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TPCR5 and GDPCR2 Launch and Engagement Event

Thursday, 7 October 2010
10.00-12.45

Victoria Park Plaza Hotel

Welcome and Agenda

- **10.15** **Opening Speech** (Alistair Buchanan)
- **10.30** **Key Issues and Review Timelines** (Rachel Fletcher)
- **10.40** **Gas Distribution Perspectives** (Steve Edwards - WWU)
- **10.50** **Transmission Perspectives** (Pauline McCracken - NG)
- **11.00** **Q&A Session - Table Discussions**
- **11.45** **Tea Break (Panel to review responses)**
- **12.00** **Q&A session**
- **12.30** **Next Steps and Getting Involved** (Stuart Cook)
- **12.45** **Close**

The background features a large, stylized white arrow pointing to the right, set against a blurred image of a modern building with a glass facade and a large, glowing, multi-layered circular structure resembling a stylized sun or a futuristic energy source. The overall color palette is dominated by blues, whites, and oranges.

RIIO

A New Way to Regulate Energy Networks

Alistair Buchanan, CEO
Ofgem

Content

- Re-cap on July Messages
- The Consultation Phase
 - Events
 - Issues Arising and Resolution
- Key Messages
- Conclusion
 - Investment and Prices
 - Investors have a role to play

The Headlines

Goodbye RPI-X

Hello RIIO (R is revenue, I is incentives, I is innovation and O is for outputs)

Goodbye 5 years (3 years "left alone")

Hello 8 years (7 years "left alone")

Goodbye Poor customer involvement

Hello Customer Engagement

No money for R&D or improving carbon footprint

DNO, GDN, TO get £1-2 billion for LCNF (Low Carbon Networks Fund)

Commitment not to impair RAV

Enables financial package to get support and introduction

Great link to Discovery (£200 bn needed by 2020)

Regulatory policy can assist the delivery of £32bn by 2020

MOVING ON FROM RPI - X

RE-CAP – (1)

IT IS

WACC - clarity

RPI

Ex Ante

Low Carbon R&D: £500m+

IT IS NOT

WACC - subjective

CPI

Ex Post

**No Allowance under old RPI-X
formula**

AN INVESTMENT BASED PACKAGE

CONSULTATION PHASE - EVENTS

LOCAL TO "RIIO"

- Extensive visits to Fund Managers, companies, city etc
- Prof Paul Grout (Economics, Bristol University) approved as advisor on TPCR5/GDPCR2

LINKED TO "RIIO"

- HMG confirmed radical market reform packages, due Spring 2011
- DG Energy confirms focus on interconnection/networks
- Ofgem announced review of 'T' charges (Project TransmiT)

NON-LINKED

- Ofgem ruling on NG confirmed as Supreme Court refuse to take case
- Consumer : Miss-selling investigation, probe remedies, review 65 day rule etc
- Major Projects : Milestones hit on Offshore Project (Rd 1) and Smart Meters (Prospectus)

RIIO CENTRAL TO OFGEM'S WORK

CONSULTATION ISSUES - 1

DEBATE

CONCLUSION

8 YEARS

Some argue that too long for security, others too short for sustainability.

No movement. It stays as per July at 8 years. (see slide10)

COST OF DEBT

Some argue legacy debt may get impacted by 10 yr trailing average. Others like clarity.

We are convinced that clarity and transparency outweighs the short term company treasury views.

LCNF

Will this be managed as 3 pots of money with 3 panels?

We can confirm the final intention that G and T will have "pots". Yet to finalise view on panel management.

INDEX

RPI or CPI

RPI

CONSULTATION ISSUES - 2

DEBATE

CONCLUSION

Equity

Was the language slanted to favour debt over equity?

Read text to get comfort. Ofgem intent is not to dictate companies corporate structures. This is not an anti equity package .

Accelerated depreciation

General acceptance of the merits of the case but more comfort needed (for future generations of investors) on the protections for financeability

Read text to get comfort. Ofgem intent is not to use RIIO model as a cash grab.

Fast Track

A lot of interest in making this work but some questions over whether it is possible to get much fast track in GDPCR2/TPCR5.

It will be a challenge on Ofgem and GDN's/TO's to really get significant fast track advances in GDPCR2/TPCR5.

MESSAGES ON EQUITY

"Providing greater transparency and predictability about the way we approach each element of financeability should provide comfort to investors and make the sector more attractive to both equity and debt investors"

"Some stakeholders raised a concern that the wording in the recommendations document may imply a bias in favour of debt over equity. This was not our intention and we have clarified our approach below to remove this perception."

"(We) will enable efficient network companies to raise their equity and debt as they need to finance their regulatory obligations."

"In terms of equity metrics, we will take into consideration the impact of our price determination proposals on such ratios as the notional RAV/EBITDA and Regulatory Equity/Earnings for the regulated company."

ALL QUOTES FROM FINAL DOCUMENT

MESSAGES ON ACCELERATED DEPRECIATION

"In assessing financeability we will take into consideration both the relevant cash flow and equity metrics for the notional company. In addition, GEMA will review a company's case should it be financeable but nevertheless have a negative impact on cashflows caused by the implementation of RIIO."

"We also recognise that there are arguments that lengthening/reducing the time over which capital is remunerated (taken in isolation) could raise/reduce the riskiness of cash flows and therefore cost of capital. Where this is the case, we will reflect this in the allowed return."

"Where a company does demonstrate that application of the financeability principles in a single step would cause an efficient company financing difficulties, we will implement transition arrangements to ensure financeability."

"(We would expect transition) to be no longer than a single control period (8 years)."

TWO FURTHER AREAS TO REITERATE

(1) THIRD PARTY DELIVERY (i.e. TENDER/AUCTION) HAS KEY HURDLES

- (1) Large separable enhancement projects only
And
- (2) Long term benefits **MUST** exceed costs
And
- (3) Cannot be used if risk to timely delivery of key outputs
But
- (4) Could be useful if new technologies involved ,etc
Also
- (5) If used, it would require a competitive process

(2) DO RECOGNISE UNCERTAINTY MECHANISMS

- (1) At a price control we would consider events that fall outside a company's control
- (2) We set out where and how we would use them
- (3) If need be we will trigger a full scale review if the issue is big enough

TWO IMPORTANT AREAS WHERE GEMA GIVES GUIDANCE

CONCLUSION 1 – INVESTMENT AND PRICES

1. **£32 bn is big money over 10 years**

- +75% on current RAV
- +100% p.a. on last 20 years capital spend run rate

2. **“The scale of investment required means higher energy bills are almost certain.”**

3. **“Horse and Cart” analogy works**

- £32 bn on pipes and wires is part of £200bn needed in GB (Project Discovery)
- Pipes and wires need to “pull the cart” of generation

REASSUANCE FOR CONSUMERS - THEIR MONEY WELL APPLIED AND SPENT

CONCLUSION 2 – INVESTORS HAVE A ROLE TO PLAY

We rely on investors to:

- Keep pressure on management teams not to underperform
- To support management teams to appeal Ofgem’s decisions if they believe them wrong.

You will have:

- Enough regular information to make these judgements
- An awareness that all NO’s could outperform in theory (i.e. **No “median theory” is in play**)

- Investors must be alert that ineffective, lazy or poor management will be found out under RIIO.
- GB Network Regulation was never intended to be risk free.
- There is now a wider template for risk/reward.

CONSUMERS AND INVESTORS HAVE COMMON INTERESTS

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Introduction to the Price Control Reviews

Rachel Fletcher, Partner Distribution
Ofgem

The context for the reviews

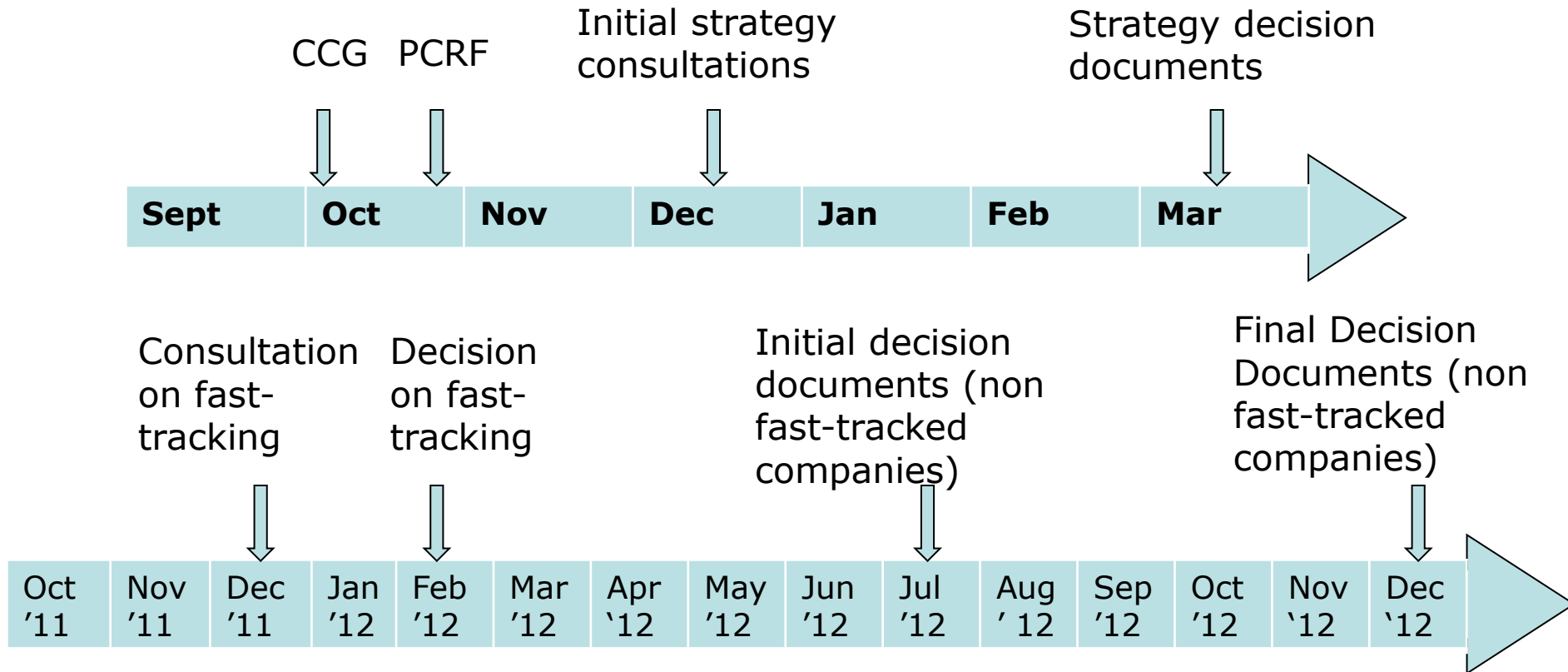
- Environmental and low carbon targets
- Security of supply considerations and concerns
- The need to ensure safety
- Rising cost of energy and fuel poverty
- New forms of energy supply - particularly renewables – and demand requirements

Making RIIO real

First price controls to implement RIIO. What's different?

- Increased focus on outputs
 - Working groups to move us to specific output measures
 - The focus of today's panel and Q&A session
- Increased focus on consumers
 - Stakeholder engagement, like this event, to get customers' views. Stuart Cook will cover in more detail
- Fast-tracking and proportionate regulation
 - Requires a new review timeline
- Specific stimulus for innovation (open letter this week)

Timelines: Publications and Decisions



The background of the slide is a composite image. On the left, there are rows of solar panels under a bright sun. On the right, a hand is shown holding a white document. In the bottom left corner, a blue gas burner is visible. The overall theme is energy and customer service.

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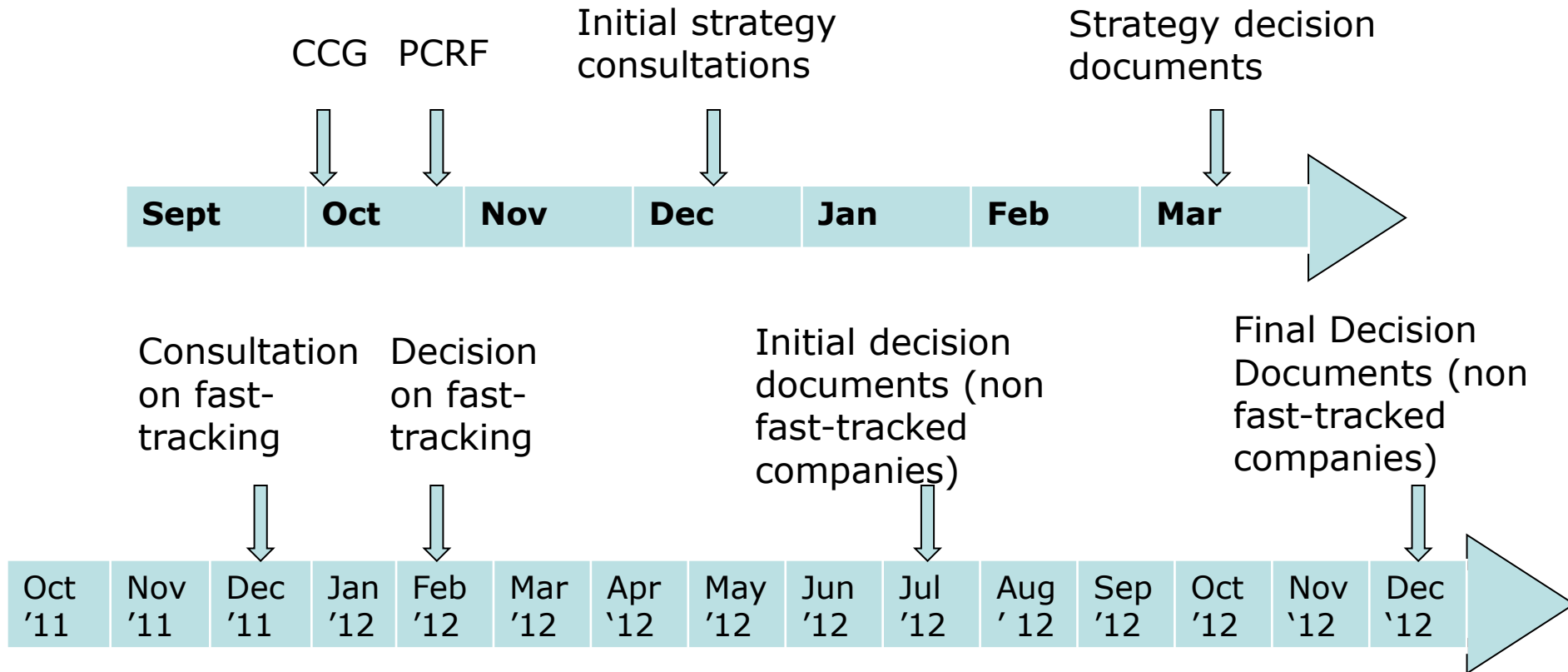
Promoting choice and value
for all gas and electricity customers

The background features a large, stylized white arrow pointing right, overlaid on a blurred image of a solar panel array and a large, glowing orange gear. The overall color palette is light blue, white, and orange.

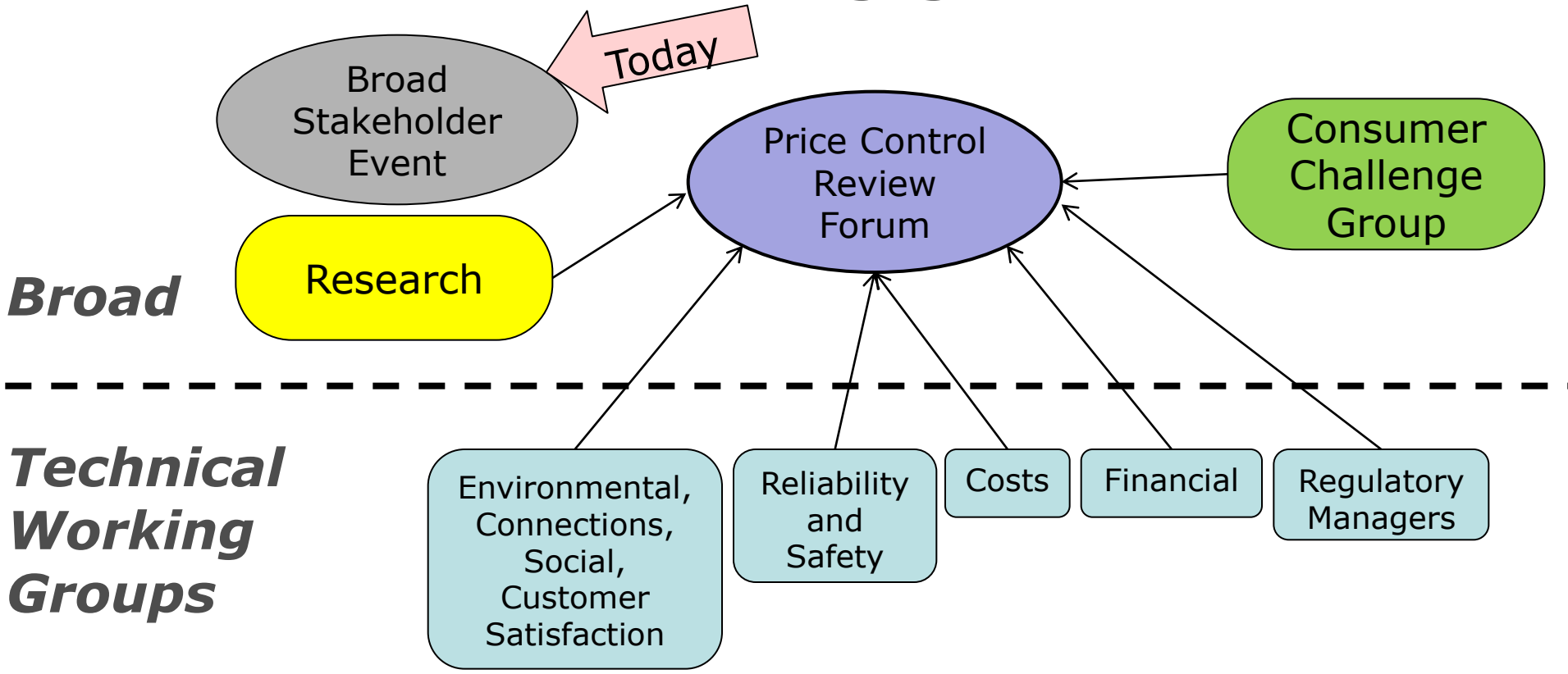
Next Steps and Getting Involved

Stuart Cook, Senior Partner
Smarter Grids and Governance
Ofgem

Next Steps: A reminder of the timetable



How to get involved: Ofgem's approach to stakeholder engagement



Not just Ofgem: Each company will run its own stakeholder process

- Companies need to know what their customers want, so they can put in place plans that will deliver that, and defend those plans with Ofgem.
- Some issues are company-specific.
- You have heard from two of them today, but they will all be engaging with you over the next few months.

Best way to get your voice heard depends on the issue(s) you want to raise

I want to:	Best approach:
Get into detailed discussions on specific issues e.g. carbon monoxide	Ask to join the relevant working group
Raise a general issue, or table a proposal	Submit a paper or question to the PCRF, or a person on it
Put my views on the public record	Respond to a written consultation such as the one in December
Discuss an issue that only applies to one gas or electricity company	Contact company directly through its own stakeholder process

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