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RIIO-ED1

Business plan assessment and fast-track decision

22 November 2013

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Andrew Wright – Interim Chief Executive

RIIO – LEADING NETWORK REGULATION

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RIIO - A new approach to Network Regulation

Revenue

Constraint set up front to ensure:

- Timely and efficient delivery
- Network companies are financeable
- Transparency and predictability
- Balance between costs faced by current and future consumers

=

Incentives

Deliver outputs efficiently over time with:

- 8 yr control
- Rewards/penalties for delivery
- Upfront efficiency rate

+

Innovation

Technical and commercial innovation encouraged through:

- Core price control incentives
- Innovation stimulus package

+

Outputs

Outputs set out in clear 'compact', reflecting expectations of current and future consumers

RIIO - Financeability: Our duty

Financeability duty

- **Ofgem's Principal objective**: to protect the interests of existing and future consumers
- Must also "have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them"

- In the interest of consumers that efficient network companies can secure finance in time and at reasonable cost
- No bail-out if financial distress is due to own behaviour
- No reward of inefficiency or unwarranted returns
- Capital structure remains the responsibility of network companies' management

Regulatory commitment: Transparency, predictability, transitional arrangements (no sudden impact on cash flow)

RIIO – Investors have a role to play

We rely on investors to:

- Keep pressure on management teams to outperform
- 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

- 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

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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
    - ✓ Fast-track of strong and well justified business plans
    - ✓ Level of scrutiny commensurate with quality and justification of proposals
  - ✓ Uncertainty mechanisms - customers pay only for necessary expenditure
  - ✓ Financeability not compromised – transition where needed

Balancing investment needs and costs to consumers

Hannah Nixon – Senior Partner, Distribution

RIIO-ED1 – ASSESSMENT & FAST-TRACK DECISION

RIIO-ED1 - Key messages

- Fundamental change in DNO's approach to price controls
- Step improvement in quality of business plans
- Stakeholder engagement at the heart of DNO's plans
- WPD's four DNOs (East Midlands, West Midlands, South Wales and South West) proposed for fast-track – subject to two consultations:
  - fast-track proposal, and
  - methodology for assessing equity market returns.
- Other 5 DNO groups must resubmit business plans in March 2014, but most have scope for proportionate treatment

Ofgem committed to maintaining stable regulatory environment

RIIO-ED1 – Business plan assessment - Criteria

Five key assessment criteria

- **Process:** Has the DNO followed a robust process?
- **Outputs:** Does the plan deliver the required outputs?
- **Resources (efficient expenditure):** Are the costs of delivering the outputs efficient?
- **Resources (efficient financing):** Are the proposed financing arrangements efficient?
  - Technical accounting: RAV, totex capitalisation, pensions, tax;
  - Corporate finance: Return on RAV, depreciation, financeability, transitional arrangements.
- **Uncertainty & risk:** How well does the plan deal with uncertainty and risk?

Assessed in the context of historical performance

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RIIO-ED1 – Business plan assessment - Summary

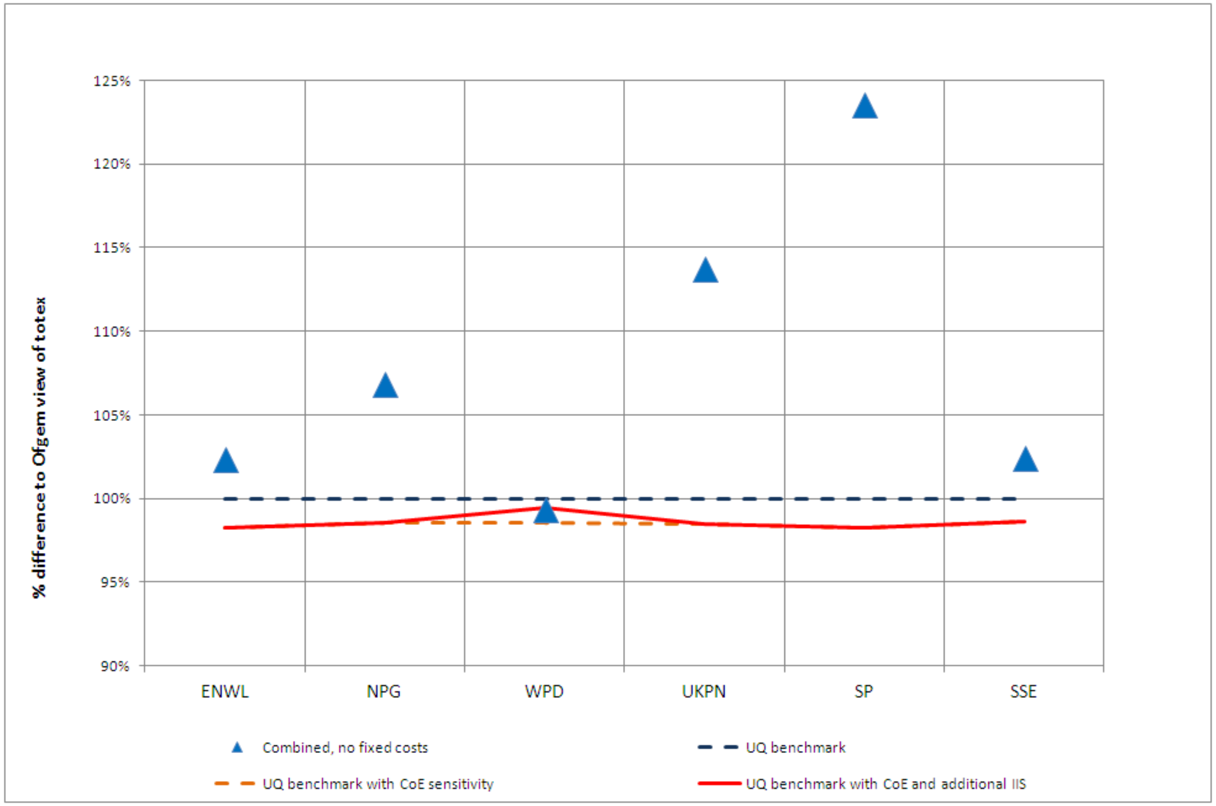
Summary assessment

DNO Group	DNO	Process	Outputs	Resources – efficient costs	Resources – efficient finance	Uncertainty and risk
Western Power Distribution	WMID					
	EMID					
	SWALES					
	SWEST					
Electricity North West Ltd	ENWL					
Northern Powergrid	NPgN					
	NPgY					
UK Power Networks	LPN					
	SPN					
	EPN					
SSE Power Distribution	SSEH					
	SSES					
SP Energy Networks	SPD					
	SPMW					

WPD proposed for fast-track; others proportionate treatment

RIIO-ED1 – Business plan assessment

Assessment of efficient expenditure



UQ= Upper quartile
Combined = Top-down & bottom up analysis
No fixed costs = no additional cost allowance for ENWL

Tested against cost of equity scenarios

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RIIO-ED1 – Business plan assessment - Financial parameters in strategy

	RIIO-ED1 Strategy Decision	DPCR5
COST OF EQUITY	6.0% - 7.2%	6.7%
COST OF DEBT	iBoxx non-financials (10+ yrs, A and BBB ratings)	3.6%
NOTIONAL GEARING	Will be assessed on cash flow volatility and DNO business plans	65%
ASSET LIVES	45 years for new assets, straight-line depreciation	20 years, straight-line depreciation

DNOs to justify any transitional arrangements needed

RIIO-ED1 – DNOs' business plan assumptions - Summary

	DPCR5 (all DNOs)	WPD (4 DNOs)	ENWL (1 DNO)	NPg (2 DNOs)	UKPN (3 DNOs)	SSEPD (2 DNOs)	SPEN (2 DNOs)
Cost of equity (real post-tax)	6.7%	6.7%	6.8%	6.7%	6.7%	6.7%	6.7%
Cost of debt (real pre-tax)	3.6%	iBoxx 10-year trailing average index					
Notional gearing	65%	65%					
Asset lives transition	N/A	8 years	8 years	8 years	8 years	8 years	Immediate
Totex (2012-13 prices)	£17bn	£7.1bn	£2bn	£3.2bn	£6.8bn	£3.9bn	£4bn
Totex capitalisation rate	~72%*	80%	72%	70–72%	70%	70%	80%
Real RAV growth	17% avg	24%	20%	17%	18%	15%	33%
Real revenue change†	+33% avg	-5%	-21%	-8%	+3%	-10%	-4%

Figures based on revenue profile assumed in DNOs' business plans
* 85% totex + 0% non-operational & business support
† Relative to end of previous price control period

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RIIO-ED1 – Business plan assessment & Fast-track decision

Western Power Distribution (WPD)

Well justified

- ✓ **Process:** Clear and reasonably easy to navigate business plan; robust and broad stakeholder engagement; only DNO to explicitly incorporate interests of 'future' consumers; long-term view includes RIIO-ED2 & beyond strategy.
- ✓ **Outputs:** Ambition to remain best performing DNO in customer service; reliability targets more challenging than Ofgem's; comprehensive social strategy.
- ✓ **Efficient cost:** Challenging cost package, most cost-efficient of all DNOs – stress-tested for different levels of cost of equity. Includes efficiency savings from acquisition.
- ✓ **Efficient financing:** CoE and gearing justified by NERA study. Overall consistent with Ofgem's Strategy Decision, but not considered new information since then.
- ✓ **Uncertainty & risk:** Good process for developing 'best view' scenario for low carbon technology (LCT) take-up; good strategy for flexing investment around low carbon scenarios

WPD proposed for fast-track

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RIIO-ED1 – Consultation on equity market returns methodology

Proposal to fast-track WPD conditional on consultation

- **Why are we consulting?** Competition Commission's provisional determination for NIE (12 Nov) includes a different position on equity market returns. CC (or CMA) is our appeal body for ED1 decisions -its position on a material matter of policy therefore important to us.
- **What is different?** CC assumes 6.0% equity market return giving more weight to contemporary evidence (since middle of last century and since credit crunch). Regulators have conventionally assumed 6.5-7.5%.
- **What are we consulting on?** Our methodology for assessing equity market returns. Careful consideration –decision not made lightly.
- **What is the potential effect on cost of equity?** We estimate 0.8%
- **How does it affect WPD's fast-track?** If consultation outcome is to adopt CC's position, WPD will be given opportunity to accept an adjusted cost of equity.
- **How does it affect non-fast-tracked DNOs?** Resubmit business plans assuming our current methodology but consider any changes that might be necessary.

RIIO-T1 & GD1 not affected

RIIO-ED1 – Business plan assessment & Fast-track decision

Western Power Distribution (WPD)

Key Financial Parameters			
Cost of Equity (real post-tax)	**6.7%**	Totex capitalisation rate	**80%**
Notional gearing	**65%**	Real revenue change	**-5%**
Asset lives transition	**8 years**	Closing RAV (growth)	**£7.2bn (+24%)**
Efficiency incentive	**70% (for fast-track)**	Totex (2012-13 prices)	**£7.1bn (4 DNOs)**

(£m 2012/13 prices)	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Opening RAV	5,769.0	5,968.8	6,151.3	6,292.6	6,446.6	6,590.6	6,747.7	6,955.7
RAV additions (totex slow pot)	727.2	723.8	684.1	700.2	691.1	705.1	709.9	715.7
Depreciation	(527.4)	(541.3)	(542.8)	(546.1)	(547.2)	(548.0)	(501.8)	(501.2)
Closing RAV	5,968.8	6,151.3	6,292.6	6,446.6	6,590.6	6,747.7	6,955.7	7,170.3
Totex fast pot	181.8	181.0	171.0	175.0	172.8	176.3	177.5	178.9
Total Totex	909.0	904.8	855.1	875.2	863.9	881.4	887.3	894.7

WPD proposed for fast-track

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RIIO-ED1 – Business plan assessment & Fast-track decision

Western Power Distribution (WPD) – Outputs	
Safety	▪ Compliance with the Health & Safety Executive
Customer satisfaction	▪ Target: Above current industry average; compares well to other industries ▪ Incentive: +/-86 RoRE bps
Connections	▪ Target: Improve connection times and customer engagement ▪ Incentive: +23/-52 RoRE bps
Environment	▪ Undergrounding: £7.7m, 55km; carbon footprint: -5%; SF6 leakage: -17%; holistic approach to losses reduction; continue current revenue protection services; address electricity theft (conveyance/unmetered)
Reliability	▪ Target: Tougher for three of the four DNOs than Ofgem's methodology ▪ Incentive: +/-250 RoRE bps
Social	▪ Adopt British Standard of Inclusive Provision, improve understanding of consumer vulnerability, improve service provided for vulnerable customers, help address fuel poverty through regional partnerships

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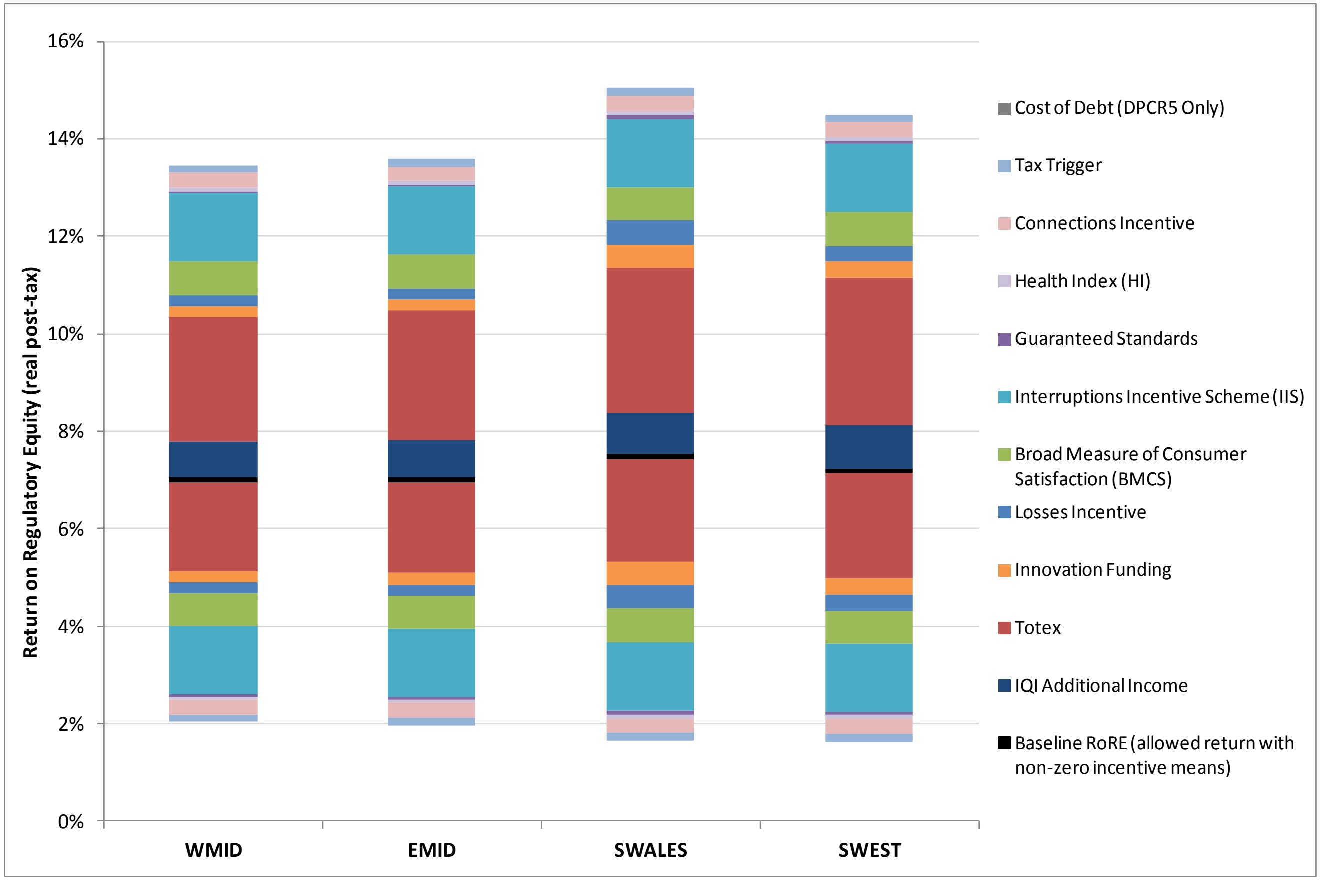
RIIO-ED1 – Business plan assessment & Fast-track decision

Estimated RoRE ranges for WPD in RIIO-ED1



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RIIO-ED1 – Next steps – Two parallel consultations

Date	RIIO-ED1	Equity market return methodology
Feb 2012	Launch consultation	
Sept 2012	Strategy consultation	
Mar 2013	Strategy decision	
July 2013	Business Plans	
Nov 2013	**Initial Assessment & Fast-Track proposal**	**Decision to consult**
Dec 2013		Publish consultation document
Feb 2014	Fast-Track Final decision	Decision keep/change methodology
Mar 2014	Non-Fast-Track Business Plans resubmitted	
July 2014	Non-Fast-Track Draft Determination	
Nov 2014	Non-Fast-Track Final Determination	
1 April 2015	RIIO-ED1 commences	

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Hannah Nixon – Senior Partner, Distribution

Q & A

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1 Business plan assessment & Fast-track decision

- Electricity North West Ltd (ENWL)
- Northern Powergrid (NPg)
- UK Power Networks (UKPN)
- SSE Power Distribution (SSEPD)
- SP Energy Networks (SPEN)

2 Map of 14 DNOs location and ownership

3 RIIO-T1 & GD1 – Summary key figures

APPENDICES

RIIO-ED1 – Business plan assessment & Fast-track decision

Electricity North West Ltd (ENWL)

Cost of Equity (real post-tax)	**6.8%**	Totex (2012-13 prices)	**£2bn (1 DNO)**
Notional gearing	**65%**	Real revenue change	**-21%**
Asset lives transition	**8 years**	Closing RAV (growth)	**£1.9bn (+20%)**

Justified / broadly acceptable

- ✓ **Process:** Clear; evidence of stakeholder engagement; long-term delivery strategy
- ✓ **Outputs:** Ambitious targets for customer satisfaction vs. historic performance; comprehensive losses reduction strategy
- ✓ **Finance:** Broadly consistent with Ofgem's Strategy Decision, but not considered new information since then;
- ✓ **Uncertainty & risk:** Good LCT forecasts and scenarios; potential reinforcement for Moorside nuclear.

Must improve / needs further scrutiny

- ? **Efficient cost:** Above Ofgem's overall benchmark (factoring 6.8% CoE); cost efficiency not fully justified.

ENWL to resubmit business plan March 2014

RIIO-ED1 – Business plan assessment & Fast-track decision

Northern Powergrid (NPg)

Cost of Equity (real post-tax)	**6.7%**	Totex (2012-13 prices)	**£3.2bn (2 DNOs)**
Notional gearing	**65%**	Real revenue change	**-8%**
Asset lives transition	**8 years**	Closing RAV (growth)	**£3.0bn (+17%)**

Justified / broadly acceptable

- ✓ **Process:** Clarity and readability of plan praised by stakeholders; good use of stakeholder feedback to inform the plan
- ✓ **Outputs:** Generally strong proposals, very comprehensive social strategy
- ✓ **Finance:** Broadly consistent with Ofgem's Strategy Decision, but not considered new information since then
- ✓ **Uncertainty & risk:** LCT take-up and volumes forecasts; strategy for managing uncertainty around low carbon scenarios

Must improve / needs further scrutiny

- ? **Efficient cost:** Above Ofgem's overall benchmark; high assumptions for real price effects and overall inefficiency on asset replacement

NPg to resubmit business plan March 2014

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RIIO-ED1 – Business plan assessment & Fast-track decision

UK Power Networks (UKPN)

Cost of Equity (real post-tax)	**6.7%**	Totex (2012-13 prices)	**£6.8bn (3 DNOs)**
Notional gearing	**65%**	Real revenue change	**+3%**
Asset lives transition	**8 years**	Closing RAV (growth)	**£6.2bn (+18%)**

Justified / broadly acceptable

- ✓ **Process:** Clear and well-structured; understand what stakeholders require, good use of stakeholder feedback to inform the plan
- ✓ **Finance:** Broadly consistent with Ofgem's Strategy Decision, but not considered new information since then
- ✓ **Uncertainty & risk:** LCT take-up and volumes forecasts; strategy for managing uncertainty around low carbon scenarios

Must improve / needs further scrutiny

- ? **Outputs:** Ambitious objectives vs current performance. Proposals on asset health, asset loading and resilience lacking
- ? **Efficient cost:** Above Ofgem's overall benchmark; concern on efficiencies of load-related expenditures and asset replacement

UKPN to resubmit business plan March 2014

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RIIO-ED1 – Business plan assessment & Fast-track decision

SSE Power Distribution (SSEPD)

Cost of Equity (real post-tax)	**6.7%**	Totex (2012-13 prices)	**£3.9bn (2 DNOs)**
Notional gearing	**65%**	Real revenue change	**-10%**
Asset lives transition	**8 years**	Closing RAV (growth)	**£3.5bn (+15%)**

Justified / broadly acceptable

- ✓ **Process:** Presentation and clarity generally acceptable; some information on stakeholder engagement strategy and use of feedback
- ✓ **Finance:** Broadly consistent with Ofgem's Strategy Decision, but not considered new information since then

Must improve / needs further scrutiny

- ? **Efficient cost:** Above Ofgem's overall benchmark; asset replacement strategy; load-related unit costs; cost savings from use of smart grid solutions
- ? **Outputs:** Good customer service and connections; concerns on losses reduction, social commitments and reliability
- ? **Uncertainty & risk:** Significantly de-risked plan; little justification for proposed new mechanism

SSEPD to resubmit business plan March 2014

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RIIO-ED1 – Business plan assessment & Fast-track decision

SP Energy Networks (SPEN)

Cost of Equity (real post-tax)	**6.7%**	Totex (2012-13 prices)	**£4bn (2 DNOs)**
Notional gearing	**65%**	Real revenue change	**-4%**
Asset lives transition	**Immediate**	Closing RAV (growth)	**£4.1bn (+33%)**

Justified / broadly acceptable

✓ **Finance:** Broadly consistent with Ofgem's Strategy Decision; uses range of models; took on board some recommendations of RIIO financeability study with regard to beta estimates

Must improve / needs further scrutiny

? **Process:** Some information difficult to find; concerns about accuracy of asset data; limited consideration of long-term

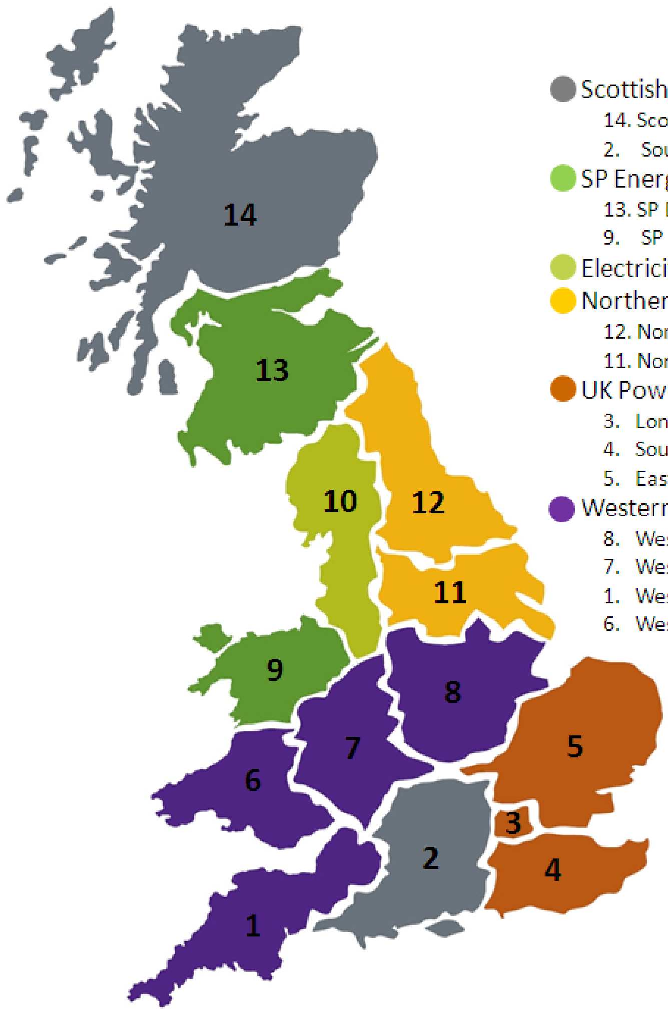
? **Uncertainty & risk:** Little consideration of risk or transition between LCT take-up scenarios

? **Outputs:** Ambitious customer satisfaction objectives; no losses reduction proposal; weak asset health, loading & resilience; social commitments narrow

? **Efficient cost:** Outlier in assessment of efficient costs

SPEN to resubmit business plan March 2014

DNO location and ownership



- Scottish and Southern Energy
  - 14. Scottish Hydro Electric Power Distribution plc
  - 2. Southern Electric Power Distribution plc
- SP Energy Networks
  - 13. SP Distribution Ltd
  - 9. SP Manweb plc
- Electricity North West Limited (10)
- Northern Powergrid
  - 12. Northern Powergrid (Northeast) Limited
  - 11. Northern Powergrid (Yorkshire) plc
- UK Power Networks
  - 3. London Power Networks plc
  - 4. South Eastern Power Networks
  - 5. Eastern Power Networks plc
- Western Power Distribution
  - 8. Western Power Distribution (East Midlands) plc
  - 7. Western Power Distribution (West Midlands) plc
  - 1. Western Power Distribution (South West)
  - 6. Western Power Distribution (South Wales) plc

RIIO-T1 & GD1 (2013-2021)

	SHETPLC (Fast-tracked)	SPTL (Fast-tracked)	NGET TO	NGGT TO	GDNs
Cost of Equity (real post-tax)	**7.0%**	**7.0%**	**7.0%**	**6.8%**	**6.7%**
Cost of Debt (real pre-tax)	**iBoxx 10 year trailing average**				
Notional gearing	**55%**	**55%**	**60%**	**62.5%**	**65%**
Asset lives transition	**16 yrs**	**8 yrs**	**8 yrs**	**na**	**na**
Totex capitalisation rate	**All: 90%**	**All: 90%**	**All: 85%**	**Base: 64% Increm: 90%**	**Stepped capitalisation 36-66% (depending on GDN)**
Real revenue growth	**212%**	**42%**	**30.5%**	**28%**	**4.7%**
Real RAV growth	**263%**	**77%**	**69%**	**42%**	**6.7%**
Totex (2009-10 prices)	**£4.2bn**	**£2.1bn**	**£14.5bn**	**£4.9bn**	**£14.4bn**

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