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Dear Alistair

TRANSMISSION PRICE CONTROL REVIEW: COST OF CAPITAL

We are writing to you separately from our response to the initial proposals in order to express to you our strong concerns about Ofgem's initial view on the cost of capital and about the limited supporting evidence presented in the consultation papers.

We think the current estimate of the cost of capital is insupportably low and is in need of further development. We therefore support the additional work which Ofgem has said it will carry out with the assistance of its consultants. However, as we said during and after the last distribution price control review (DPCR4), we do not believe that it is appropriate for Ofgem to reveal its more developed views only at the final proposals stage, as this allows no opportunity for debate and challenge. We do not believe that such an approach is appropriate for something so fundamental to the UK's networks businesses, or that it is consistent with the principles of better regulation (in particular those relating to accountability, consistency, and transparency). We strongly urge Ofgem to reconsider this aspect.

We have asked NERA to examine and comment on Ofgem's view of the cost of capital and two papers are attached to this letter for consideration:

1. A Review of Ofgem's Initial Proposal for TPCR
2. DGM Cost of Equity Estimates for UK Transmission Companies

EDF Energy endorses the views expressed by NERA in these papers. In particular, there are a number of key areas that we would like to bring to your attention.

Risk Free Rate

Ofgem is to be commended for moving to estimates of the risk-free rate based on long-term historical averages. We have been proposing this for some time. However, care is required to ensure that the time-series data chosen are free from significant bias. In choosing a ten-year historical average of UK ILG (index linked gilt) yields, Ofgem has unfortunately selected data that are profoundly biased, following the introduction of the Minimum Funding Requirement for pensions schemes in 1997, and the more recent introduction of the Pension Protection Fund and FRS17 (which have further encouraged funds to hold gilts). For these reasons, the UK ILG yields no longer serve as a robust measure for estimating the risk-free rate applicable to decisions by investors in private companies. NERA has identified Eurozone index-linked government bonds as an unbiased alternative, which suggests a risk free rate in the region of 2.5%.

Estimate of Beta

Ofgem has assumed an equity beta of 0.9 for transmission companies, equivalent to an asset beta of 0.36 assuming a gearing of 60%. It is unsatisfactory that Ofgem has not set out its methodology for arriving at its estimate. This needs to be corrected.

NERA has examined the ten-year average asset beta for National Grid together with the asset beta implied by NERA's DGM analysis. This evidence indicates a significantly higher asset beta of 0.43 (which NERA notes is consistent with recent regulatory determinations in Europe). Even if Ofgem disputes this value, there are no grounds for adopting Ofgem's assumed equity beta without some analysis to back it up.

Equity Risk Premium

Ofgem has not set out its methodology for deriving the equity risk premium. This again is unsatisfactory. Even though NERA concludes that an estimate of 5.2% is supportable, we believe that Ofgem must publish its analysis.

DGM Estimates of the Cost of Equity

Ofgem states that it has undertaken DGM analysis of the cost of equity and finds it to be consistent with its estimate of 7%, but does not report the results or the methodology used. Since the DGM approach is the only check on CAPM based estimates, this lack of transparency is disappointing and needs to be corrected. As the matter currently stands, we are unable to verify that the errors identified by NERA's analysis of Ofgem's equivalent DPCR4 work have been addressed.

NERA estimates the cost of equity to be 8% compared with the 7% used by Ofgem. The relevant analysis is set out in detail in the second of the papers referred to above.

Financial Modelling

Ofgem has used target/threshold financial ratios that are significantly lower than those specified for DPCR4. Such ratios are not consistent with the maintenance of a single A credit rating. Ofgem should justify the reasons for changing its DPCR4 assumptions and should also explain how, if at all, the new threshold financial ratios are consistent with its other assumptions on gearing and credit rating.

Issuance Costs

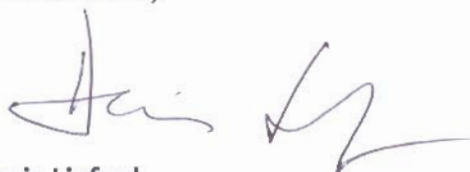
We are pleased to see that Ofgem recognises that the allowance for the cost of equity includes an element to cover issuance costs. In principle, there should also be a corresponding allowance for the costs of issuing debt (though we recognise that the sums concerned will be much smaller).

Concluding Remarks

We sincerely hope that you will carefully consider the matters raised in this letter and those in the attached NERA reports, and will present amended views on the cost of capital well in advance of the TPCR final proposals. The allowed cost of capital is fundamental to the continued success of the UK's networks businesses, including the delivery of key elements of the government's energy policy. While regulatory judgement may well be needed in some areas, the issue should be debated in an objective, fully transparent, and timely manner.

Ofgem's current approach falls short in such respects at present, but there is still time for these deficiencies in the process to be corrected.

Yours sincerely

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

Denis Linford
Director of Regulation