

# Cost of capital of National Grid's GB electricity and gas transmission businesses

## Executive summary

- 1 The attached paper represents National Grid's position on what would be a reasonable rate of return for the purpose of setting price controls for National Grid Electricity Transmission (NGET) and National Grid Gas National Transmission System (NGG) for the period 2007 to 2012.
- 2 In the paper, we show the following two ways of estimating this rate of return:
  - (a) replication of Ofgem's DPCR4 analysis, while taking account of capital market movements since DPCR4, which suggests a real post-tax cost of capital of around 4.7%; and
  - (b) an alternative approach, based on inferring cost of capital from the value which investors have put on network companies with similar risk profiles, which suggests around 4.8%.
- 3 At the same time, we suggest (as Ofgem itself has suggested) that setting a price control rate of return needs to be informed by a wide variety of considerations. We suggest that factors which need to be taken into account include, in particular:
  - (a) uncertainty about how capital markets will move over the course of the next price control period;
  - (b) the implications of the need for much increased capital expenditure on gas and electricity networks, not least for increased 'terminal value' risk (the risk arising from the amount of RAV which will be exposed to regulatory decisions to be taken well after the current price review); and
  - (c) the importance of consistency in regulatory decisions, especially with respect to those components of cost of capital which are less directly matters of fact.
- 4 Other factors which also need to be considered, and to which Ofgem itself has drawn attention, include: changes which Ofgem is planning to make to the overall regulatory regime for NGG and NGET (particularly those changes which can be expected to impact on the trade-off between risk and return); and returns available to the transmission licensees in other regulatory jurisdictions.
- 5 Leaving aside the implications of impending changes in the regulatory regime (as we do not know what the changes will be or, therefore, what their effects will be), we suggest that taking account of all of the above reinforces the case for a cost of capital in the range suggested in paragraph 2 above and, indeed, strengthens the case for the top of that range.