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4th February 2011

Dear Mr Cook

Ofgem has encouraged stakeholders to contribute to the debate on the RIIO proposals and this letter summarises our views on what we have heard and read from OFGEM so far.

The few key points that we make in this letter will be familiar to the regulator because we have raised them in our discussions with Alistair Buchanan in a number of meetings we have had with him in the last 9 months. Our views are expressed from the perspective of an equity investor in this industry.

Key issues:

1. **Proposal to extend assumed asset life of electricity transmission assets from 25 to 45-55 years**

   This proposal, which seems to be motivated by theory rather than pragmatism, will have a very detrimental effect on cash flows when implemented. The transition arrangements that the regulator has alluded to are very unclear and cannot be relied upon to offset the damaging effect these proposals will have on cash flows. The negative consequences on the balance sheets and dividend paying ability of transmission businesses are extremely unwelcome especially for equity investors.

   This proposal, in our view, will significantly increase the equity risk of transmission businesses and consequently will increase the return we would require from any investment we might have in them.

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2. Changes in accounting for repex which will be capitalised at 100% rather than the current 50%

This is less material than the asset life issue but will further erode near term revenues and cash flows and exaggerate the effects outlined above.

3. Transition relief to help smooth the effects on cash of 1 and 2 above

Transition arrangements will be subject to a process of negotiation with Ofgem in which companies must show that they need relief to help fund their businesses. The outcome of these negotiations will clearly depend on various measures and interpretations of financeability, an arcane process in which we place little faith. We are especially cautious because the regulator has again reiterated his expectation for further equity injections and dividend holidays in transmission and distribution businesses.

4. Proposals for lower allocated costs of debt and equity

(i) Ofgem has proposed to mechanise the cost of debt by using a 10 year trailing average of BBB and A rated corporate bonds. This approach would produce a current cost of debt of approximately 3.1% (significantly lower than the current allowed cost of debt) and this would fall further in the immediate future.

This approach gives no flexibility to allow the cost of debt to reflect prevailing and forecast market conditions, and of course, further reduces the overall WACC.

(ii) Ofgem has proposed a range for the cost of equity of 4.0% to 7.2%. Any outcome less than the top end of this range will represent a reduction in returns. The middle of this range clearly represents a material reduction.

Crucially, Ofgem has not shown how equity risk faced by investors in this sector has reduced, which in turn would justify lower returns. We believe that the risks faced by equity investors in this sector will rise under RIIO not fall.

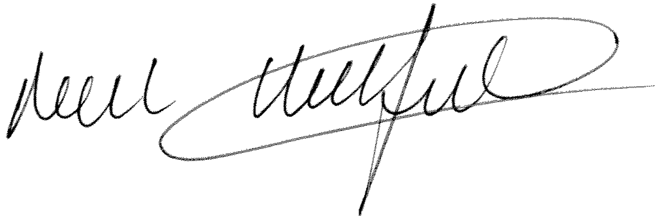
Conclusions

The cumulative effects of these proposed changes will be profoundly negative for shareholders in electricity and gas transmission and distribution businesses. Specifically, the changes to asset lives and repex will have a significantly negative multi-year impact on cash flows. Furthermore we do not believe that this impact will be mitigated sufficiently by as yet unclear transition arrangements. This will in turn place further stress on some stretched balance sheets and will inevitably lead to dividend cuts.

Collectively these measures will increase risk and consequently increase required returns from investments in this sector. However RIIO also contains cost of capital proposals which, far from increasing base returns, will significantly reduce them. We have cautioned the regulator on a number of occasions about the inadequacy of base returns but these words appear to have fallen on deaf ears. As we have said before, this sector must compete for our investors' capital with all other sectors. Furthermore, as the demand for massive incremental capital in the energy sector unfolds so returns must rise to stimulate a sufficient supply. Again these simple laws of economics seem to have been ignored and what we are faced with is more risk and less return.

Overall, this is a very unappealing prospect which we cannot ignore. Consequently, for the record, we have decided to exit substantially our investments in the regulated utility sectors, the largest of which was an £800m investment in National Grid plc.

Yours sincerely



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