

18 May 2007



energy**networks**
association

Julie Hawes
Airport Inquiries Coordinator
Competition Commission
Victoria House
Southampton Row
London
WC18 4AD

18 Stanhope Place
Marble Arch
London W2 2HH

T +44 (0)20 7706 5100

F +44 (0)20 7706 5101

info@energynetworks.org

www.energynetworks.org

Dear Julie

Review of Heathrow and Gatwick Airport Price Controls

I am writing on behalf of members of the Energy Networks Association (ENA)¹ in connection with the Competition Commission's statutory review of the Civil Aviation Authority's proposed price controls for Heathrow and Gatwick Airports.

The ENA is the body funded by the UK's electricity and gas transmission and distribution network operators. It also has as Associates, a number of other network asset owners and operators, including two UK independent electricity distribution network operators.

The ENA's members are capital intensive infrastructure businesses who collectively have invested many billions of pounds to ensure that the public continue to benefit from high quality energy delivery networks. They are companies who operate in a highly regulated and typically price controlled environment in which investment recovery periods are measured in decades. It is therefore of critical importance to our members that UK regulatory practice is stable and has similarly long-term horizons.

The Commission will be aware that EDF Energy and Central Networks (both ENA member companies) have jointly submitted evidence to the Commission regarding the Civil Aviation Authority's (CAA's) risk free rate assumptions in its determination of the cost of capital. The purpose of this letter is to ensure that the Commission understands that this evidence is strongly endorsed by ENA members listed below.

The Commission will be aware that Ofgem used a risk free rate of 2.5% in its recent gas and electricity transmission price control reviews, as it did previously in its 2004 distribution price control review. We are therefore surprised by the CAA's estimate of just 2%. Clearly, a 50bp (20%) downward movement in one of the core assumptions used by regulators to estimate the cost of capital is a matter of considerable concern to companies interested in a stable and long-term regulatory environment.

Consequently, EDF Energy and Central Networks commissioned a report from the respected economic consultants NERA to examine the CAA's risk free rate proposals.

NERA identified a number of important weaknesses in the CAA's approach, including perhaps most fundamentally, its failure both to follow regulatory precedent and evidence and to correct for the distorting effects on UK gilt yields of pension fund regulations and the Pensions Protection Fund.

NERA also identified other important problems with the CAA's analysis. Firstly, there is the misleading use of the lower boundary (1.65%) of the range used by Ofgem in its Initial Proposals for the transmission price control review – when in fact the value used for the Final Proposals was 2.5%. Secondly, there is the CAA's use of shorter term spot rate evidence for the risk free rate when other components, such as the equity risk premium and beta are normally derived from long run time-series data. Using different time bases is particularly problematical since it ignores the inverse relationship between the risk free rate and the equity risk premium.

Finally, given the presence of distortions in Government bond markets, the CAA's estimate of the risk free rate would have benefited from reference to a wider range of evidence. NERA has looked at such evidence and has additionally developed an approach utilising the analysis of swap markets. This approach is corroborated by previous analysis carried out in 2001 by two Bank of England economists (Copper and Scholtes).

We strongly support the development of consistent and robust UK regulatory practice across the utility sector as it is fundamental to the achievement of a stable and predictable regime in which investors, companies and customers can have confidence. We therefore have serious concerns about the CAA's current approach to estimating the cost of capital for Heathrow and Gatwick Airports in their Quinquennial Review.

We fully endorse the criticisms of the CAA's proposals contained within the NERA report and trust that the Commission will take note of them in its deliberations.

Yours sincerely



Nick Goodall
Chief Executive

¹ CE Electric UK, Central Networks, EDF Energy, National Grid, Northern Gas Networks, Scottish & Southern Energy, Scotia Gas Networks, Scottish Power, United Utilities, Wales & West Utilities.