



ofgem

City Briefing

16 July 2012

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CHIEF EXECUTIVE

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Smarter Grids

- RIIIO-T1
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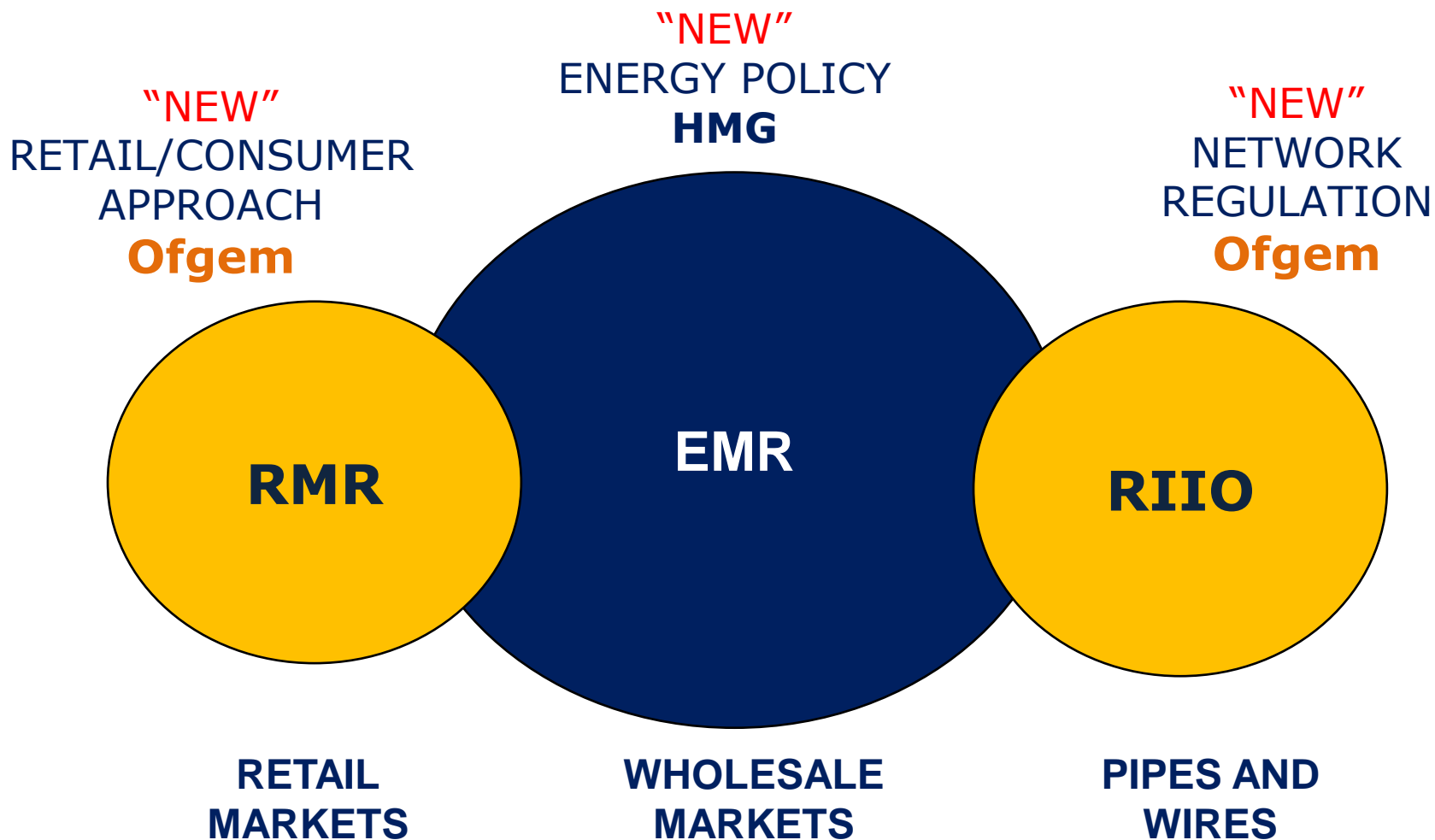
Markets

- RMR
- Electricity market
 - Discovery
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 - Gas security of supply
 - Capacity Assessment

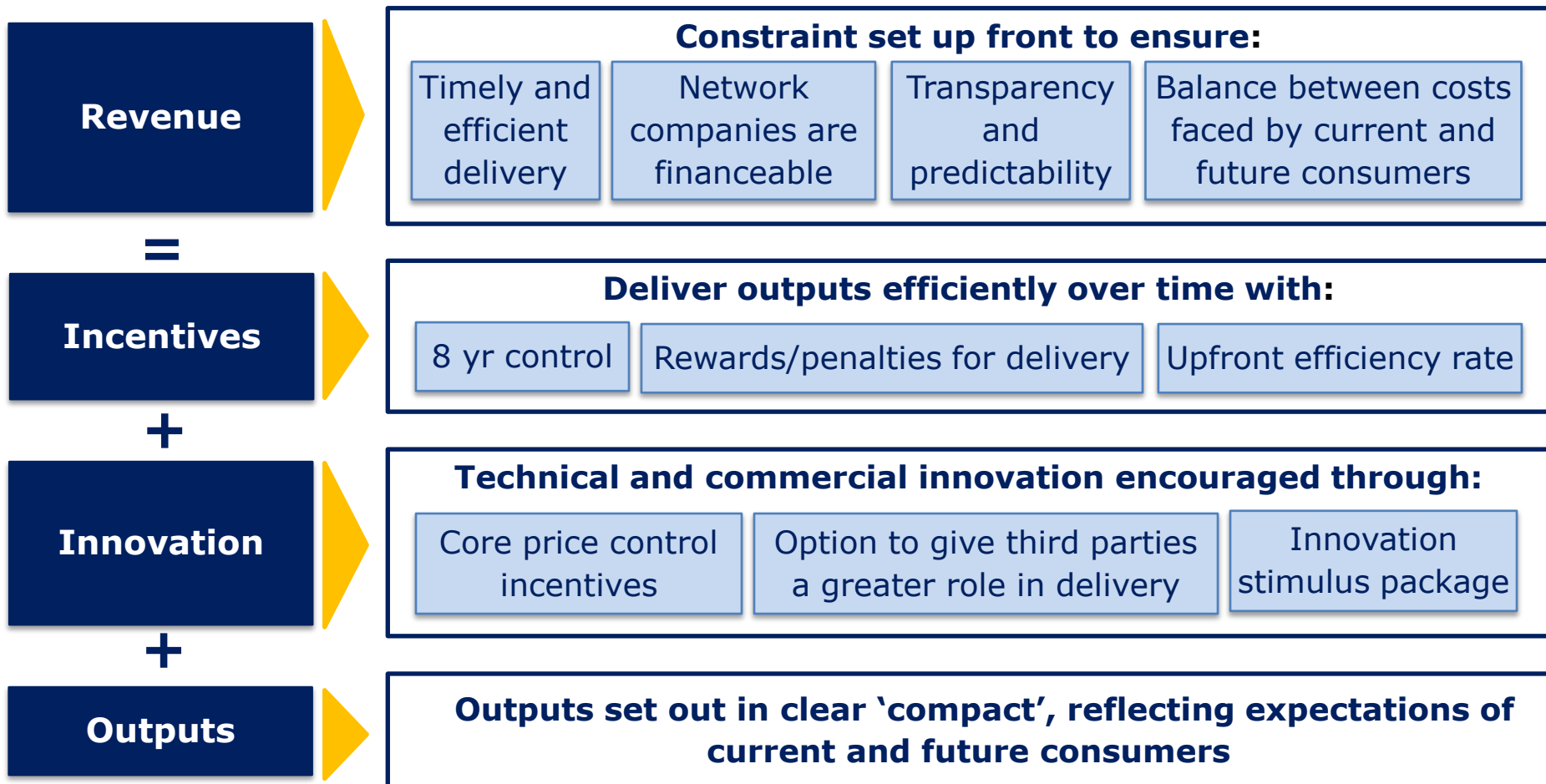
Other

- Investigations
- Offshore transmission
- E-Serve: Government programmes

Background – 2012 A year of Change



RIIO: A new approach to Network Regulation



RIIO – 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 companies could outperform in theory (ie No “median theory” is in play)

- Investors to be alert: 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

RIIO – So far so good

First price controls under RIIO have achieved:

- ✓ Fundamentally changed behaviour and Board discussions at companies
- ✓ Significant step-up in stakeholder engagement to present well thought-out, detailed and better justified business plans
- ✓ Ofgem staying true to RIIO principles:
 - ✓ Framework and key parameters clearly set out early on
 - ✓ Transparency of approach from early on– No 'black box' dates
 - ✓ Increased stakeholder engagement – including investors
 - ✓ Proportionate treatment
 - ✓ Higher level of scrutiny focused on areas not well justified
 - ✓ Two Scottish TOs fast-tracked
 - ✓ Flexibility in allowed costs ensure customers pay only for necessary expenditure
 - ✓ Financeability not compromised – transition where needed

Balancing huge investment needs and costs to consumers

RIIO-T1 Fast-track - Final Proposals

| Summary Proposals | | |
|------------------------|--|--------------------------|
| | SHETL | SPTL |
| Totex Base View | £1bn | £1.6bn |
| Totex Best View | £4.2bn | £2.1bn |
| Cost of Equity | 7.0% | 7.0% |
| Cost of Debt | iBoxx 10yr trailing avg. Bespoke weightings | iBoxx 10yr trailing avg. |
| Gearing | 55% | 55% |
| Asset lives transition | 16 yrs | 8 yrs |
| Capitalisation rate | 90% | 90% |

RIIO-T1 Initial Proposals

Financial Parameters

| | NGET | | NGGT | |
|--|---------------------------------------|-----------------|--------------------------|----------------------------------|
| | Business Plan | Ofgem IP | Business Plan | Ofgem IP |
| Cost of Equity (real post-tax) | 7.5% | 7.0% | 7.5% | 6.8% |
| Cost of Debt (real pre-tax) | iBoxx 10 year trailing average | | | |
| Notional gearing | 55% | 60% | 55% | 62.5% |
| Asset lives transition (20 to 45 yrs) | 16 yrs | 8 yrs | na | na |
| Capitalisation rate TO | Base: 86% UM: 100% | All: 85% | Base: 57% Increm: 90% | Base: 53% Increm: 90% |
| Revenues growth | | 25.1% | | 31.4% |
| RAV growth | | 63% | | 45% |

RIIO-T1 Initial Proposals

Totex

| 2009/10 prices (£bn) | | Business Plan | | Ofgem IP | | % Diff. (Total) |
|----------------------------|--------------|---------------|------------|-------------|------------|--------------------|
| | | Base | Uncertain | Base | Uncertain | |
| NGET TO | Capex | 12.0 | 1.3 | 9.1 | 2.6 | -12% |
| | Opex | 2.6 | na | 2.2 | na | -15% |
| | Totex | 14.6 | 1.3 | 11.3 | 2.6 | -12.6% |
| NGGT TO | Capex | 1.8 | 3.7 | 0.8 | 2.6 | -38% |
| | Opex | 1.5 | na | 1.5 | na | -3% |
| | Totex | 3.3 | 3.7 | 2.3 | 2.6 | -30% |

Total RIIO-T1 Capex = £15.1bn

RIIO-T1 Initial Proposals

Ofgem Initial Proposals v Business Plans

NGET

- Moved from Baseline to Uncertainty Mechanisms (c£1bn)
- Capex unit costs efficiencies – in line with TPCR4, consultants' evidence and Scottish TOs. (c60%)
- Opex efficiency – reduced maintenance, indirect and business support costs. (c20%)
- Disallowed expenditure – RIIO-T2 outputs. (c20%)

NGGT

- Reduced incremental capex – unit costs and timing. (c60%)
- Reduced volumes & unit costs for compressors & other capex. (c20%)
- Opex efficiencies and reduced RPEs– in line with TPCR4 and consultants' reviews. (c15%)
- Moved baseline to uncertainty mechanisms. (c£0.5bn)

RIIO-GD1 Initial Proposals

Financial Parameters

| | Business Plans | | | | Ofgem IP |
|-----------------------------------|----------------------|----------------------|------------------------|-------------------------------------|--|
| | NGGD | NGN | SGN | WWU | |
| Cost of Equity (real post-tax) | 7.2% | 7.0% | 7.2% | 7.2% | 6.7% |
| Cost of Debt (real pre-tax) | 10yr trailing avg | 10yr trailing avg | 10 year 'BBB' index | 10yr avg +35bps, cap & collar | iBoxx 10yr trailing average |
| Notional gearing | 55-60% | 62.5% | 60% | 62.5% | 65% |
| Repex transition (50% to 100%) | 8 yrs, 75% all | Applied to totex | Applied to totex | 8 yrs, stepped | 8 yrs stepped (75% avg) |
| Totex capitalisation rate | 46-53.4% | 52.6% | 50.7% -51.5% | 45.6-60.2% | 54-60% |
| Revenue growth | | | | | 3.9% |
| RAV growth | | | | | 1.0% |

RIIO-GD1 Initial Proposals

| Totex | | | |
|-----------------------------|----------------------|-----------------|----------------|
| 2009/10 prices (£bn) | Business Plan | Ofgem IP | % Diff. |
| NGGD | 7.7 | 6.2 | -19.1% |
| NGN | 1.8 | 1.6 | -13.1% |
| SGN | 4.2 | 3.6 | -12.8% |
| WWU | 1.9 | 1.5 | -24.8% |
| Total Totex | 15.6 | 12.9 | -17.4% |
| Capex + Repex only | 9.6 | 7.6 | -21.5% |

RIIO-GD1 Initial Proposals

Ofgem Initial Proposals v Business Plans

The total proposed reduction of c17% is explained approximately equally by the following factors:

- Disallowances for output related costs, eg iron mains replacement (the largest single disallowance at c£650m) and asset integrity investment.
- Adjustments as a result of our benchmarking analysis, eg comparative efficiency modelling.

RIIO-ED1

| Timing | |
|------------------|--|
| Date | RIIO-ED1 |
| Feb 2012 | Launch consultation |
| Sept 2012 | Strategy consultation |
| Feb 2013 | Strategy decision |
| May 2013 | Business Plans |
| Autumn 2013 | Initial Assessment/Fast Track decision |
| Autumn 2013 | Fast track Initial Proposals |
| Spring 2014 | Fast track Final Proposals |
| June 2014 | Non-Fast track Initial Proposals |
| Nov 2014 | Non-Fast track Final Proposals |
| April 2015 | Implementation |



Key Issues:

- Timely & cost-effective connection of new low-carbon technologies
- New types of generation
- New and unusual demand
- Uncertainty of take up of new technologies (eg local generation, heat pumps, electric vehicles)
- Consider tools like smart grids

Project TransmiT

What is it?

Independent review of the charging arrangements for gas and electricity transmission networks

Options consulted on Dec/11

- Current: 'Investment Cost Related Pricing' (ICRP)
- **'Improved ICRP'** *Ofgem's preferred approach*
- 'Socialised'

Decision May/12

- Industry will continue work on **'Improved ICRP'** model and consult on detailed changes to the charging methodology

Retail Market Review (RMR)

Why? Need to regain consumer trust

- Failure to respond sufficiently on 2008 probe remedies:
 - Door step selling
 - Bills/Annual statements
 - Number/complexity of tariffs
 - Adherence to new licence conditions
 - Standards of conduct
- Further evidence on pricing dynamics
- Further evidence on health of competition

What? Transparency & Accessibility

- Fewer and simpler tariffs
- Strengthen information and prompts
- Enforceable standards of conduct (domestic and SME)
- Enhanced protections for SMEs
- Liquidity measures
- Further work on segmental accounts and transparency

Welcome moves by some suppliers to restore consumer trust

Retail Market Review (RMR)

Steps to Recovery

Suppliers

- All doorstep selling suspended
- Most suppliers acknowledge past shortcomings
- Reform packages from most major suppliers
- Some enforcement cases resolved

Ofgem initiatives

- Enhance comparability
- Enforce high standards across the sector
- Simpler and fewer tariffs
- Increase engagement of consumers
- Increase confidence through transparency

Electricity Market

Ofgem – Project Discovery

Conclusions

(Mar/09-Feb/10)

- £200bn investment potentially needed over next decade
- Early action needed to ensure security of supply at lowest cost possible to consumers
- Ofgem action: Improve functioning of underlying market / price signals
 - RMR Liquidity proposals
 - Electricity cash-out reforms

Options for consultation

A

Targeted Reforms

B

Enhanced Obligations

C

Enhanced Obligations +
Renewables Tenders

D

Capacity Tenders

E

Central Energy Buyer

Electricity Market

Government – Energy Policy

**Electricity
Market
Reform**
(2010–on-going)

- White Paper July/11
- Technical update: Dec/11
- **Draft Energy Bill: June/12**
- Legislation: 2012-13
- Implementation: 2014

Carbon Floor

£16 in 2013,
up to £30 in
2020

EPS

450g CO₂
(no impact on
gas plants)

CfD/FiT

L-T contract
with protection

Capacity Mechanism

Auction open
to all – HMT to
trigger

ROC

2014-17:
ROC or CfD

Radical package – Enough to unlock purses?

Reports to DECC

Electricity Capacity Assessment

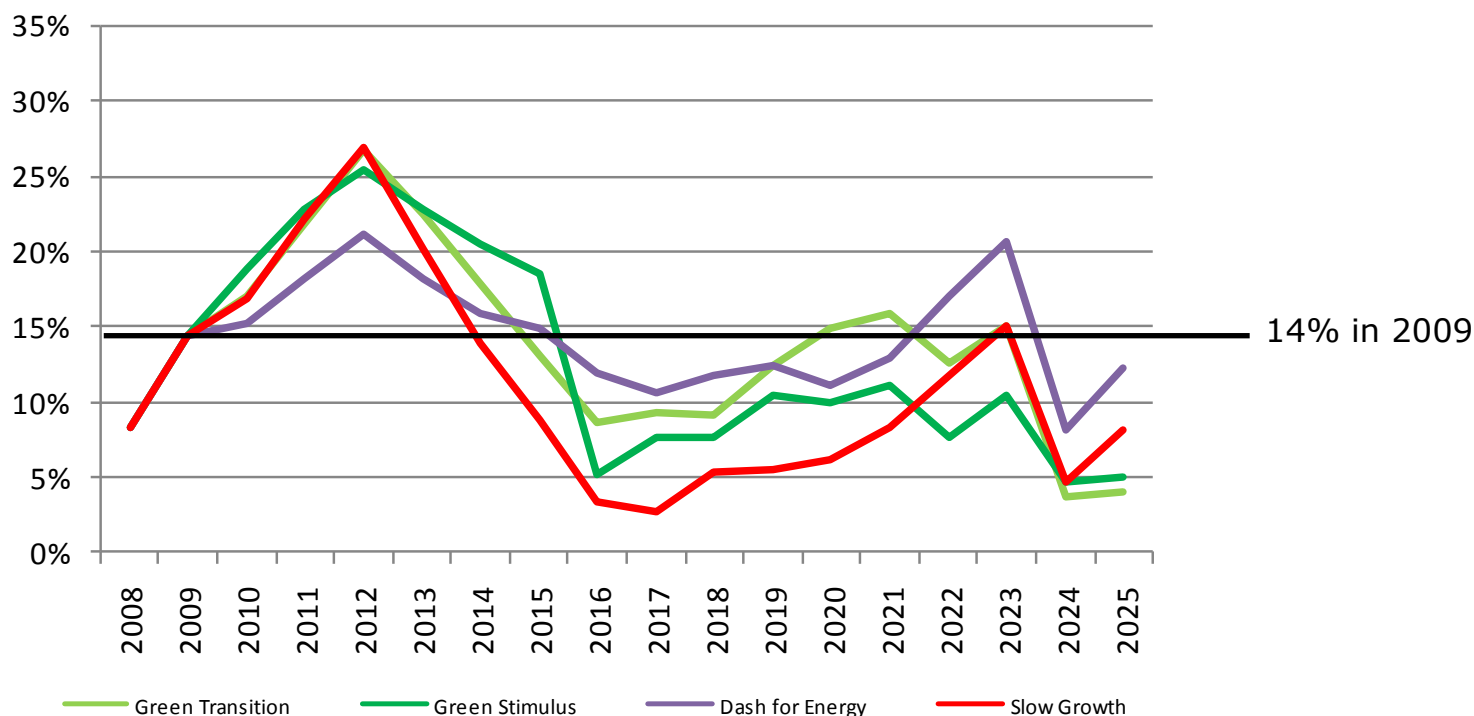
- Ofgem to provide outlook for electricity capacity margin for the period 2013 to 2017 and the associated risk to security of supply
- Report to Secretary of State: Autumn/12

Gas Security of Supply

- DECC mandate Nov/11
- Ofgem to investigate impact, cost and benefits of further interventions available
- Report to Secretary of State: Autumn/12

Reports to DECC – Electricity Capacity Assessment

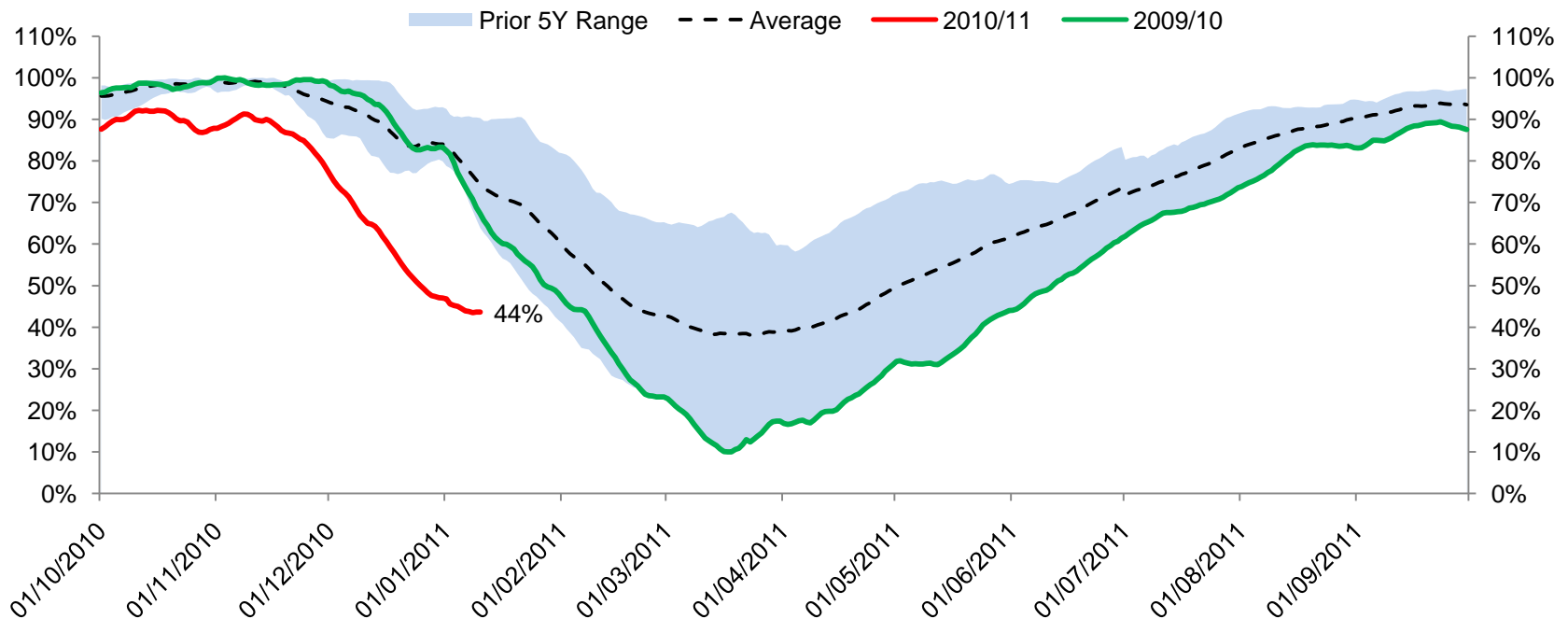
Capacity Margins – Project Discovery (2010)



Tight margins under some Discovery scenarios

Reports to DECC – Gas Security of Supply

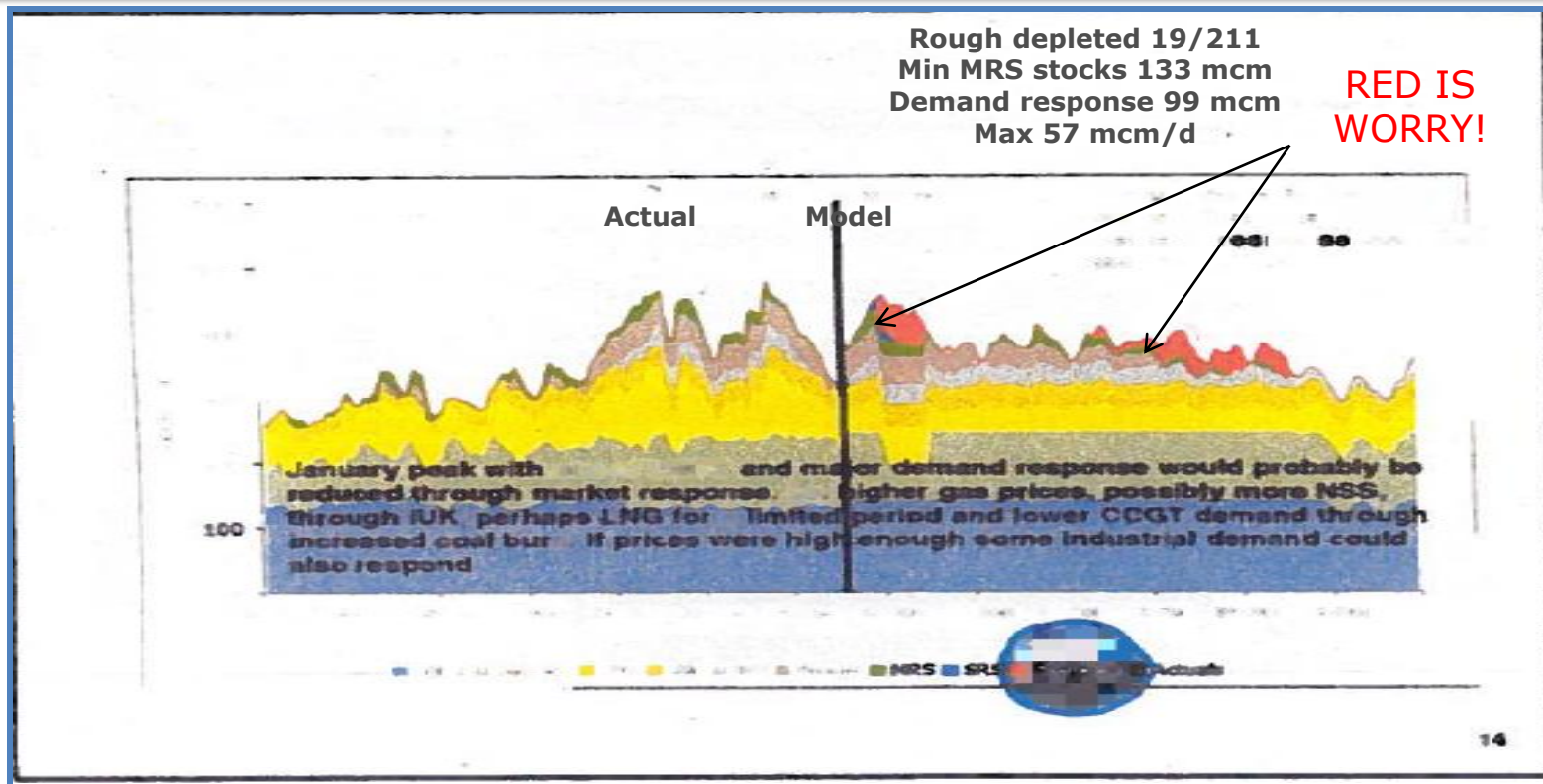
What about Gas? (1)



GB storage – Historic low Jan/11 (44%)

Reports to DECC – Gas Security of Supply

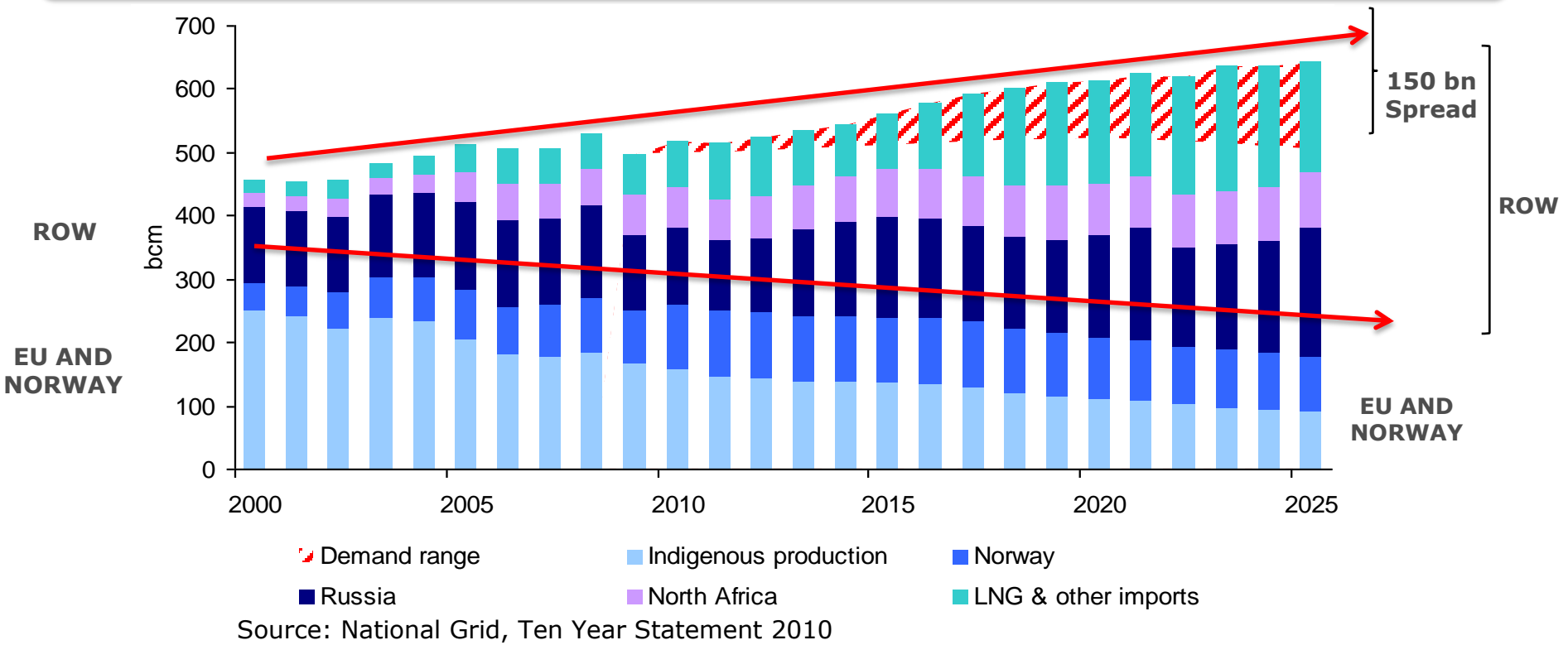
What about Gas? (2)



Scenario 3 – Cold weather, less LNG, Norwegian loss

Reports to DECC – Gas Security of Supply

What about Gas? (3)



Risk: Increasing dependence on non-Euro imports (Russia, Qatar, North Africa)

Investigations

Misselling

Sept/10 – on-going

- **EDF** – agreed £4.5m package to help vulnerable consumers (9 March/12)
- **npower** – on-going
- **Scottish Power** – on-going
- **SSE** – on-going
- **E.ON** – on-going (NEW launched April/12)

Complaints handling

Summer/10 – on-going

- **npower** – fined £2.0m
- **British Gas** – fined £2.5m
- **EDF** – on-going

Non-cost reflective tariffs

March/11 – on-going

- **Scottish Power**
- Direct Debit v Standard Credit tariffs

Misleading marketing

June/11 – on-going

- **Scottish Power**
- Marketing around price rise announcement

Ofgem E-Serve

Offshore Transmission

- **Transitional Round (TR) 1:** Total 9 projects, £1.1bn. 5 have completed, c£360m.
- **TR 2:** Total 4 projects, 2 phases, TR2a and TR2b, c£1.3bn in total. 1 preferred bidder appointed so far (Lincs), 4 short-listed bidders for 2 other projects.
- **Enduring regime:** Two models: 'generator build' or OFTO build'. Currently consulting on updated proposals. Revised tender regulations planned to be in place by end 2012.
- **Coordination:** March/12 - Joint DECC/Ofgem conclusions on costs, risks & benefits. Ofgem consultation on changes to offshore regime.

Management of Government Programmes

- Renewable Obligation (RO)
- Climate Change Levy (CCL)
- FiT (Feed-in Tariff)
- Renewable Heat Incentive (RHI)
- Carbon Emission Reduction Target (CERT)
- Community Energy Saving Programme (CESP)

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Q&A

Contact

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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