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David Gray  
Managing Director Networks  
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1) → TPCR responses  
↳ Andrew Mann  
2) → Duncan Innes

Dear David,

I write in response to the Updated Proposals for the Transmission Price Control Review.

In essence, I would like to reiterate the views I outlined during my presentation at the Ofgem Initial Proposals Workshop in July. I attach a copy of that presentation for reference.

The key issue for us as investors is that the allowed return on capital is first both sufficient to attract capital and fair, and second, designed such that an efficient company can indeed outperform.

Having spoken to the three companies involved during the process, it seems continued progress is being made on the details of the review, with the possible exception of the unit cost component of the capex allowance where agreement needs still to be achieved on the starting costs at least. Further, it would seem logical that where penalty mechanisms exist, there should be corresponding incentive mechanisms for outperformance. Due to these two factors in particular, there seems some doubt on the part of the companies as to whether they may even be able to meet the allowed return. However, these are matters that it would seem further constructive discussion should be able to resolve.

The area that remains that is fundamental to us as investors in the sector is the rate of return. In order to continue to attract equity investment into the sector the allowed return, in our view, should not be set below 4.6% post tax, as opposed to the current modelling assumption of 4.2%.

We would argue strongly that the post tax cost of equity remains 7.5% as per the Electricity Distribution review, and that the beta remains at 1.0 as per prior reviews. Indeed the Smithers report, while intellectually interesting, does not really help the debate on beta, and it appears to highlight considerably uncertainty on this issue. Beyond these comments, I would prefer not to be bogged down by theory here, and reinforce simply the need for the return to be sufficient to attract equity capital into the sector.

The alternative is of course that each of the listed companies have a wide array of investment options, as do we as investors, and both will naturally direct that capital to where a sufficient return can be made (that is, there remains the option for companies to sell or spin off parts of their regulated

networks). Investors have a choice of investing in the Water sector with a return of 5.1% (rising up to 5.7% at the end of the period due to financeability) or Electricity Distribution at 4.8%, as opposed to the Transmission sector.

Here I take comfort from the comments in Chapter 8.1 of the Updated Proposals where it is stated that the cost of capital will take account of factors such as 'consistency with past regulatory reviews', and the 'investment focus of the review'. My understanding is it was this same investment focus that governed the establishment of a cost of capital at the top end of the proposed range in recent reviews: the range has been set initially here at 2.8% to 4.8%; versus the Electricity Distribution range of 4.2% to 5.0%, with 4.8% selected as the final allowed return in that case.

In conclusion, we hope that the return will be set at a level sufficient to attract equity capital into the sector, which we believe should be at least 4.6% post tax, and that the final determination will be structured such that an efficient company can reasonably be expected to outperform the regulatory contract.

Yours sincerely,



Julian Gould  
Director  
European Fund Manager, Schroders

cc: Alistair Buchanan  
Chief Executive

Robert Hull  
Director – Transmission

Peter Bucks  
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