Capital International

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6 August 2004

David Gray
Managing Director of Regulation
and Financial Affairs
OFGEM
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Dear Mr. Gray,

I am writing in response to your request for formal responses to the Initial Proposals for the Electricity Distribution Price Control Review dated June 2004. I am the European Utilities analyst for Capital International Research, Inc, the research company for Capital Guardian Trust Company, Capital International Limited, Capital International KK, Capital International SA, and Capital International, Inc. We have invested in the UK energy sector since privatisation, and very much appreciate the opportunity to comment on these very comprehensive proposals.

I would like to comment in more detail on two issues:

1. The range for the cost of capital, which I believe has been set too low in the context of other regulated monopolies in Europe and the US.
2. Operational efficiency targets, which, in some cases, might be too ambitious.

On the first point, I understand the draft proposals are based on 4.6% post-tax in real terms, which is the mid-point of the 4.2% to 5.0% range suggested in OFGEM's March 2004 document.

Renewing and expanding economically necessary, but sometimes inadequate, infrastructure, and addressing security of gas and electricity supply requirements are now top priorities for governments, regulators and companies in the US and Europe. As a result for the first time since privatisation, UK electricity distribution businesses will be competing with other countries and companies for investment capital. In order to attract this capital, the regulatory framework must be sufficiently attractive. Given this need to compete for capital, I believe that at the proposed range of 4.2% to 5%, the UK electricity distribution companies will be disadvantaged.

OFGEM's proposed range is below OFWAT's draft determination on the cost of capital for the water companies in England and Wales. I would like to draw your attention to the fact that under their current price control, many of the Water Companies in England and Wales were valued by the stock market, below their Regulatory Asset Base. This was despite the fact that some of them have achieved returns higher than the regulatory cost of capital. Only when it began to look likely that the next price control would allow a higher cost of capital, as has turned out to be the case from today's announcement, did the sector valuation rise. I believe low equity valuations can increase a company's cost of financing over the medium-term.

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OFGEM's proposed range is also lower than those in other regulated monopoly businesses in the UK, Europe or the US, including: BAA (UK), Enagas (gas transmission in Spain), Gas Natural (gas distribution Spain), and Snam Rete Gas (gas transmission in Italy). I do not regard any of these businesses as higher risk when compared with electricity distribution, but they all share the need to attract capital for their substantial investment programs.

With regard to operational efficiency targets, I would also like to encourage OFGEM to provide sufficient incentives for outstanding companies to earn in excess of the stated cost of capital. As long-term investors in this sector, we want companies to have incentives to provide the best possible customer service and network quality. I believe the proposals make some progress towards this objective, and would encourage more work in this area.

I am also concerned that the operational efficiency targets may be too demanding given the industry is moving out of the cost management phase towards investment and renewal. Sometimes when businesses experience growth or expansion costs rise, cost pressures are inevitable, and I believe this inflection point needs to be taken into account when setting these targets.

In conclusion, I would like to commend OFGEM on their continual effort to strike the right balance between the long-term interests of customers and investors. Thank you very much for the opportunity to comment on these initial proposals.

Yours sincerely,

Gina Miscovich