

“Ofgem’s proposals, although presenting real challenges, offer an acceptable balance of risk and reward...

...we are confident that we can provide a superior return for investors.”

Steve Holliday
Chief Executive

National Grid has today accepted Ofgem’s final proposals for the five-year UK gas distribution price control beginning 01 April 2008.

This fact sheet gives an overview of the price control, highlights the key issues and outlines the regulatory process.

ACCEPTANCE OF THE PRICE CONTROL

Ofgem’s final proposals for the five-year gas distribution price control have improved in all areas compared to their updated proposals issued in September.

There are five key components of the gas distribution price control. While elements of the proposals result in some real challenges, taken together they form an acceptable balance of risk and reward.

Rate of return: UK gas distribution assets will be allowed an operational (‘vanilla’) real return of 4.94%, based on:

- 3.55% pre-tax real cost of debt.
- 7.25% post-tax real cost of equity.
- Assumed gearing of 62.5%.

This is equivalent to a 4.3% post-tax real return, slightly below the allowed return on our UK transmission assets.

This allowed return is applied to our regulatory asset base, which Ofgem has agreed at £6.4bn at 1 April 2008.

Opex: Ofgem propose a 5-year controllable opex allowance for the price control of £1.9bn, including an embedded 2.5% annual efficiency assumption. This allowance represents a significant challenge for National Grid over the price control.

However, the proposals include new mechanisms that allow the recovery of specific uncertain costs:

- Shrinkage gas volume allowances fixed for the price control period, de-risking the cost of shrinkage gas by setting a price allowance for procurement of replacement gas based on the day ahead gas reference price.
- Re-opener for specific costs arising from implementation of the UK Traffic Management Act 2004, which includes obligations expected to result in higher street works costs.
- Revenue driver to fund any cost increases for providing emergency service coverage for the UK’s gas distribution network. This is triggered in the event of any reduction in supplementary activity e.g. meter work.

Capex and repex: As a result of this review, investment in our gas distribution networks in the UK will be substantially higher than in previous regulatory periods. Ofgem has proposed a capex allowance of £0.7bn, and a repex (mains replacement expenditure) allowance of £2.1bn for the price control period. On the basis of these allowances, we project that our gas distribution UK regulatory asset base will grow by almost 25% over the 5 years to 2013.

Other incentives and features: Ofgem’s proposals include various features and incentives that either reduce risk, or provide opportunities for outperformance. These include:

- Removal of transportation volume drivers from our revenue allowance, similar to the 2007/08 one-year control.
- Information Quality Incentive with rewards/penalties for delivery of capex versus allowances.
- Mains replacement incentives with rewards/penalties for delivery of repex versus allowances.
- Capacity outputs incentive with rewards/penalties for trade-offs between investment and interruption auctions.
- Environmental emissions incentive with rewards/penalties for reducing gas leakage.
- Reward only incentive for improvements which reduce the environmental impact of gas distribution; facilitating network extensions; and promoting gas safety.

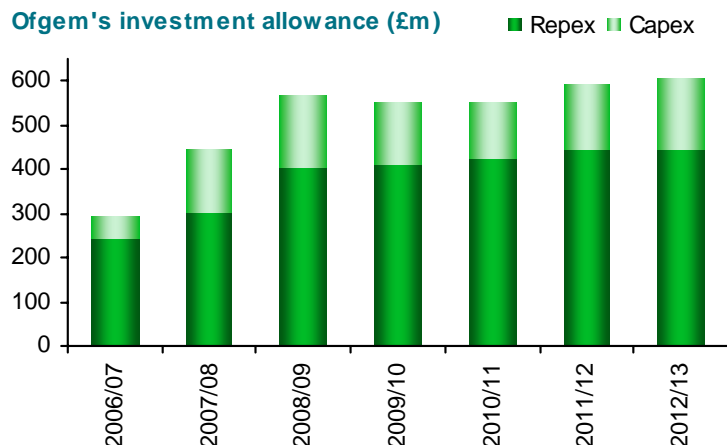
Pensions: Ofgem’s pension proposals allow full funding of our ongoing contributions, and recovery of the majority of our current pension deficit, based on current actuarial valuations.

Overall: These proposals will result in a 2% real annual increase in gas distribution UK allowed revenues for each of the 5 years to 31 March 2013.

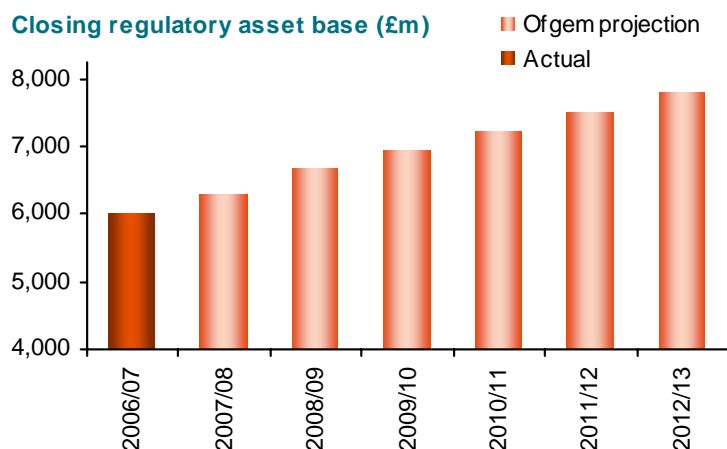
On the basis of these proposals, we are confident that we can provide a superior return for investors, while meeting our licence obligations, and delivering a sustainable gas distribution network for the future.

KEY DATA

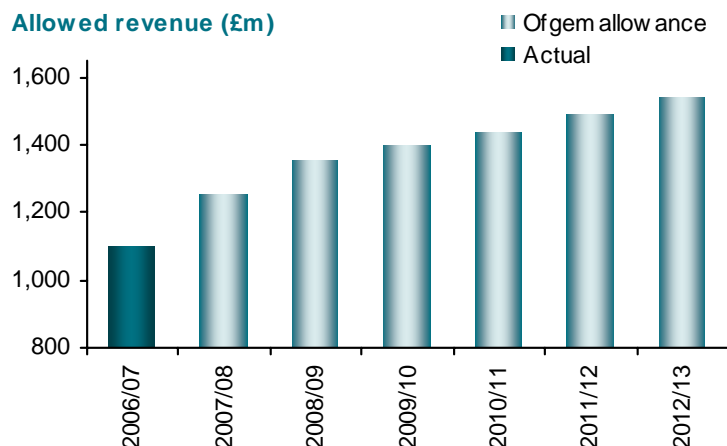
Ofgem's investment allowance (£m)



Closing regulatory asset base (£m)



Allowed revenue (£m)



THE REGULATORY FORMULA

The UK gas distribution price control proposals define the level of revenue that National Grid is allowed to recover from its customers.

The regulatory process derives this from an estimate of operating expenditure, capital expenditure, financing costs and corporation tax for the relevant period, in this case 2008/09 to 2012/13.

These inputs are used, together with the regulatory asset value i.e. the value ascribed by Ofgem to the capital employed in the regulated gas distribution business, to calculate the allowed revenue. The regulatory asset value is adjusted each year to reflect asset additions, depreciation and the rate of inflation.

The allowed revenue is then profiled across the price control period, determining the immediate change in revenues in the first year of the price control (or 'P0') and the path of revenues over the remaining year (or 'X'), with two key considerations being the financial profile of the businesses and the longer term trend in revenues.

THE PRICE CONTROL IN CONTEXT

In our 2006/07 results our Gas Distribution UK revenues contributed around 15% of National Grid's revenues, and around 20% of National Grid's operating profit. Ofgem's proposals will clearly result in significant growth in both the gas distribution regulatory asset base and revenues, as shown in the charts on the left.

This price control covers just 4 of National Grid's 20 main regulatory controls, and is one aspect of National Grid's growth prospects. Other factors expected to drive growth, that we have previously announced, include:

- Around £16bn of investment in our UK & US electricity and gas networks over the 6 years to March 2012, growing our UK regulatory asset base by over 35% and our US rate base by over 25%. Our plans are on track, by September 2007 we had invested £3.8bn.
- Implementation of our global operating model and driving savings in our regulated controllable cost base, which is around £2bn annually.

Further information on these and other drivers can be found in our results announcements or annual reports on our website: www.nationalgrid.com.

All figures, either quoted or in charts, are nominal unless otherwise stated.

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FURTHER INFORMATION:

Documents relating to the review can be found on the Ofgem website at www.ofgem.gov.uk

Final proposals:
<http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf>

Final proposals – supplementary appendices:
<http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/GDPCR%20final%20proposals%20appendix%20rev.pdf>

Analyst presentation:
<http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/031207%20GDPCR%202008-13%20FP%20analysts%20presentation.pdf>

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