SP TRANSMISSION

RIIO-T1 Transmission Price Control

January 2012

SP Transmission successfully fast-tracked

SP Transmission is pleased to announce that it has reached agreement with the Government energy regulator Ofgem to fund an investment plan totaling £2.6 billion pounds over the 8-year period from 2013 to 2021.

Our stakeholders and industry commentators agree that the size and speed of this investment is critical in delivering a low carbon system that meets European carbon reduction targets and provides a platform for further innovation, while also ensuring that an ageing asset base can be replaced. This decision marks an important milestone in the ongoing process of rewiring the United Kingdom for a low carbon future.

The key highlights of our agreed plan are:

Strong Investment focus

- We have secured £2.6 billion of investment meaning that SP Transmission ("SPT") Regulatory Asset value will grow by 220% to £3.2billion. This investment will deliver capacity to:
  - Accommodate a large increase in offshore and onshore wind generation (of around 11 GW in Scotland) in accordance with the United Kingdom's legally binding target for Renewable Generation and decarbonisation of the economy.
  - Increase the export capacity of the SPT transmission network from around 3.3 GW at 1 April 2013 to close to 7 GW by 31 March 2021.
  - Significantly reduce constraint costs to the UK consumer by £1.7 billion pounds cumulatively to 2021 and facilitating £2 billion pounds in reduced carbon emissions (equivalent to 45 million tonnes of CO_2).
  - Avoid constraint costs which would rise to £16 billion pounds by 2030 without the investment.
  - Modernise the network to ensure that the excellent security of supply and reliability presently enjoyed in the SPT area is maintained.
  - Create up to 1,500 new directly associated jobs in the SPT franchise area in this period.
- We have carefully calibrated our plan to mitigate the impact on our stakeholders and customers throughout Scotland and the United Kingdom. The outputs described above will account for a 10 pence per annum increase to the average customer's annual bill.

Financial Issues – supportive framework

- Real post tax WACC of 4.5% (recent comparisons are Transmission Rollover 4.26%, DPCR5 4.0%) including:
  - Return on Equity of 7.0% in real terms
  - Cost of debt allowances based on a 10 year trailing average of iBoxx non financials 10+ maturity series for an average of A and BBB ratings,
  - 55% gearing assumption
- Strong commitment to funding through regulatory depreciation allowances.
  - All investment prior to 1 April 2013 remains at 20 years (approximately £1.4B) with
  - New investment transitioning from 20 to 45 years over 8 years on a linear basis.
- Continued indexation of revenues and the regulatory asset value at RPI
- A number of important risk mitigation measures on major infrastructure projects

RIIO – Revenue using Incentives to deliver Innovation and Outputs

SP TRANSMISSION

Dear Stakeholder,

Frank Mitchell
CEO
SP Energy Networks

ScottishPower are pleased to have concluded the package with Ofgem, which strikes a fair balance for both our customers and stakeholders. Concluding this package allows the transmission investments required to support the green economy to proceed and also create some 1500 new jobs in Scotland."

We will now focus on advancing the delivery of our recruitment and investment programmes on the basis that we have agreed:

- A stable and predictable financial package that works over an extended 8-year price control period,
- Minimises customer costs by funding some 20% of our proposed investment only when the need case is demonstrated, and
- Manages the delivery risk faced by companies to recruit, train and enhance and update electricity networks.

Over recent months I have been pleased with a very positive engagement with the Ofgem team and we have worked effectively with Ofgem to address the areas of concern for both parties and on behalf of all of our stakeholders.

Ofgem's assessment of our investment plan leaves it relatively unchanged, which reflects well on our asset risk management approach and comparative unit costs. In recognition of the accuracy of our investment forecasts, I was pleased to see that we have received the maximum reward possible under Ofgem's Information Quality Incentive Mechanism.

In my view therefore this investment package provides the right balance between minimising customer costs and providing the financial stability that we need as a business through to 2021. We can now focus on delivering the agreed outputs, and in so doing provide the necessary grid network that is absolutely essential in moving to a low carbon economy in the UK.

Notes:

The next steps in the process are for Ofgem to consult on Initial Proposals for fast-tracking for SPTL and SHETL on 6 February 2012. This will be followed by a six week consultation period with responses by 19 March. Ofgem will then set out a final decision on fast-tracking and, if appropriate, fast-track Final Proposals in April 2012.

Please also find attached links to the SP Transmission RIIOT1 website:

http://www.spenergynetworks.co.uk/publicinformation/stakeholder_riio.asp

For further information on RIIO-T1 please contact:

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SP TRANSMISSION

RIIO-T1 Announcement – Supporting Document

Overview of RIIO-T1

RIIO-T1 represents the most important period in Transmission infrastructure investment to have taken place in the last 6 to 7 decades. In the last 20 years SP Transmission ("SPT") has invested some £1.5 billion pounds to maintain our system at the leading edge of performance in global Transmission networks.

In the next 8-years our investors (equity and debt) and customers are being asked to support investment of £2.6 billion pounds to:

- Accommodate a large increase in offshore and onshore wind generation (of around 11 GW in Scotland) in accordance with the United Kingdom's legally binding target for Renewable Generation and decarbonisation of the economy.
- Increase in the export capacity of the SPT transmission network from around 3.3 GW at 1 April 2013 to close to 7 GW by 31 March 2021.
- Significantly reduce constraint costs to the UK consumer by £1.7 billion pounds cumulatively to 2021 and facilitating £2 billion pounds in reduced carbon emissions (equivalent to 45 million tonnes of $CO2$).
- Avoid constraint costs which would rise to £16 billion pounds by 2030 without the investment.
- Modernise the network to ensure that the excellent security of supply and reliability presently enjoyed in the SPT area is maintained. This investment is being targeted at an ageing asset base where the majority of the 275 kV network is over 40 years old, significant sections of the 132 kV network is over 60 years old and with an ageing asset base that is also impacted by higher levels of utilisation arising from Access reform and by our future network requirements.
- Create up to 1,500 new directly associated jobs in the SPT franchise area in this period.

We have taken care to develop an efficient business plan package with a baseline minimum investment and the flexibility to scale up through volume drivers and investment triggers. This ensures that customers pay only for investment and outputs that we undertake while also providing us with the necessary cash flows to deliver our plan, and in so doing ensure we fully support Government policy objectives and roadmaps.

Investment Plan

SP Transmission has secured approximately £2.6B of investment which will underpin its network expansion and asset replacement plans for the period April 2013 to March 2021.

Ofgem's assessment of our plan leaves it relatively unchanged, which reflects well on our asset risk management approach and comparative unit costs. In recognition of the accuracy of our investment forecasts, we have received the maximum reward possible under Ofgem's Information Quality Incentive Mechanism.

65% of our investment plan will allow expansion of our network to accommodate the growth of renewable generation in the south of Scotland, in order to meet UK renewable energy targets. Specifically, the money will allow the connection of 2.5GW of renewable generation in our area, and close to 7GW of transmission export capacity from Scotland to England.

35% of our investment will be used to address issues with our existing network plant and circuits, a significant proportion of which was built in the 1950s – 1960s and require replacement due to their condition. This includes over £300m to replace around 40% of our high voltage overhead line conductor, originally built in the 1960's, and around £120m to replace 50% of our 1950/60's vintage air-blast and bulk oil circuit breakers, which have become less reliable and more costly to maintain. The remainder of the investment will be targeted at other critical equipment (transformers, cable, telecoms equipment) which is obsolete, poorly performing or unreliable.

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The main changes to our Investment Plan from our July 2011 Plan are set out below:

1. Capital Expenditure

There are NO changes to our planned projects or to our unit costs; hence our total capital expenditure has not changed from our July 2011 plan.

Wider System Reinforcements:
Five wider system schemes totaling £466m (at 09/10 prices) originally to be funded through revenue triggers have been moved into our ex ante allowance, as follows:

i) Western HVDC
ii) SPT-NGET Series Compensation
iii) East-West Upgrade
iv) Hunterston-Kintyre link
v) Pre-construction for non-baseline wider works

Generation Volume Driver:
We will fund the planned connection of 2.5GW of generation through our ex ante allowance, and a revenue driver set at £42k/MW will adjust revenues around this baseline. This compares with our July 2011 plan where we proposed to connect 1.6GW through our ex ante allowance and 0.9GW through a volume driver at a rate of £50k/MW.

Non-Load Projects:
Rather than fund through specific volume drivers, we have agreed to move two 275kV switchgear projects to our ex ante allowance.

2. Other Outputs

SF6 Gas Leakage:
The target SF6 leakage range have been amended from 1.48% - 1.45% in our July Business Plan to 1.47% - 1.29% in our updated Plan.

Unsupplied Energy:
We have agreed to a collar of 3% of allowed revenue.

Connections:
We have agreed that penalties apply if we do not comply with licence obligations relating to connection activities.

Financial

We are confident that our fast-tracked business plan strikes a fair balance between adequately financing an investment plan of around £2.6 billion pounds and minimising price increases for customers.

In providing the outputs described above SP Transmission will account for a 10p per annum increase to the average customer's annual bill.

During RIIO-T1 we expect to raise around £200m in new equity to support the investment programme which sees the RAV grow from £1.4 Billion to over £3.2 Billion.

We have worked closely with Ofgem to agree a financing plan which will achieve strong investment grade credit ratios over the eight year period of RIIO-T1. This is in part achieved by incorporating a transitional arrangement mitigating the negative cash flow impact of moving to a 45 year asset life assumption for the purposes of calculating depreciation allowances. Other key components of the package are as follows:

	DPCR5	TPCR Rollover	RIIO-T1
Cost of Debt	3.6%	3.25%	3.2%
Cost of Equity	6.7%	7.0%	7.0%
Gearing	65%	60%	55%
Real Vanilla WACC	4.69%	4.75%	4.91%
Real Post Tax WACC	4.03%	4.26%	4.49%

Note: *In calculating post tax WACCs we use a Corporation Tax ate of 28% for TPCR4 and DPCR5, a rate of 25% for TPCR4 Rollover and 24% for RIIO-T1.*

Cost of Debt: The allowed cost of debt during RIIO-T1 will vary in relation to a benchmark index (a ten year trailing average of iBoxx non-financials 10+ maturity series for an average of broad A and broad BBB ratings) as set out within Ofgem's March policy decision document. The figure of 3.2% is expressed in real terms and is at the point Ofgem previously quoted as being the index as at March 2011. This will vary during the period depending on the index

Indexation of the allowed cost of debt offers protection against changes in interest rates in the long term.

The allowed cost of debt, in common with all other components of regulated revenue, is inflated annually by RPI.

Cost of Equity: The cost of equity at 7.0% (real) is consistent with previous Transmission reviews and is 30 basis points higher than the recent Distribution review. We believe that this will be sufficient to provide dividends that will retain existing and attract new investment.

An allowed cost of equity at 7.0% lies within Ofgem's suggested range of 6.7%-7.2% set out within their March policy decision document. During our negotiations with Ofgem we accepted a reduction in the cost of equity of 20 basis points from 7.2%. Despite this we believe that the actual cost of equity facing SPTL to be somewhat higher as discussed in our original business plan and we will seek to outperform incentives contained within the package to increase our returns on equity.

Gearing: We have agreed a significantly lower notional gearing of 55% than seen at previous reviews.

Despite the advantages of a stable UK regulatory regime we are mindful of market sentiment around financial risk particularly within the current economic climate in the UK and the Eurozone. Alongside our concerns about certain areas of risk inherent to the RIIO regime we felt that a lower level of gearing was a key component of our financial package.

Other Financing items: During RIIO-T1 we continue to enjoy a form of accelerated depreciation allowance. Ofgem's policy is to lengthen assumed asset lives to 45 years for the purposes of calculating depreciation allowances. Other things being equal this causes companies' revenues to decrease. Ofgem have sought to mitigate this by allowing existing assets to continue to be depreciated on the current 20 year life basis. In order to further protect our financial ratios we apply a transitional arrangement for new capital expenditure such that new assets do not begin to adopt a 45 year life until after RIIO-T1.

Whilst being NPV neutral the **'speed of money'** or in other words the extent to which revenues are conferred immediately as opposed to being conferred over time via the RAV is an important consideration when assessing financeability in the short term. We find that we are sufficiently financed without having to additionally accelerate revenues in the period and as such have modeled a fast/ slow money split of around 10/90 which is similar to that expected to be seen in expenditure on a statutory accounting basis.

We considered a scenario which modeled a higher percentage of fast money. Whilst this brought forward cashflows, the corollary is lower value within the RAV at the end of the price control period.

In terms of **risk** the RIIO-T1 period presents both risk and opportunity. We have concerns about potential short term exposure to likely rising interest rates for instance. However on the other hand we are faced with a set of incentives which though challenging will present opportunities for outperformance. Ofgem have also recognised the quality of our plans and as a direct result SPTL is entitled to additional revenues under the Information Quality Incentive. On balance we feel that the package presents an appropriate balance of risk and reward from the perspective of both customers and shareholders.