

RIIO

ofgem

**RIIO : A NEW WAY TO REGULATE
ENERGY NETWORKS**

**City conference call
4 October 2010
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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

The logo for the Office of Gas and Electricity Markets (Ofgem), featuring the word "ofgem" in a white, lowercase, sans-serif font inside an orange rounded rectangle. The background of the slide is a collage of images: solar panels on the left, a large white arrow pointing right in the center, and a close-up of a gas burner on the right.

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Promoting choice and value
for all gas and electricity customers