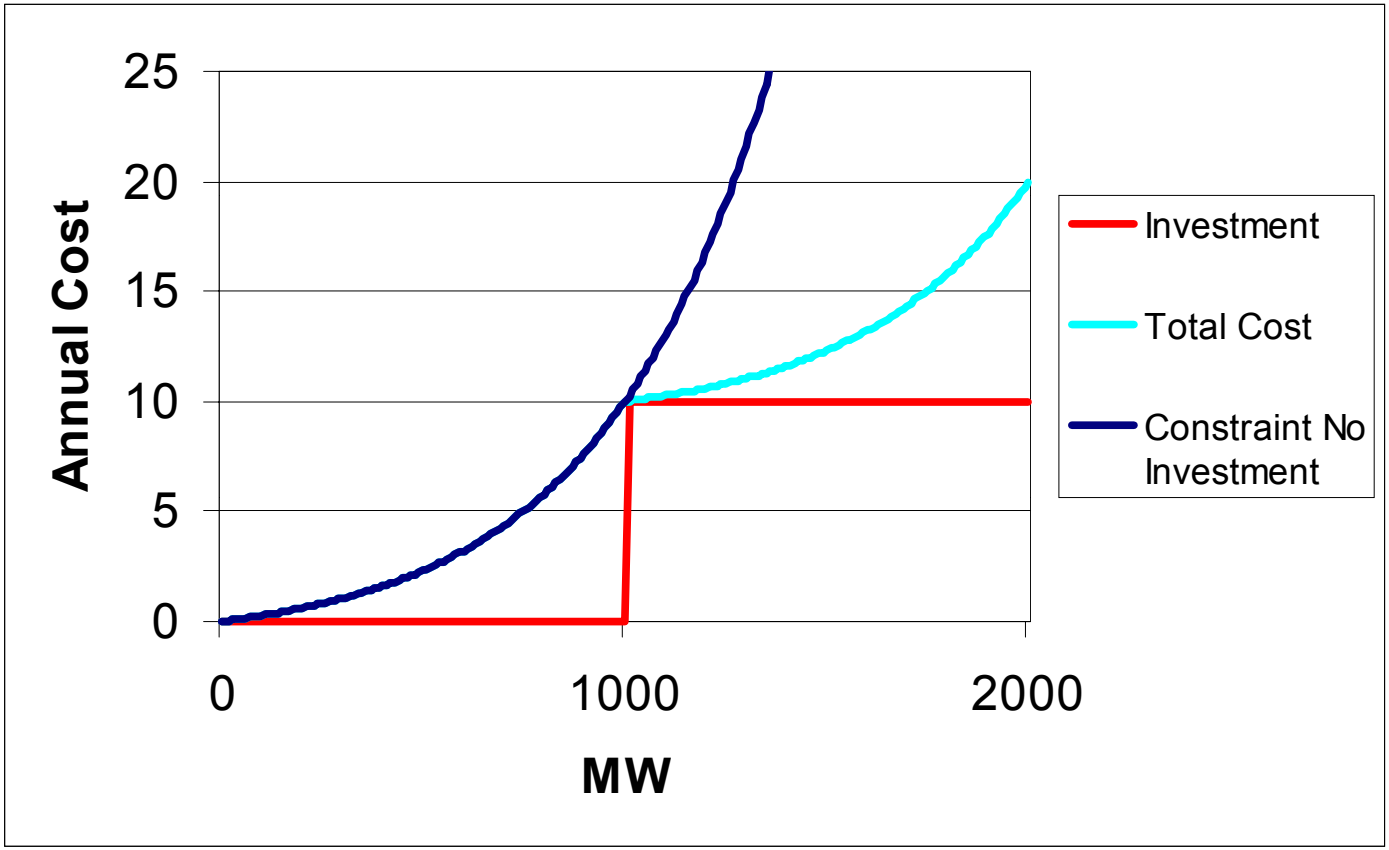
Revenue Driver - 'Local'

- Two options
  - Formula approach, or
  - £ per MW plus pass-through
- Formula approach in general gives a better fit for SHETL but will be difficult to codify in a licence
- "£ per MW plus pass through" simpler to apply and established precedent in distribution
- Further urgent work required to develop proposals
  - scheme parameters
  - high cost schemes
  - caps and collars on overall exposure

Revenue Driver - Deep

- Small number of large projects
- Driven by aggregation of generation in particular zones
- number of potential issues that will have to be resolved before these would be acceptable

Lumpy Investment



Issues for Revenue Driver

- Investment is often economic even if only small percentage of incremental capacity is utilised
- But £/MW driver encourages investment only when 100% capacity “required”
- Risk of delayed investment
- By definition, there is no “future proofing” of network, even if efficient
- Higher risk for licensee therefore higher cost of capital
- And potential for sub-optimal investment

Design of Mechanism

- £/MW driver not appropriate
  - Would not deal with lumpy investment
  - Potential incentive problems (wait till capacity signed up)
- Step release mechanism?
  - Would deal with lumpy investment issue
  - Need to resolve timing issues and detailed form
- Existing Major works funded through “TIRG”
  - Economic test of efficient investments
  - Funds released when construction starts
  - Incentive on licensee for timely and efficient delivery

Financing Issues

- Efficient companies should be capable of earning 5.5% to 6% post tax real, including scope for outperformance, to attract equity
- Particularly important given SHETL's financing issues
  - Current RAV £270m
  - Current revenue £50m
  - Potential Capex £1.1bn
- Ofgem's range for the cost of capital is therefore a concern
- While CAPM is important, it should not be the only evidence - Ofgem needs to take account of the market and other regulatory precedents

Incentives

- Agree that Capex rolling incentives should be employed
  - removes perverse incentives for timing of efficiency improvements
  - consistency with Distribution
- Agree that IFI should be introduced
- Opposed to “penalties only” scheme for interruptions

Summary

- Cost of Capital is a key concern
- Much work to do in defining and quantifying the revenue driver mechanisms
- More work to do on incentive mechanisms (e.g. interruptions and capex rolling incentive)