



Julie Hawes (Airports Inquiries Coordinator)
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

27 April 2007

Dear Ms Hawes

Airports Quinquennial Review – Submission of Evidence by EDF Energy and Central Networks

Thank you for the invitation to submit evidence to the Competition Commission's (CC's) statutory review of the Civil Aviation Authority's proposed price controls for Heathrow and Gatwick airports.

EDF Energy owns and operates the three price-controlled distribution networks which cover south east England, Central London and the east of England, and which collectively have 7.8 million connected customers. Central Networks owns and operates the two distribution networks in the Midlands and has 4.9 million connected customers. Together, the two companies have 45% of the GB total of 28 million connected customers.

Both companies therefore have a very direct interest in the development of utility regulation in the UK, and on the CC's recommendations to the CAA.

We are very concerned about the CAA's approach to the cost of capital, and are particularly worried about its proposals in respect of the risk-free rate element of the CAPM. It is on this issue that we wish to submit evidence to the CC's deliberations.

In November 2004, Ofgem estimated a value for the risk-free rate of 2.5% for the distribution price control covering the period 1 April 2005 to 31 March 2010 – a value which Ofgem used again in its November 2006 transmission price control reviews. However, just four months later, the CAA adopted a risk-free rate estimate of 2% - some 50bps lower. We do not believe this to be a credible outcome and consider that there are important aspects which the CAA has omitted to take into consideration.

We note that in past determinations, regulators have taken a longer term view of the risk-free rate than appears to be the case with the CAA and their advisors, Europe Economics. In particular, other regulators have rightly recognised the relatively recent distorting effects on UK gilt yields caused by new funding and reporting obligations placed on pension funds.

We do not claim to be experts in the estimation of the risk-free rate. We have therefore commissioned NERA to help us articulate our broad concerns in a far more expert and cogent manner than we could manage ourselves. We are therefore pleased to both endorse and submit the attached report from NERA, which we ask is used as an input into the CC's deliberations.

We note that the CC's report to the CAA, due in September 2007, may not be made public until sometime later – possibly in 2008. Given that Ofgem is due to publish its gas distribution price controls in November 2007, we believe that it would be useful for the CC to publish working papers on the cost of capital and other matters of interest throughout the summer of 2007.

In conclusion, our distribution businesses are long-term businesses which involve very substantial capital expenditure programmes, typically funded through long-term debt instruments and cost recovery through regulated revenues over decades. It is therefore important for regulators to take an equally long-term view on funding and to base their risk-free rate assessments on robust data adjusted for any shorter term distortions. We hope that this submission helps the CC to take such a long-term view.

I can confirm that both this letter and the attached report from NERA can be published on the CC's website.

Yours sincerely

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