Promoting choice and value
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Gas distribution price control review 2008-13
Initial Proposals
Analyst presentation

29 May 2007

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

To access this recording after the call dial +44 (0) 207 190 5901 and enter the pin 135945# The recording will be available until close of play on 4 June.

Disclaimer: The information contained in these slides is a summary of the proposals for the gas distribution price control. Full details of GEMA's initial proposals for the price controls are set out in the publication "Gas Distribution Price Control Review Initial Proposals". The information contained in these slides is intended to summarise some aspects of the key features of the initial 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.

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

Key themes

- Benefits of GDN sales beginning to be realised through comparisons
- Significant scope for operating cost efficiencies
  - allowances on average 8% below 07/08
- Increased investment driven largely by HSE-mandated mains replacement programme
- Cost of capital – consistent approach to recent reviews – decision at final proposals
- GDN charges to increase by 0.6% per annum
- Work in progress

Operating costs - approach

- Our consultants have benchmarked both direct and indirect opex at a disaggregated level to upper quartile
- Disaggregated benchmarking more robust as cost drivers are clearer, but results in more challenging target
- Therefore uplifted so total opex across GDNs equivalent to a top-down frontier approach
- Real price effects of 1-2% p.a./ productivity assumption of 2.5% p.a.
- Regional factors for GDNs operating in London
- Pension contribution rates increased in line with GDN forecasts and deficits funded in full

Operating cost allowances

GDN		Average annual opex 2002-07	07/08 Allowances	Average annual allowance 2008-13
NGG	East of England	110.2	109.8	95.7
	London	74.5	71.7	67.0
	North West	82.9	80.4	74.0
	West Midlands	60.6	59.9	54.0
NGN	Northern	77.6	77.3	73.0
SGN	Scotland	66.3	65.2	57.0
	Southern	111.0	105.5	105.4
WWU	Wales & West	79.3	82.7	71.9
Total		**662.4**	**652.5**	**598.0**

2005/06 prices. Figures include pensions but exclude shrinkage allowances

Capex / Repex - approach

- Benchmarked unit costs
- RPEs, regional factors and efficiency improvements also applied where appropriate
- Consultants' assessments of workload
- Bottom-up analysis, particularly of large capex projects
- GDN and Ofgem views compared using IQI (equivalent to sliding scale mechanism in DPCR4) - outputs include:
  - Capex/repex allowances as percentage of Ofgem's view
  - Incentive rate for under/overspend during control
  - Additional income/penalty

Capex/repex post-IQI

GDN		Total capex/repex allowances 2008-13	%age reduction from company forecast	Under/over spend incentive rate	Total additional income/(penalty) 2008-13
NGG	East England	683.1	6.1%	33%	5.4
	London	566.6	15.9%	33%	4.2
	North West	604.2	10.7%	33%	4.6
	West Midlands	415.6	4.8%	33%	3.4
NGN	North England	618.9	8.9%	36%	9.3
SGN	Scotland	485.1	20.1%	23%	-9.6
	South England	1,114.0	21.2%	23%	-22.1
WWU	Wales & West	637.0	13.7%	32%	3.0
Total		**5,124.5**	**13.9%**		**-1.8**

2005/06 prices

Indicative RAV

	NGG	NGN	SGN	WWU
Opening RAV 1 April 2008*	5,907.7	1,340.0	3,200.7	1,234.0
Capex/repex Additions	2,269.6	618.9	1,599.1	637.0
Less: repex expensed (50%)	-828.2	-198.7	-492.8	-193.6
Depreciation	-1,075.6	-245.4	-586.5	-223.9
Closing RAV 31 March 2013	6,273.5	1,514.9	3,720.5	1,453.5

2005/06 prices

* As per 1 year control – will depend on GDNs' actual spend 2006-08

Cost of capital

- TPCR most recent reference point
- Long-term trailing average debt costs still on downward trend
- Current yields could support a figure as low as 3%
- Cost of equity - between 6.5% and 7.5% as per previous reviews – relative risk analysis will determine where
- Gearing 62.5% in previous control, but IDNs able to maintain investment grade ratings at 70%+

	TPCR Dec 2006	GDPCR May 2007	Indicative range
Cost of debt (real, pre-tax)	3.75%	3.55%	3.0-3.75%
Cost of equity (real, post-tax)	7.0%	7.0%	6.5-7.5%
Gearing (% debt)	60%	62.5%	60-70%
Vanilla WACC	5.05%	4.84%	

Other financial issues

- Maintaining policy of expensing 50% repex but keeping open mind
- Any change unlikely to be > 10% in either direction, due to effects on key ratios and changes to allowances
- No change to depreciation (45 year straight-line)
- Current tax treatment of repex vs. regulatory treatment leads to regulatory tax losses for most GDNs
- No profiling – keeps allowances cost-reflective
- Initial financeability review does not raise serious concerns

Revenue allowances

GDN		Allowances 2007/08	Average annual Allowances 2008/13	Average annual % change
NGG	East England	427.2	416.8	-0.8%
	London	245.1	261.2	2.2%
	North West	285.5	286.7	0.1%
	West Midlands	217.8	218.3	0.1%
NGN	North England	273.5	281.0	0.9%
SGN	Scotland	194.3	192.7	-0.3%
	Southern	432.4	450.4	1.4%
WWU	Wales & West	252.0	261.7	1.3%
Total		**2,327.7**	**2,368.7**	**0.6%**

2005/06 prices

Outstanding items – may lead to material changes by final proposals

- Whether to introduce an opex rolling incentive
- Assessment of LTS capex in light of interruptions and offtake reform
- Capacity outputs incentive for final 18 mths of price control
- Assessment of riser replacement workload
- Assessment of extent to which emergency services costs impacted by loss of meter work
- Impact of waste management regulations and Traffic Management Act
- Relative risk analysis: GDPCR vs. TPCR
- Update costs analysis for 06/07 actuals and revised forecasts

Next steps

- GDN 2006/07 actuals due 1 June
- Initial proposals workshop 5 July (provisional)
- Responses to initial proposals due 13 July
- GDN reforecasts due 13 July
- Outcome of appeal of offtake reform due during July
- September update due for publication 24 September
- Final proposals to be published early December

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