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Robert Hull  
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Dear Robert

With reference to your Updated Proposals on the Transmission Price Control Review (TPCR), published in September 2006, we welcome the opportunity to comment on the specific issue of the appropriate cost of capital for transmission network businesses.

As you are no doubt aware, Macquarie, through the infrastructure funds it manages, is an active investor in the regulated utility sector in the UK, Europe and around the world. Issues such as the appropriate cost of capital have an impact beyond the transmission sector as it is clear that regulatory decisions on the cost of capital are informed by debates and outcomes across various types of regulated business. As such we are keen to contribute to the current debate on the transmission network cost of capital.

#### Comments on the Smithers & Co report

To inform our views on the Smithers & Co report published in September we engaged NERA Economic Consulting to assist in evaluating the key conclusions, and the implications for the cost of capital. We have provided NERA's report alongside this submission.

For the risk-free rate and cost of debt we have concluded that the estimates in the Smithers report are not unreasonable. However it is important to note that NERA has concluded that UK gilt yields have been affected by the current appetite of UK pension funds for government securities, and hence an estimate of the risk-free rate unbiased by this factor would be 2.5% ie. higher than the value used in Ofgem's modelling assumption.

The major conclusions from NERA's work is that Smithers' estimated cost of equity for network utilities is materially understated, primarily due to

methodological issues in estimating the beta factor for these companies. As noted above - other factors covered in the Smithers report, such as the cost of debt and risk-free rate, appear to be within a range of reasonable outcomes, albeit that the resultant estimates for the cost of debt and cost of equity are themselves presented as wide ranges, which is not particularly helpful for assessing what an acceptable outcome would be for the cost of capital.

Smithers appear not to adjust the cost of equity estimate to be consistent with the same gearing assumption as the cost of debt. Instead, Smithers' estimate of the equity beta appears consistent with actual gearing (which NERA calculate to be around 37% over the period of analysis) whereas Smithers' cost of debt assumption is consistent with a gearing of around 60% (consistent with an A- debt rating). A recalculation of the Smithers cost of equity estimate, using an equity beta of 0.85 - 0.95 (consistent with a 60% gearing level and Ofgem's current assumption on beta of 0.9), results in cost of equity of 5.7% to 8.1%.

Based on this, and using Smithers' estimates for the other factors, the mid-point estimate for the post-tax cost of capital is 4.6%. We believe that this level should be seen as the absolute floor for the outcome of the TPCR. This conclusion is also consistent with the Oxera submission of 17 July which proposed a post-tax cost of capital of 4.6% - 4.8%.

#### Regulatory commitment and consistency

It is clear that market evidence and the choice of appropriate parameters for cost of capital estimates are open to a degree of interpretation and subjectivity. As a long-term investor in the sector we are therefore concerned not only with the appropriate cost of capital at a point in time but also the key issue of regulatory commitment and consistency. As Oxera noted in its submission - attention should be paid to the fact that "...investors make decisions on whether to undertake investment based on the expected risk and return profile over the lifetime of the asset".

We recognise that required investor returns, as observed in the capital markets, do vary over time. However it is important when assessing an appropriate level for the cost of capital that it is not seen as being unduly influenced by short-term market trends and recent transactional activity.

The final consideration we would wish to stress is the very real risk that by setting the cost of capital materially below that of other regulated sectors, investors may determine that the expected returns in the transmission sector do not provide an adequate return compared to other choices of investment. This may result in potential financeability issues and/or increased funding costs for the transmission sector and its capital investment requirements. Regulatory cost of capital determinations from other regulatory bodies including Ofgem, Ofcom, CAA, Ofreg and Postcom have averaged 4.85% since PR04 and 4.95% since 2000.

Conclusion

Our conclusion on the proposed cost of capital for the transmission businesses is that the outcome should incorporate a cost of equity which reflects the long-term nature of the investments in the sector. Based on the adjusted version of the Smithers data we believe the post-tax cost of capital should be in the range 4.6% - 4.8%.

Yours sincerely



Martin Stanley  
Executive Director



Peter Antolik  
Division Director