RPI-X@20

Stakeholder Workshop – 7 November 2008

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British Gas has unique perspective as the only big energy supplier without network assets

- We spend £2bn p.a. on gas and electricity network charges
- The other five major suppliers all own network assets, either in the UK or abroad, and are therefore conflicted
- British Gas provides a well-resourced, independent challenge to the network operators in the industry

RPI-X is a myth!

- Recent price controls:
  - Electricity Distribution (2004): RPI with P_o average 1.3%
  - Transmission (2006): RPI+2 (RPI for gas, with P_0 of 8%)
  - Gas Distribution (2006): 1 yr control with 11.5% increase
  - Gas Distribution (2007): RPI+2

- Our annual network charges have increased by 10% in real terms in last 3 years (20% nominal)

- The rate of increase is likely to accelerate, given further pressure for capital investment

Customers pay more as a consequence of T&D volatility

- Unlike commodity price risk, suppliers cannot hedge T&D cost risk
- We take substantial price risk on T&D costs
  - 24% (3.7 million) of our household customers on fixed price deals
  - 70% of our industrial, commercial and business customers are on fixed price (network charge risk retained by us)
- If our T&D charges exceed forecasts, we make lower margin (or our tariff customers have to pay more)
- Customers are charged a risk premium for fixed and capped products to cover T&D volatility

There is no visibility or predictability about how our costs will vary

- Our forecast range of variance around our expected T&D cost for 2009 is £300 million (15% around our central estimate)

- This is 50% more than our average annual net profit over the last five years

- High value reopeners within a control period are common
  - e.g. Transmission investment to support renewables (£560m agreed in 2005)
  - e.g. Tree cutting (£50m for 5 DNOs in 2009/10)

- Reopeners transfer price risk to suppliers and customers, and should only be used in exceptional circumstances

- Networks are better placed than suppliers and customers to manage these risks

RPI-X has not performed well for capital investment

- Under RPI-X, capex focus has been on inputs (ie £ invested) and not delivered outputs (ie measurable operational improvement)
  - Networks incentivised to spend to build the RAB
  - Networks often receive higher capex allowances than they spend

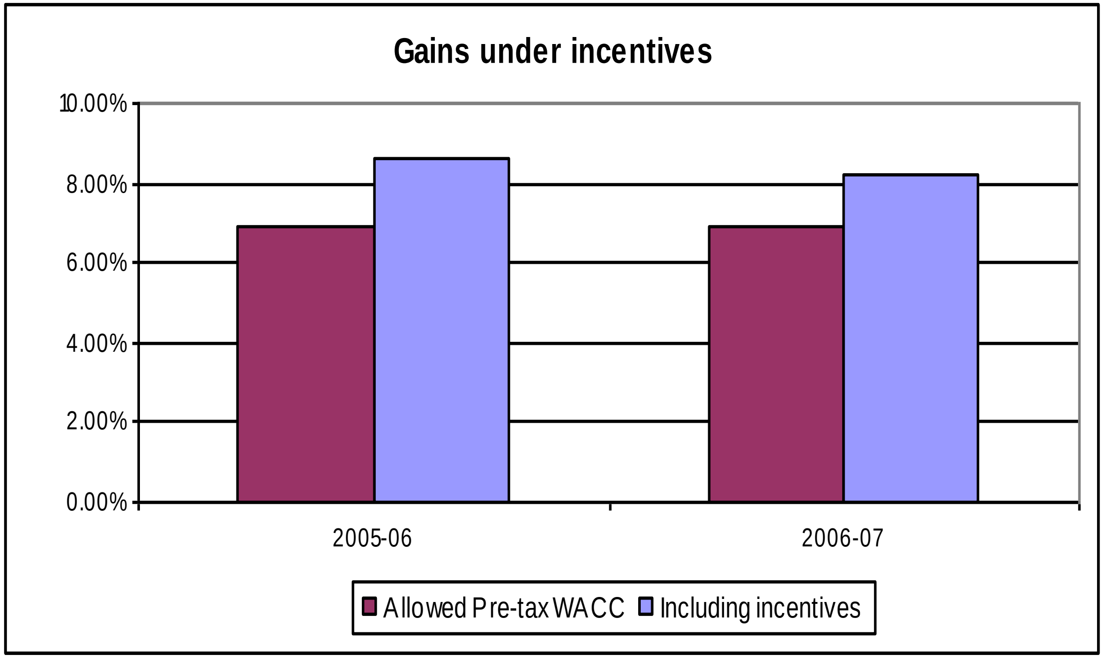
      e.g. Most DNOs have to date underspent their capex allowances, including two by more than 30%
- These are major concerns as networks want to spend £10 bn+ in next five years to transform our energy networks
- However, model has driven greater opex efficiency, where benchmarking is more effective on shorter term, recurring spend

Incentive scheme returns are high relative to level of operational performance

- Incentives to improve capex delivery and encourage more sustainable networks have led to complexity and questions over value for money, where "start to earn" levels are too generous

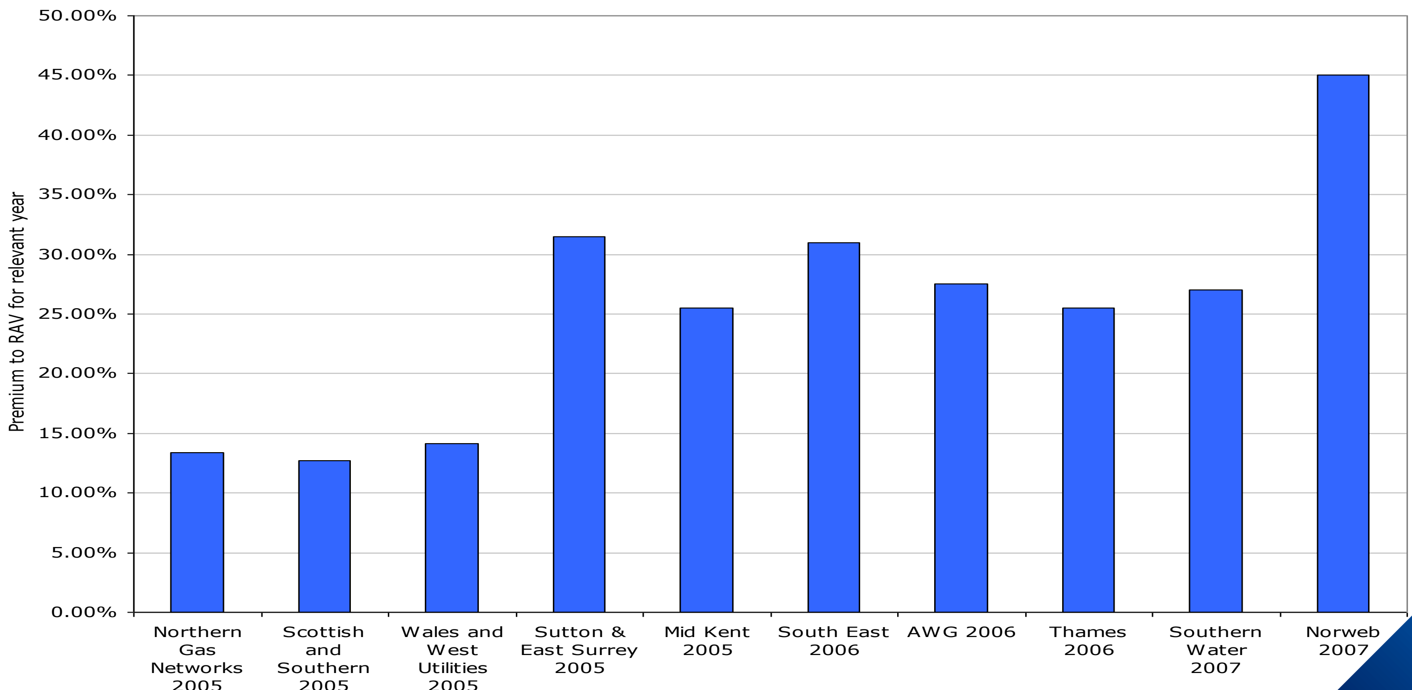
  e.g. DNOs received in total over £100 million for an <u>increase</u> in losses of 2% from 2004/5 to 2005/6

- Incentive payments under DPCR4 are adding £200-250m p.a. to DNO revenues, equivalent to about an extra 1.5% on the allowed WACC



RAV premia suggest networks will outperform the regulatory settlement

- Evidence from transactions for listed power and water company shares shows the 'true' WACC, was lower than the allowed WACC
- Listed regulated utilities have lost 8-13% vs FTSE loss of 30% over period Jun 07-Oct 08, pointing to continued relatively low cost of equity and a likely continued market asset ratio premium



Wider engagement is key to better capex planning and budgeting

- Create competitive dynamic in the negotiations (e.g. airport constructive engagement)
- Give competitive market players (suppliers, generators, customers) a formal approval role in the process
- However current complexity disincentivises wider engagement
- No network operator has rejected an Ofgem price control decision and appealed to the CC since 1997

British Gas' view of success for RPI-X@20

- Rewards to network owners correspond much more closely to the risks they bear and the performance they deliver
- Networks bear more risk, recognising costs to customers and suppliers of charging volatility
- Networks get rewarded for their capital expenditure based on their delivery of customer-driven outputs