Cost of Equity– initial views

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CEPA presenting viewpoint based on ongoing work for Centrica plc

Agenda

1. Implications of regulatory reform
2. Recent relevant decisions
3. Performance by networks
4. Market response
5. Evidence from transactions
6. Conclusion

Implications of regulatory reforms

- First price reviews under new framework, but extent of reforms can be overstated:
  - Elements of the framework were used previously by Ofgem and Ofwat.
  - Some debate about whether the change in cash-flows implied by the RIIO framework will increase the cost of equity, although the extent of any change is not yet known.
  - Any impact likely to be small.
  - Competition Commission (CC) appeal made no adjustment for the risk impact of lengthening cash-flows.
- Equity risk may even be falling owing to other aspects of RIIO, specifically the greater certainty provided by cost of debt indexation and an eight year control with a four year re-opener.

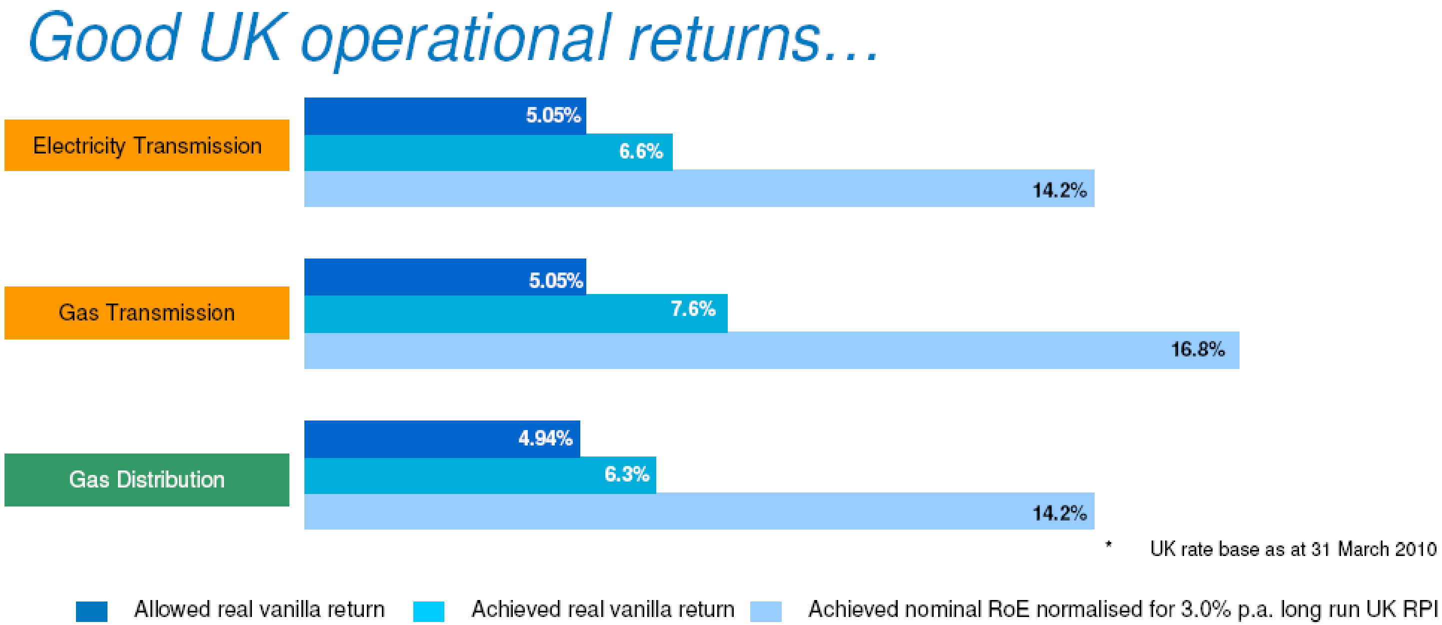
Recent relevant decisions

Element	2006	2007	Nov. 09	Dec. 09	Jun. 10	Oct. 10
	TPCR4	GDPCR	PR09	DPCR5	CC (Bristol)[1]	CAA NATs
Rf	N/A	N/A	2.0	N/A	2.0	1.75
ERP	N/A	N/A	5.4	N/A	5.0	5.25
Equity β	N/A	N/A	0.94	N/A	0.92	1.35
CoE (post tax)	7.0	7.25	7.1	6.7	6.6	8.8

Source: Competition Commission / Ofgem

- Decisions post December 2009 based on evidence supporting a lower cost of capital:
  - CC: ILG yields have remained constant at about 1 % for five years…no evidence for risk-free rates of over 2%.
  - CC: dismissive of forward looking approaches based on somewhat arbitrary assumptions, and concludes that a range of 4 - 5% for the ERP is appropriate.
  - CC also notes that increased economic uncertainty may make investing in regulated utilities more attractive.

Continued outperformance by networks



Source: National Grid, August 2010

- National Grid continues to outperform the allowed WACC
- This outperformance is unlikely to be from efficiencies alone
- Publication of RORE analysis will assist understanding of drivers of outperformance
- Note that post the rights issue, City analysts point to shares trading at a premium to RAB

Market response to RIIO announcement: City views

"We feel it is more about signposting what Ofgem is currently doing, and increasing incentivisation with reduced uncertainty". In particular: the move to inflation linking is "a positive, in our view"; increasing the duration of price control periods "brings extra clarity"; the increased incentivisation is "highly progressive"; the enhanced engagement "reduces the possibility of CC involvement". The analysts also regard the statements made on financeability as positive."

Credit Suisse

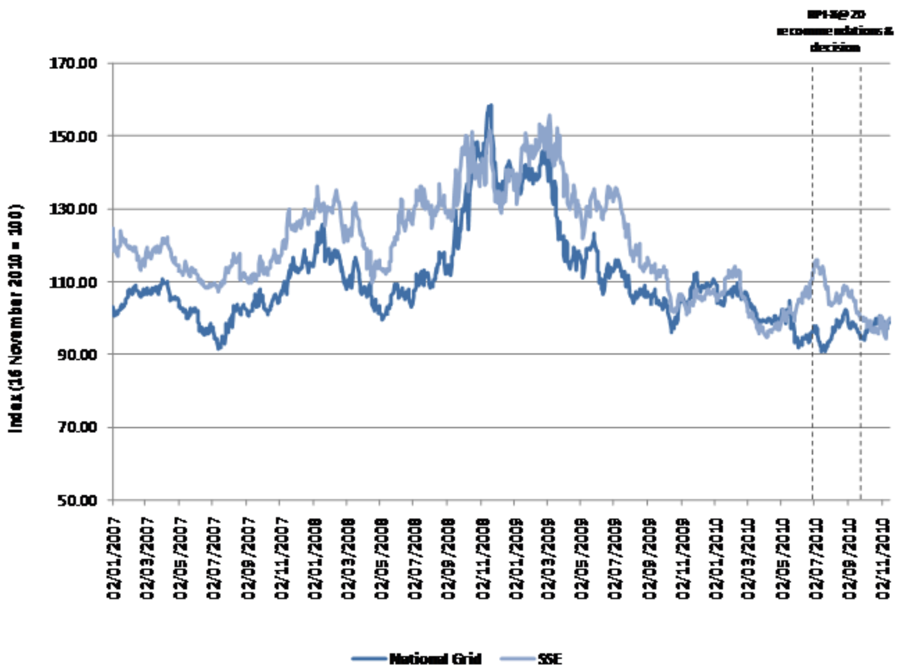
"Generally the industry has welcomed the RIIO proposals, although the depreciation issue has been a worry. The aim is to give companies new incentives to outperform and longer periods to do so, which should in the round be a positive."

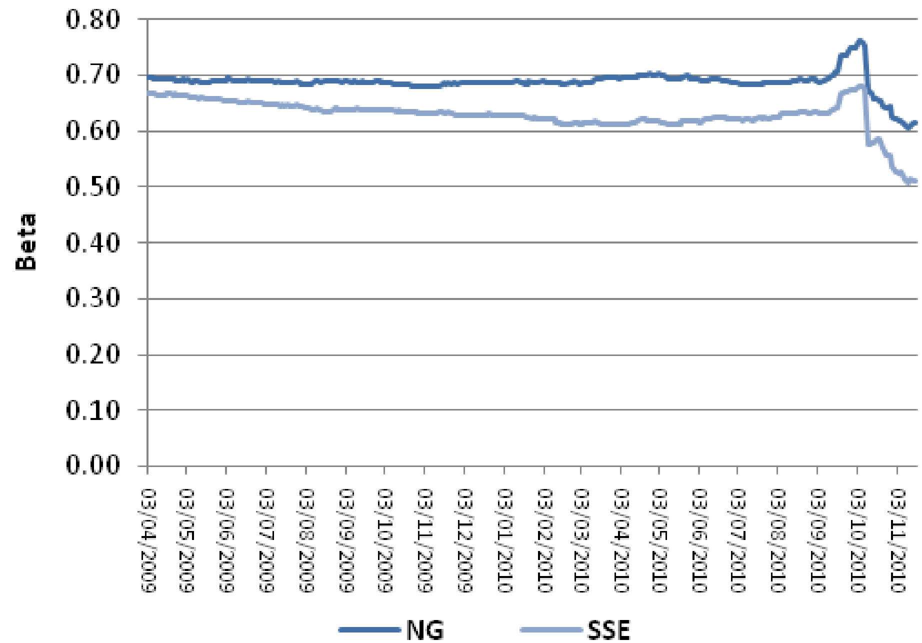
Citi

"The UK story is becoming more visible with a regulator that is keen to ensure investment in the sector... [the] regulatory review period extended from 5 to 8 years: This should provide greater certainty for investors and allow the companies to make longer term plans."

JP Morgan

Market response to RIIO announcement: share price movements and betas

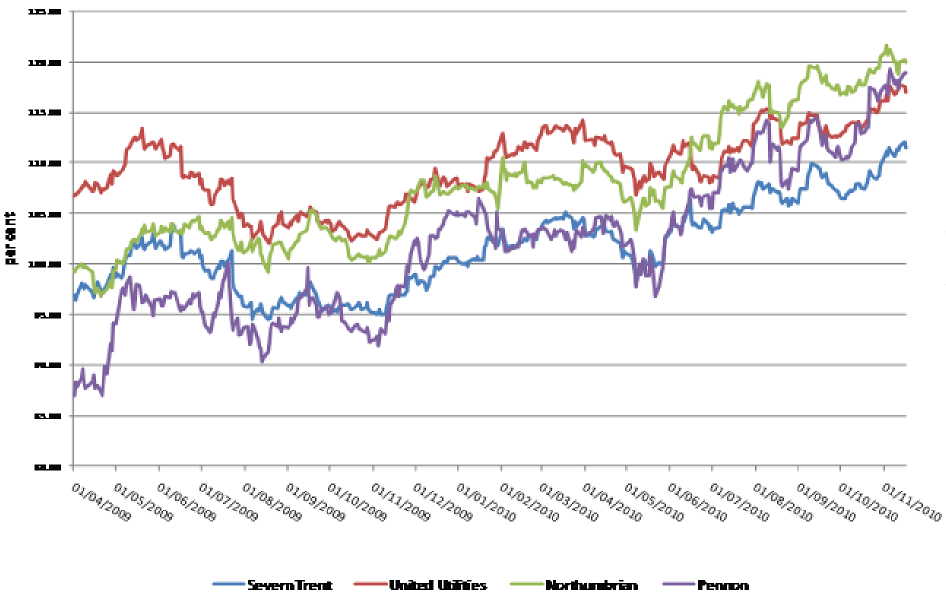


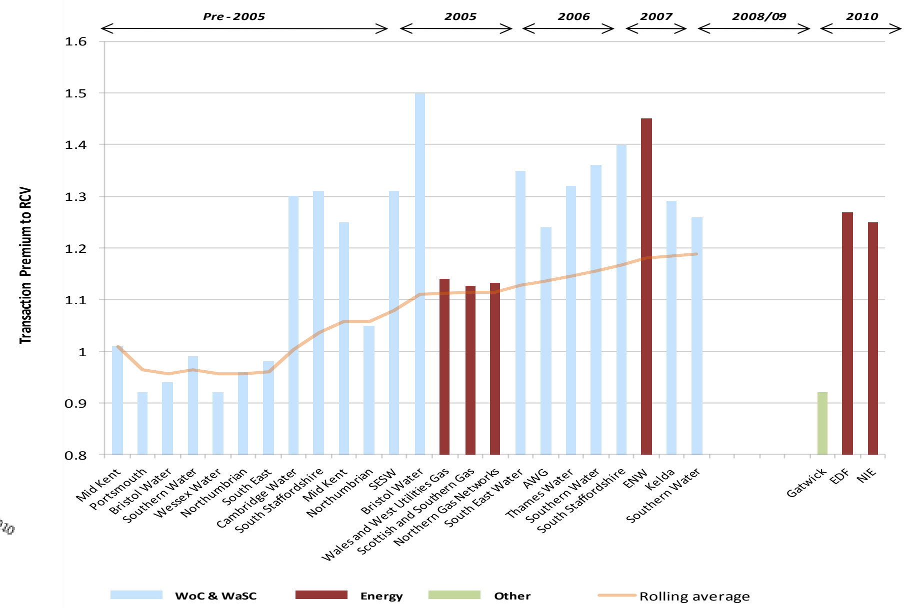


Source: CEPA analysis of Bloomberg data

- Share price movements relative to FTSE do not suggest a significant increase in perceived risk.
- Beta statistic has been relatively stable until recent fall, reflecting increased appetite for infrastructure in general. Indication is that, as expected, equity beta for UK energy networks is certainly less than one.

Evidence from infrastructure transactions





Source: CEPA analysis of Bloomberg data

- Credit Suisse, regarding EDF sale, highlights the attractiveness of "long-duration, RPI index-linked assets remunerated in real terms". It also notes a reduction in its cost of capital estimate (for water), "lower[ing] the vanilla real cost of capital to 3.3% versus the regulatory allowed 5.1%", which fits with increasing MARs.
- EDF transaction cannot reflect cost savings alone, but suggests that the acquirer expects to achieve significant outperformance against the cost of capital.

Conclusion on cost of equity

- No evidence that the overall impact of RIIO has been to increase risk to energy networks.
- Market evidence suggests that RIIO has not increased the perception of risk for energy network companies by stock market participants.
- Increased appetite for UK infrastructure investment.

Overall, the WACC, and the cost of equity in particular, has fallen since TPCR4/ GDPCR, and it may even be the case that is has fallen further since the DPCR5 determination

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