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25 January 2010

Dear Hannah,

Suspension of Ofgem's policy on mergers between energy network companies

I am responding to your open letter of 7 December 2009 on the above. I can confirm that this response may be placed on Ofgem's website.

In addressing the question of whether to support Ofgem's "minded to" decision to suspend its 2002 and 2007 merger policies, we believe it would have been helpful if Ofgem had set out its own rationale for both a suspension and a potential review of the policy. Instead, Ofgem has only set out the drivers behind the need for a review (which we broadly believe are the right ones), but has not properly explained why its current policies cannot remain in force for the relatively short space of time up to mid 2010, when any new policy is expected to be put in place.

Suspension of the current policy for energy network companies creates uncertainty in the market. This is not consistent with the implicit beta and WACC ascribed to these companies. In particular, the relatively low WACC used by Ofgem for the latest DPCR 5 period relies on a transparent, low risk and predictable regulatory environment, which needs to be supported by a dynamic and liquid transaction market for these assets. In the case of this decision, uncertainty would arise, because potential purchasers will need to anticipate the outcome of a "case by case" assessment, rather than refer to an established policy. Any action that dilutes liquidity in the transaction market must increase the risks for potential investors and hence should be reflected in a higher WACC.

Therefore, we do not believe it appropriate for Ofgem to suspend its merger policy. If it does so, it should at least provide clear advice about what the ground rules will be for the interim period, together with an explanation of how this is consistent with the low risk level of this industry.

Moreover, we note that uncertainty in the market for energy network companies is not in consumers' interests, because it will potentially deter new investors and distort competition between existing and future owners – an important element in realising the benefits of incentive regulation.

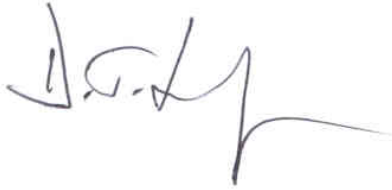
Finally, the prospect of a non-linear outcome (as OFGEM seems to be hinting in its letter) suggests that, should there be a number of mergers during the suspension period, different outcomes may apply to individual transactions, depending on where they are in the 'queue'. This would contradict the principles of transparent and fair regulation.

In summary, we do not support the suspension of Ofgem's current merger policies for network companies. However, should Ofgem decide to do so it must ensure the risks to network companies are minimised by conducting its review as quickly as possible, and by

setting out the matters it will take into account when making case by case decisions - including details as to how it will address multiple transactions arising within the suspension period.

Should you have any questions about this response please do not hesitate to get in touch with Paul Delamare on 07875 112317 or myself.

Yours sincerely

A handwritten signature in black ink, appearing to read "D. Linford".

Denis Linford
Corporate Policy and Regulation Director