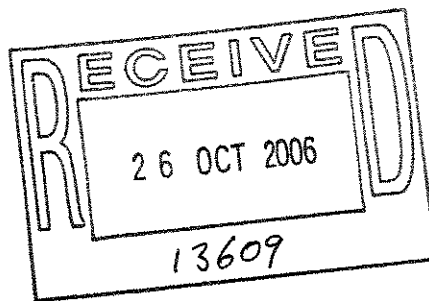


25 October 2006

David Gray
Managing Director, Networks
Ofgem
9 Millbank
London
SW1P 3GE



cc: Peter Bucks
Kieran Donaghue
Joanna Whittington
+
cc: Bob Hull
Duncan Innes

Dear David,

As long-term shareholders of a number of UK regulated businesses, we would like to express our views about the interim proposals for electricity and gas transmission. While we list these below under a number of headings, we believe that taken together they represent a significant negative shift in regulation and will significantly impair the ability of the companies in question to attract and retain equity investors.

1) Cost of capital

- Overall, we are concerned about the level of the cost of capital assumed by Ofgem. It appears to place too much weight on the exceptionally benign conditions for utilities over the last few years. With these conditions it is very difficult to draw long term conclusions using 5 year rolling averages for market observations.
- This difficulty in obtaining problem free data is even harder for observable company betas. The disruption caused by the TMT bubble is a well noted phenomenon. Readings since then are not suggestive of the need of any significant change in the beta from 1. It is hard to see where the evidence has come from to justify this specific change since the DNO review in 2004.
- The cost of debt assumed by Ofgem in the interim proposals looks too low when assessed using longer-term data that ignores the benign conditions of the bond market (gilt rates and credit spreads). We also find it hard to understand why Ofgem's assumption is below the bottom of the range seen in the report prepared for Ofgem by Smithers and Co.
- We also see no reason for Ofgem's large shift in its view on the risk free rate since the DNO review. Again it is hard to understand why Ofgem's assumption is below the bottom of the range seen in the report prepared for Ofgem by Smithers and Co.
- Overall the allowed returns for both debt and equity do not look attractive for equity investors compared to current expectations about wider market returns. This is concerning given the increased investment focus of the current review and the shift in risk and reward contained in the interim proposals (see further below).

2) Investment focus of the current review

- We note that Ofgem appreciated the implications of a higher investment focus for a regulated company in the DNO review and sought to take account of this when setting the cost of capital.
- The increased investment focus gives rise to a number of uncertainties:
 - i. Cashflows for equity investors in particular are pushed further into the future.
 - ii. As a result proportionally more of the cashflows for equity investors become subject to future regulatory reviews (increasing regulatory risk)
 - iii. Execution risk is increased (i.e. the uncertainty as to whether the company can deliver on the significant investment programmes).
- We do not feel that Ofgem has adequately justified why it has adjusted returns from the level set for the DNOs in 2004, given that the current review also carries a significant increase in investment focus for the companies concerned.

3) Risk and reward

- In discussions with the companies, it has become apparent that there has been a significant deterioration in the risk-reward balance in the current review. This does not feel appropriate given the increased risks associated with delivery of a sharply increased investment plan, considerable uncertainty over future network requirements (both load and non-load related), and the wide gap between Ofgem and the participating companies over the starting point (both in terms of unit costs and size of programmes).
- Among our particular concerns are the following areas:
 - i. The 25% rule for efficiently spent but inadequately forecasted capex in electricity and non-load related gas transmission. The potential to lose such a high amount of value is unacceptable (even allowing for the need to incentivise honesty in regulatory negotiations). In the Gas LDZ mini-review, to see 40% of the NPV of the efficiently spent and in retrospect justifiable capex disallowed from the prior period was a nasty surprise for equity investors. Given the uncertainty over forecasts and the wide disagreement between Ofgem and the companies at this stage over the future requirements, we believe these risks are too high.
 - ii. The revenue driver rules for new entry gas transmission capacity also appear to offer increased levels of uncertainty and risk with little potential reward. The duration, in particular, of the revenue drivers before the capex enters the RAB appears to be too long given the risk/reward balance.
 - iii. The penalties for timely delivery of new entry and exit capacity for the gas transmission network appear to be exceptionally onerous and one-sided. The increased size of individual projects automatically increase the risk of the maximum penalties being imposed, especially given the limited build period in the year (i.e. once the year's window for building is over, any delay that spills over into the following year will almost automatically trigger the full penalty).
 - iv. The divergence between Ofgem and the companies on opex also looks to be unsatisfactorily high, especially given the cost pressures that are observable in the wider economy, particularly to capital and energy intensive industries.

- Overall, we feel the regulator has not made clear to equity the risks facing the companies and certainly hasn't given satisfactory examples of how the companies can achieve meaningful out-performance (in the order of 10% of allowed returns for the best in class companies). We believe the regulator hasn't addressed the issue of how the lower out-performance potential of a maturing regulatory regime impacts the overall attractiveness of regulated companies to equity investors. This is particularly critical given sharp step up in investment focus.

4) The example of PFI project returns

- We find it useful to compare regulatory returns for utilities with other long-term infrastructure type projects. At present, it is worth noting that such projects offer significantly higher equity returns (with most companies targeting equity IRRs of around 14%).
- There are a number of differences to the sort of investment seen in a utility (especially given its large established asset base), but given the increasing investment focus of the current review the comparison is becoming more pertinent:
 - i. Equity returns are set at the outset and debt financing is arranged for the full duration of the ownership of the asset.
 - ii. There is significant scope to immediately sub-contract a large part of the construction costs of the project.
 - iii. At the outset there are clearly defined contractual outcomes that the project has to deliver.
 - iv. Debt funding is 80%, not significantly higher than Ofgem's current proposal of 60%.
 - v. However, risks and rewards accrue fully to the equity holders - implying a greater variability of outcomes.
- Overall, the comparison highlights the number of uncertainties facing the utilities in the next regulatory period for which we believe they are not receiving adequate reward.
- We would note that the current investment plans for the UK would suggest that such PFI projects will be a significant competitor to the utilities in their task of raising capital.

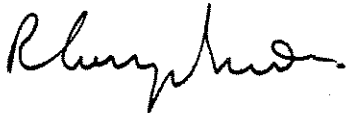
5) Examples from other utilities

- We would also note that other utilities across Europe facing significant investment programmes enjoy more favourable terms.
- BAA for its T5 project was allowed a higher level of returns.
- Red Electrica and Enagas face very high levels of investment and the current regulatory deal equates to an equity IRR somewhat above 10% with meaningful out-performance also possible on opex and capex.
- Terna, Snam Rete Gas and Gaz de France all enjoy a premium to their allowed cost of capital for the most critical parts of their investment programmes (up to 200 basis points for five years).

To summarise, we feel the current transmission interim proposals contain significant risks for the companies while investors face the possibility that they will at best earn an unsatisfactory allowed cost of capital and face significant downside to this. For this to remain attract to equity investors, the cost of capital needs to reflect adequately the investment focus and prevailing market expectations; the risk-reward balance needs to be improved to allow for the potential of meaningful out-performance as well as penalties for under-performance; and the divergence between the companies and Ofgem on costs and investment programmes needs to be narrowed. Compared to other infrastructure returns currently seen in the UK and Europe, the overall package comprises too little carrot and too much stick. Unless there is significant improvement in the final proposals, we would be happy to support any of the companies involved if they decided to refer the matter to the competition commission.

We would be happy to discuss any points raised in this letter. We would appreciate it if this letter was not made public as attributable to Newton without prior discussion on the matter, while we would happy for it to be included in the responses on a non-attributable basis.

Yours truly,



Robert Canepa-Anson
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Newton Investment Management.