Press Release

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Promoting choice and value for all gas and electricity customers

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Regulator sets tough investment-led price controls on regional electricity networks

- **Investment up 40 per cent on the last five years' spend to £7.2 billion, including sustainability funding (£6.7 billion capex plus £500 million low carbon fund)**
- **New £500m fund paves the way for large-scale trials of smart grids and other technology required in a low carbon economy**
- **The two most efficient companies can spend the sum they asked for, but overall the bids were cut by 8 per cent as Ofgem ensured value for money for consumers**
- **Ofgem sets the companies tougher targets for network reliability, and customer service**

The final proposals will govern the revenue of the 14 Distribution Network operators (DNOs) for five years from April 2010. With an average increase in electricity bills of £4.30 a year, householders will get better customer service, improved reliability and a greener electricity supply. The new controls will also open the way for much-needed local power generation and other developments to help tackle climate change.

The regulator's Chief Executive Alistair Buchanan said: "Our proposals are tough on inefficiency and poor service but are fair in allowing the companies to invest to replace ageing network assets and in improving the environment. The controls provide great opportunities for companies which are more efficient and excel at providing what their customers want - but they will penalise poor performers.

"We have listened to consumers' expectations of top quality service, reliability, fair prices and environmental improvement for today and for the future."

As part of the price control Ofgem sets the cost of capital which is the benchmark return on investment for each DNO. Ofgem has set a 4.7 per cent actual (called vanilla) weighted average cost of capital (using a pre-tax cost of debt and a post-tax cost of equity). Our assessment, assisted by Price Waterhouse Coopers, is that low risk utilities like the DNOs can adequately finance themselves at this rate. Additionally, we have set robust incentive mechanisms that give companies significant opportunities to boost overall returns. Alternatively, if DNOs fail these incentives their shareholders, and not consumers, will carry the costs of underperformance.

The proposed investment returns plus the £6.7 billion allowed spend ensure that DNOs can fund the capital expenditure both to replace ageing equipment – some of which is more than 50 years old, and to link the networks to renewable generation.

The DNOs will have an opportunity to bid for cash from a new £500 million fund earmarked for innovative projects that will combat climate change. This Low-Carbon Fund (LCF) will be available to DNOs and partner companies to use over the next five years to help to pave the way for local generation, growth in electric vehicle use and other projects that will be needed to meet our climate change targets.

Ofgem chairman Lord Mogg said: "This fund breaks new ground in regulation. Its objective is to encourage companies to be more innovative with new technologies and commercial arrangements. This will allow companies to play a full part in combating climate change. The fund demonstrates Ofgem's commitment to meeting the challenge of a low carbon economy."

Ofgem has also reformed the treatment of DNO pension costs to strike a fairer balance between customers, employees and shareholders. This package is inline with incentives faced by other regulated utilities and private companies.

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Notes to editors and analysts

1. The 14 DNOs are regional monopolies and customers rely on regulation by Ofgem, rather than normal competition, to get the service they require at a reasonable price. We set the total revenues that DNOs can collect from customers and we place incentives on DNOs to innovate and find new ways to improve their efficiency and quality of service. This is achieved through a price control which we set every five years. The current price control expires on 31 March 2010 and the fifth distribution price control will run from 2010 to 2015.

2. Electricity customers pay around £3.6 billion annually for the distribution of electricity from the high voltage national grid to homes and businesses. This accounts for approximately 16 per cent of domestic customer electricity bills, with a typical domestic customer paying about £76 a year.

3.The DNOs will be able to raise their charges by 5.6% per annum on average with a range of between -4% to +11% across the country. For a typical household, this represents an extra £4.30 a year. The DNOs are also introducing new charging arrangements on 1 April next year that will alter the share of revenues collected from different types of customer. The new charges will better reflect the costs to the DNOs of serving different types of customer. They are designed to better reward customers who make less use of the network by installing local (or micro generation) or who are more energy efficient. Suppliers will have to decide how and when to recover any increases from different types of customers. So the actual increases that business and domestic customers will see will differ from these average figures. We have made clear to the companies that they must explain clearly to business customers and suppliers how their charges will change from next year and the reasons for those changes. The companies are already meeting with their customers to explain the changes.

4. **Financial information**

The table below shows the components of the cost of capital.

WACC	Final Proposals
Cost of debt	3.6%
Cost of equity	6.7%
Gearing	65.0%
WACC (vanilla)	4.7%
WACC (post-tax)	4.0%

Figures in real terms

5. Pensions costs account for about 10% of the costs of running a DNO. After a long and thorough consultation (including for the first time a consumer advisory panel to assist Ofgem's governing Authority in their assessment) Ofgem has decided to make some changes to the way we fund pension costs. These will strike a fair balance between customers, employees and shareholders. The new arrangements are designed to make the paying off the large pension deficits as affordable as possible for energy customers by spreading payments over a longer fifteen year period. The new incentives on managing future pension costs are designed to mimic those faced by other regulated utilities and private companies whilst acknowledging the more limited control DNO's have over these costs (About half of their employees have protected pension rights under legislation put in place at privatisation in the early 1990s.

6. One of the greatest areas of concerns for customers is the connection service that the DNOS currently offer. We are introducing tough new standards that will require DNOs to provide quotes and complete work to set timetables or have to make automatic compensation payments to customers. The companies will have to significantly improve current levels of performance from day one to avoid having to make these payments. We are also putting in place measures to increase competition for larger connections to help drive up service and lower prices.

7. As stipulated is the Initial Proposals in August 2009, Ofgem is making a statement on merger and acquisitions policy at this time (Final Proposals). Ofgem is consulting on its proposal to suspend its policy on mergers between energy network operators until its full review of those policies is complete. The regulator is minded to consider any mergers that occur while the review is in progress on a case-by-case basis. Ofgem's decision to reconsider merger policy arose from the major changes in ownership structure that have occurred in energy networks since the thorough review in 2002, and the issues that possible future mergers raise. A review now is important to ensure policies remain fit for purpose. Ofgem's role in network merger activity is to advise the Office of Fair Trading which can approve or reject a merger or refer it to the Competition Commission. Ofgem may need to advise the European Commission where a merger has an impact on other European markets. Ofgem is also able to propose conditions on merged entities through modifications to the companies' licences. Today's statement starts a new process, that is separate from the distribution price control.

8. Transforming the networks for a low carbon future

We have given the DNOs clear incentives to play a greater role in tackling climate change and to do all that they can to facilitate the transition to a low-carbon economy. These measures include:

- creating the new Low-Carbon Networks Fund (LCNF) which will provide **£500 million** over five years to stimulate the DNOs to work with others to try out new technology and commercial arrangements that will be needed to service electric vehicles, greater use of electricity for space heating and more micro and community-scale generation retaining the **£20 million** Innovation Funding Incentive (IFI) for research and development at an early stage.
- strengthening the losses incentive to make it more effective and to encourage the networks to reduce energy losses as far as possible – electrical losses on the electricity distribution networks currently account for 1.5 per cent of total GB greenhouse gas emissions, and
- requiring the DNOs to report on their own "carbon footprints" on an annual basis.

There are also a number of measures which will help to support generation connected directly to the distribution network (know as distributed generation or DG) including:

- retaining incentives for DNOs to make investments needed to connect DG;
- equalising incentives on capital and operating expenditure to remove the previous bias towards capital investment and charging the DNOs the costs of linking to the transmission network – both of these should encourage the companies to consider using demand side management or DG as a way of addressing capacity constraints;
- introducing cost-reflective charging that benefits DG which reduces the need for network reinforcement; and
- ensuring that the contracts and charging arrangements are clear and non-discriminatory.

We have also retained the allowance for laying cables underground in protected landscapes to help the DNOs to manage the local impacts of their networks in the most sensitive areas. As a result of this allowance, over 120km of cable have been put underground over the past four years.

9. Next Steps:

The DNOs and stakeholders now have until 6 January to respond to Ofgem's final proposals. If they accept them, the new price control will be introduced on April 1 2010, running until 31 March 2015.

10. Ofgem is the Office of the Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002, the Energy Act 2004 as well as arising from directly effective European Community legislation.

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