

# Ofgem Price Control Reviews

## Analyst Presentation – 25 September 2006

**The conference call, which this presentation accompanies, will be recorded.**

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**Disclaimer:** The information contained in these slides is a summary of the proposals for the transmission & gas distribution price controls. Full details of GEMA's proposals for the price controls are set out in the publications "Transmission Price Control Review: Updated Proposals" and "Gas Distribution Price Control Review One Year Control Initial Proposals". The information contained in these slides is intended to summarise some aspects of the key features of the proposals but neither GEMA nor Ofgem represent or warrant that the information contained in these slides constitutes an accurate or complete summary of the proposals.

# Scope of presentation

- Today Ofgem issued key documents relating to two price controls
  - Transmission Price Control Review Updated Proposals
  - Gas Distribution Price Control Review One Year Control Initial Proposals
- This presentation covers both documents



# Transmission Price Control Review Updated Proposals

**Note: All figures quoted are in £m 04-05 real, unless otherwise stated**

# Revenue calculations

- Proposed revenue for 2007/08 (based upon  $X=0$ ) is:

	NGGT	NGET	SPTL	SHETL	Total	% change from 06/07
2006/7 allowance	442.0	1,004.6	159.6	50.8	1,657.0	
Initial Proposals (IP)	471.1	939.7	135.5	48.9	1,595.2	-4%
September Update	474.2	1,080.5	149.9	49.3	1,753.9	6%
Change from IP	3.1	140.8	14.4	0.4	158.7	

- The major changes since IP are for NGET and SPT. Changes are due to:
  - Modelling of the depreciation cliff edge for all electricity transmission companies
  - Changes in pensions for NGG and NGET due to revised assumptions
  - Opex and capex changes
  - Changes in tax resulting from other changes

# Capex summary (2007-12)

£m	NGG	NGET	SPTL	SHETL	Total	% change from adj. bid
Capex allowance (last 5 year price control)	889	1453	152	71	2565	
Licensee original bid	1346	3816	717	834	6713	-
Licensee adjusted bid	938	3660	674	182	5455	-
Initial proposals (IP)	737	2790	555	164	4246	-22%
September Update	797	2953	576	178	4503	-17%
Change from IP	60	163	21	13	257	
September Update – change from last price control	-92 (-10%)	+1500 (+103%)	+424 (+278%)	+107 (+151%)	+1938 (+76%)	

- *This is an overall capex increase of almost 80% since last price control period, now totalling over £4.5 billion, and some £260m higher than Initial Proposals.*
- *TIRG expenditure of £530m for 2007-12 then takes total allowed spend to over £5billion (double that for the last review period). i.e. investment planned is in excess of £1billion per annum.*
- *In addition, flexible revenue adjustments will trigger more investment as customers need it*

# Controllable Opex – (2007-12)

£m	NGGT	NGET	SPTL	SHETL	Total	% change from co. bid
<b>Company bid</b>	324	896	94	34	1,348	
<b>Initial Proposals (IP)</b>	282	709	75	28	1,094	-19%
<b>September Update</b>	293	754	79	29	1,155	-14%
<b>Change from IP</b>	12	45	4	1	61	

- Overall controllable opex reductions are 14% (which includes a 1.5% per annum future efficiency assumption)

# Pensions

PENSION DATA (TO & SO combined for NG)	NGGT	NGET	SPTL	SHETL
Deficit at last valuations (2003 & 2004)	(£879m)	(£272m)	(£198m)	£44m
(Deficit)/surplus forecast by companies at IP	(£425m)	(£406m)	Surplus	Surplus
(Deficit)/surplus – September Update	(£372m)	(£406m)	Surplus	Surplus
Sept (Deficit)/surplus – after adjustments for 1) Centrica surplus, and 2) 70:30 ERDC's	(£188m)	(£358m)	n/a	n/a
Annual allowances, future funding (opex & capex) at IP	£16m pa	£19m pa	£3m pa	£2m pa
Annual allowances, deficit repair (opex & capex) at IP	£9m pa	£27m pa	n/a	n/a
Annual allowances, total (opex & capex) at IP	£25m pa	£47m pa	£3m pa	£2m pa
Annual allowances, future funding (opex & capex) - Sept Update	£19m pa	£19m pa	£1m	£2m
Annual allowances, deficit repair (opex & capex) - Sept Update	£25m pa	£46m pa	n/a	n/a
Annual allowances, total (opex & capex) – Sept Update	£44m pa	£65m pa	£1m pa	£2m pa

# Cost of capital

- We continue to use a modelling figure for cost of capital of 4.2%
  - a final decision on cost of capital will be made in December
- We are publishing a report on cost of capital, by Smithers & Co.
  - Re-affirms the view that the long run risk free rate is 2.5%
  - Estimates a real pre-tax cost of debt of 3.5-4.25%
  - Indicates that long term total market returns are in the range 6.5 to 7.5% (dependent on time horizon)
  - Highlights that statistically, network utilities represent lower than average market risk to equity investors
  - Smithers' central estimate of the real cost of equity is in the range 4.5% to 6.25%, based on a beta factor of 0.5, for a sample of listed UK water and energy utility companies. Statistical confidence intervals around these figures are, however, very large.
- We welcome comments on the report's findings

# Financeability

- We have proposed mechanisms, to deal with the depreciation cliff edge as for DPCR4
- Initial financeability modelling indicates:
  - Using baseline Ofgem estimates for Opex and Capex no licensee requires any extra funds to meet credit ratio targets.
  - Using high case Ofgem estimates for Opex and Capex SHETL (and possibly SPTL) would require extra equity to meet credit ratio targets.
- The update document sets out options to apply if licensees need to raise equity to deliver investment plans and maintain appropriate credit ratings

## Next steps

- Update Consultation responses by 24 October
- November Authority meeting to finalise issues
- Final proposals – 4th December



# Gas Distribution Price Control Review One Year Control Initial Proposals

**Note: All figures quoted are in £m 05-06 real, unless otherwise stated**

# One year control overview

## Proposed changes in allowances from 2006-07 to 2007-08

		2006-07	2007-08	% change
NGG	East of England	380.1	426.1	12.1%
	North London	223.0	244.7	9.7%
	North West	258.0	282.6	9.5%
	West Midlands	196.3	217.8	11.0%
NGN	North England	251.7	273.5	8.6%
SGN	Scotland	172.1	184.5	7.2%
	Southern	382.8	418.6	9.4%
WWU	Wales and West	223.3	241.2	8.0%
	<b>Total</b>	<b>2,087.3</b>	<b>2,288.9</b>	<b>9.7%</b>

## Areas where we have adopted a simple approach

- Capital and replacement expenditure allowances for 2007-08
  - propose total allowances of £925.9 m
  - 7 per cent less than the companies asked for
- Controllable operating expenditure allowances for 2007-08
  - propose total allowances for £563.4 m
  - 9 per cent less than the companies asked for
  - pensions, shrinkage addressed separately
- Cost of capital
  - rollover existing cost of capital but convert to a post-tax figure
  - propose 4.38% post-tax WACC, equivalent to 6.25% pre-tax
  - company specific ex ante allowance for tax

## Issues we are addressing as part of one year control

- Historical capex and repex assessment and RAV roll forward
  - GDNs are forecast to overspend allowances by £843 m or 65% over period
- Shrinkage proposals include
  - increase in total allowances from £38.9 m in 06-07 to £92.0 m in 07-08
  - new methodology for setting shrinkage allowances which removes price risk from companies
- Pensions proposals include
  - increase in total allowances from £22.1 m in 06-07 to £122.1 m in 07-08
  - adoption of Ofgem's pensions principles, arrangements to support GDN sales
- Tax proposals include
  - introduction of company specific ex ante tax allowance
  - treatment consistent with other Ofgem price controls
  - results in significant reduction in P0 reflecting GDNs' actual tax costs

# Historic capex and repex assessment

	Within allowance	Above allowance
Efficient	<p><b>Full recovery from year incurred.</b></p>	<p><b>Exposure to capital charges for 5 yrs, recovery thereafter.</b></p>
Inefficient	<p><b>Recovery of capital charges for first 5 yrs only, then no recovery.</b></p>	<p><b>No recovery of capital charges. Excluded from RAV.</b></p>

Pot 1

Pot 2a

Pot 2b

Pot 3a

Pot 3b\*

\* Reopener for change of circumstance. Full recovery up to allowed unit cost.

# Historic capex and repex assessment

## Proposed treatment of historical capex and repex (total all GDNs)

<b>How we propose to deal with the overspend</b>	
Inefficient above allowance (Pot 1)	50.0
Other disallowed overspend (related party margins, DN sales costs, connections under-recovery) (Pot 1)	72.8
Efficient overspend (Pot 2b)	634.2
Reopener (Pot 3b)	86.3
<i>Total overspend</i>	<i>843.3</i>
<b>How we propose to deal with allowed spend</b>	
Inefficient spend within the allowance (Pot 2a)	14.0
Efficient allowed spend (Pot 3a)	1291.5
<i>Total allowance</i>	<i>1305.4</i>

# RAV roll forward

## Proposed RAV forwards (total all GDNs)

	2002-03	2003-04	2004-05	2005-06	2006-07
Opening value as per last control	10,634.7				
Additions to pre-2002 assets	90.9				
Revised opening value bf	10,725.6	10,844.8	10,844.8	10,814.7	10,792.2
Depreciation	(376.3)	(380.6)	(382.4)	(383.5)	(384.7)
Net capex additions	507.0	379.4	351.4	365.3	380.4
Disposals	(11.4)	1.2	0.8	(4.5)	(3.5)
<b>Closing RAV (incl. Pot 3)</b>	<b>10,844.8</b>	<b>10,844.8</b>	<b>10,814.7</b>	<b>10,792.0</b>	<b>10,784.3</b>
Pot 2 additions (cumulative)	53.3	126.6	213.7	411.6	620.3
Pot 2 depreciation (cumulative)	0.0	(1.2)	(4.0)	(8.7)	(17.9)
<b>Total closing RAV</b>	<b>10,898.1</b>	<b>10,970.3</b>	<b>11,024.4</b>	<b>11,194.9</b>	<b>11,386.7</b>

# Next steps

Milestone	Date
Publish one year control initial proposals	25 September
Publish PB Power Report, financial model	w/c 2 October
Deadline for GDNs' main control cost submissions*	6 October
Meetings with companies	October/November
Deadline for initial proposals consultation responses	23 October
Publish main control third consultation document	Late November
Publish one year control final proposals	Early December

\* It may be necessary to update our proposals if relevant new information becomes available.



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