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Dear Colin,

Initial Proposals for Extending NGET's Price Control

I am writing in response to Ofgem's initial proposals for extending NGET's transmission price control for 2006/7.

In terms of the allowance for capital expenditure we note the ongoing work to determine the efficient level of non-load related expenditure and understand the approach taken by Ofgem in setting the initial allowance. Also, the approach taken on operating costs seems reasonable in the circumstances.

However, we are concerned that the approach taken on the cost of capital is not consistent with the option proposed by Ofgem in their 22nd July open letter, which was to "derive a value for the cost of capital based on the common components of the DPCR conclusion, but taking a view of specific risks and tax liabilities pertaining to NGC"

Instead, Ofgem have concluded that the "simple option" of using NGET's current post tax real return of 6.25% should be used. This appears to be predicated upon observations and work commissioned by Ofgem which indicate that some of the common components used in the DPCR4 model have changed since that review.

We believe to derive a new WACC without a full review of all the components (notwithstanding Ofgem's remark that parties should exercise caution in assessing the implications of the proposal) could be prejudicial to the main transmission price control review.

We therefore believe that Ofgem should derive the cost of capital using the DPCR4 outcome as suggested in their initial document. We believe that this implies using the post tax WACC of 4.8% to calculate the allowable income to cover the costs already identified in the proposals plus a high level assessment of NGET's tax position.

We also note that Ofgem do not propose to apply the capex rolling incentive for either the historic period, or the extension year. While we can understand why it might not be appropriate for the past period, given the uncertainty about the efficient level of capex, we do not understand why it is not intended that this be used for the extension year. Ofgem have already concluded in the June 2003 document on network price controls to use rolling five year retention periods for efficiency savings and this has been reiterated in their framework for the transmission price control reviews. Against this background, we would be concerned that not applying the capex rolling incentive for the extra year (06/07) would undermine incentives for NGET to efficiently invest in that year.

I hope our comments are helpful and if you have any further questions, please give me a call.

Yours sincerely,

Rob McDonald
Director of Regulation