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12th September 2011

Dear Gareth,

TPCR4 Rollover: Initial Proposal

Thank you for the opportunity to comment on the above consultation. This non confidential response is on behalf of the Centrica group of companies excluding Centrica storage.

While we have reservations about some of the principles underpinning the proposals, we accept that the package reflects a proportionate approach to the one-year rollover and we propose to return to some of these issues in the context of RIIO-T1 and GD1. Below we comment more specifically on questions 12 and 13, which we think are also relevant for RIIO-T1.

Question 12: Do you think the proposed allowed return is appropriate to a one year rollover?

We think that the proposed return on equity might be relatively generous given the market evidence presented in Ofgem's strategy decision for RIIO-T1 and GD1 (suggesting a range of 6.0% to 7.2%). We would also like to draw Ofgem's attention to the very high valuations achieved by regulated utilities at recent transactions, with RAB premiums ranging between 20% and 33% for four different transactions over the last year (see Figure 1 in the appendix to this letter). We think that it would be inappropriate to ignore this evidence given the paucity of direct market data on the cost of equity.

However, we accept that these market developments are best considered in the context of RIIO-T1 and GD1 and, as such, we agree that Ofgem's proposed approach to the WACC is reasonable and proportionate for the purpose of rolling over TPCR4.

Against that backdrop, we encourage Ofgem to resist any arguments that the market turbulences observed over the summer should be reflected in a higher WACC. While regulated utilities have not been completely immune from the current volatility, they have proved much more resilient than the market as a whole. For example, Figure 2 in the appendix to this letter shows that National Grid's share price has increased by 5% since the sovereign risk crisis aggravated in August, while the FTSE 100 has lost 10%. This is further evidence of the low systemic risk of these assets and their continued attractiveness for investors at times of market uncertainty.

As a matter of principle, we also agree that the TOs should be compensated for the costs of issuing new equity. However, we think that Ofgem will need to take a closer look at the assumptions used to set this allowance in the context of RIIO-T1 and GD1, notably the dividend yield (which is not stated in the consultation paper) and the cost of injections (currently set at 5% of the amount issued). As energy networks and other regulated utilities become increasingly cash-negative over the next decade, it is conceivable that equity investors could resign themselves to lower dividend yields, and/or that the legal and administrative costs associated with equity injections will drop (because new issuances will become more common and there will be more intense competition between financial arrangers). There is also an argument that the cost of issuing equity is covered by setting the allowed return on equity at a level towards the top end of the range.

Question 13: Do you agree with the adoption of the new pension methodology for the rollover?

We have some reservations about the treatment of deficit recovery costs as a pass through item. In our response to Ofgem's initial consultation on RIIO-T1, we explained why we believe that energy customers are exposed to greater risks with respect to deficit repair costs than in other regulated industries. While we accept that Ofgem should not reopen its pension policy for the TPCR4 rollover, we think that this issue would warrant further attention in the context of RIIO-T1 and GD1.

We note that, in the Bristol Water inquiry, the Competition Commission has considered that pension deficits were at least partly within the control of regulated companies, and that it would be inappropriate to treat this cost fully as a passthrough item. The CC decided that Bristol Water should be funded to recover only 90% of the deficit in its defined benefit schemes.

We trust that these comments have been helpful. If you have any questions or comments relating to this response, please do not hesitate to contact me.

Yours sincerely,

By e-mail

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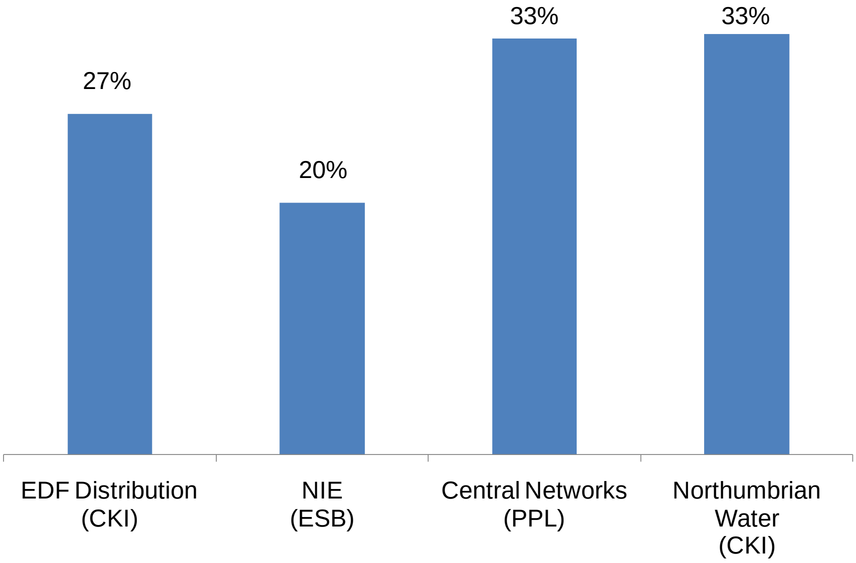
Appendix

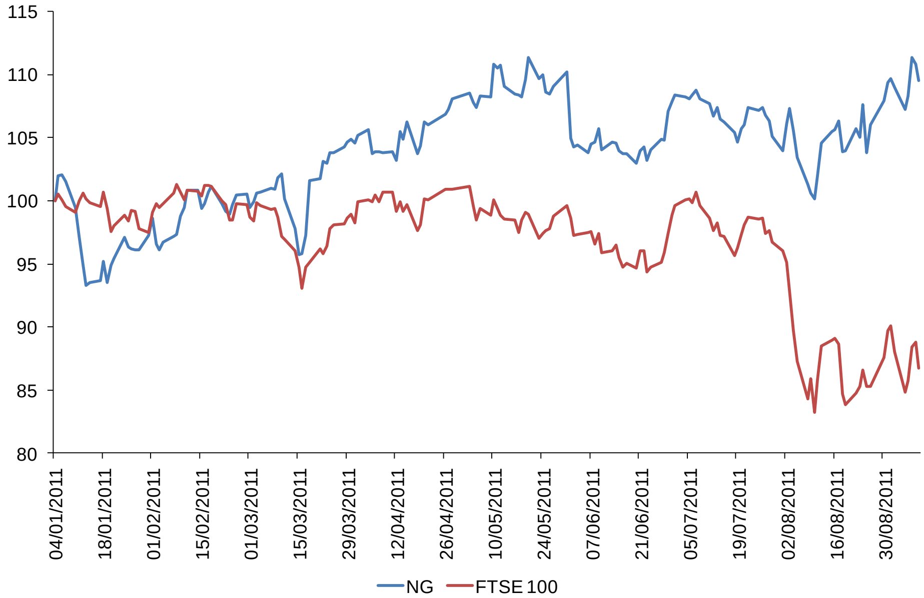
Figure 1: RAB premiums at recent transactions



Notes: the premium for EDF Distribution was reported by EDF as part of its communication on 2010 H1 results; the premium for NIE is estimated as an enterprise value of £1,209m (comprising of the equity consideration of £1,034m and the debt value of £175m) divided by the RAB value of £1,007m; the premium for Central Networks is estimated by dividing the enterprise value reported by Eon (£4bn) by the RAB value of the company as at March 31st 2011 (£3bn); the premium for Northumbrian Water is estimated by dividing the enterprise value reported by CKI (£4.8bn) by the RAB value of the company as at March 31st 2011 (£3.6bn); the ratios do not control for the unregulated businesses of Central Networks and Northumbrian.

Sources: EDF press release July 30th 2010; joint statement from ESB and Viridian – July 7th 2010; Eon investors presentation March 2nd 2011; CKI transaction announcement August 2nd 2011.

Figure 2: National Grid share price and FTSE 100 (base 100 on 04/01/11)



Source: National Grid website, Centrica analysis.

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