

FINAL TRANSCRIPT

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NGG - 2009/2010 Half Year National Grid Earnings Conference Call

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PRESENTATION

David Rees - *National Grid plc - IR Director*

Morning everybody. Thank you very much indeed for coming this morning to our half year results. Just the usual admin announcement, phones off please, Blackberrys off if you can bear it for a few minutes, and I'll hand you over now to Steve Holliday, Chief Executive of National Grid. Thank you.



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Steve Holliday - National Grid plc - Chief Executive

Thanks David. Good morning everybody. Welcome to National Grid's first half year results for 2009/'10. Let me start by giving you a summary of our performance over the past six months then I'm going to hand over to Steve to run through the financial details. But firstly I'd like to remind you of our strategy, delivering growth in both the UK and the US by focusing on transmission and distribution businesses in both gas and electricity. Today here, in addition to Steve and I, we have Mark Fairbairn, Tom King and Nick Winsler, our executive directors.

With these results you'll see how our low risk strategy is enabling us to steer a strong path through a period of great uncertainty. Due to recessions both here in the UK and the US, we've seen dramatic reductions in energy demand over the past six months. We've seen electricity demand down some 4% in the US, over 6% in the UK. Whilst we've shipped more gas this half in the United States, our distribution businesses have shipped over 11% less gas in this first half of the year. However because our rates are decoupled here in the UK and progressively more so in the United States, I'm pleased to say that those reductions have had very limited impact on our financial results.

And I'm delighted that we've had a very strong first half. These results clearly differentiate our strategy. Our pre-tax profits are up 16% as we generated net operating cash flows of GBP1.6b, almost GBP750m higher than the same period last year. A 31% increase in earnings per share is flattered by a low first half tax rate, which Steve will return to later. And we're increasing our dividend in line with our target of 8%.

Operationally we've had a strong start to the year with another important step improvement in our safety performance. Our reliability performance is on track to meet all of our targets across both the UK and the US. But I have to say, the one area I'm still not happy with is customer satisfaction. We just simply aren't where we need to be, which is sustainably and consistently in the upper quartile in both sides of the Atlantic.

Back in May I set out our key areas of focus for this year, regulation, driving further OpEx savings, driving operational improvements into our business, and maintaining a rigorous discipline around all of our investments. So, how are we doing?

First, regulation, in the US we continue to make progress in agreeing the new rates plans in both Massachusetts and Rhode Island. In the UK we've continued to work with Ofgem on the new and very necessary regulatory frameworks, and I'm going to give you a detailed update on the regulation later.

Turning to efficiency, our regulated control of the costs are down, while at the same time we've commissioned an enormous amount of new assets, and you'll see the benefit of that as our performance on our efficiency metric will improve significantly from the 8.1% that we reported last year. Meanwhile we continue to deliver our KeySpan synergy savings at a run rate of \$140m as of September, on the planned trajectory for the \$200m a year promised at the time of the acquisition.

Our capital program is on budget, GBP1.5b at the half year. It's important to recognize with this substantial investment program, our financial position's improved. We've completed the GBP2.5b of funding for this year and we've already pre-funded GBP1.3b of next year's needs. The message here is our financial position remains strong. We manage our balance sheet to optimize our cost of capital. Moody's, Standard & Poor's and Fitch have all recently affirmed our credit ratings with a stable outlook and we're forecasting improvement in all of our credit metrics this year.

I'd like to hand you over to Steve who's going to take you through the financial details of the past six months performance. Steve.

Steve Lucas - National Grid plc - Finance Director

Thank you Steve, and good morning. We're presenting our results today on a business performance basis for continuing operations. This is before exceptional items, remeasurements and stranded cost recoveries.

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As you've heard from Steve these are great results, with operation profit, profit before tax and earnings per share all up, and an 8% increase in the dividend in line with our target. We're in a sound financial position. As Steve has just said, our funding program for this year is complete and we've made good progress pre-funding for next year. Operating cash flow is strong, nearly GBP750m higher than in the first half of last year. This, together with the exchange rate, has brought our net debt down and, as expected, we've maintained our credit ratings with stable outlook.

We are well positioned for a strong full year. Investment under our regulatory agreement continue to drive growth in all our businesses. RPI indexation is benefiting our UK revenues. Operating cash flow will be significantly higher and our effective interest rate will be substantially down.

Now let me take you through the results business by business, starting with Transmission. Transmission operating profit was GBP637m and was up 4% on a constant currency basis. This good performance was mainly driven by GBP45m increase in our regulated activities with RPI indexation benefiting the U.K. Other items were GBP19m down, mainly caused by French interconnector profit returning to normal levels.

Gas Distribution accounted for GBP253m of operating profit and was 8% down on a constant currency basis. This fall was mainly caused by negative timing items. In the UK net regulated revenue was up GBP23m mainly due to the link with RPI. In addition, re-phasing of U.K. revenues from the second half to the first half increased operating profit by GBP104m.

Now, as you know, our US gas business is highly seasonal, with around three-quarters of annual revenue collected in the second half of the year. In the first half our net regulated revenue was up GBP16m, mostly due to rate increases, but this was more than offset by GBP142m of negative timing effects. We expect most of the under-recovery from this period to reverse in the second half. However, as we benefited from an over-recovery and other positive timing items last year, we will see a year-on-year negative timing impact at the full year. All other times were a net GBP24m down compared to the prior period, mainly reflecting an increase in bad debt, and I'll come back to those in just a moment.

Electricity Distribution and Generation delivered GBP169m of operating profit and was up 6% on a constant currency basis. Net revenue increased by GBP29m. This was despite a GBP20m headwind from lower delivery volumes, which were 6.6% down caused by a weakness in the industrial sector, cooler summer weather, together with the impacts of energy efficiency measures. As you know, we're in the process of filing to decouple revenues from volumes in these businesses and Steve will come back to this in a moment.

Timing items hit operating profit by GBP64m and we expect to recover most of these by the end of the year. Other items were up GBP44m, reflecting improvements in service quality, together with a couple of prior period on-off costs, mainly non-cash, which I told you about last May. For the full year we expect to see performance improve significantly in this business compared to 2008/'09.

Our non-regulated and other activities were up 6% on a constant currency basis. Grain LNG profit was up GBP16m following the commissioning of the second phase. Improvements in metering performance, predominantly due to higher unit revenue, and OpEx efficiencies also added a further GBP10m to operating profit. In January this year we took the decision to defer property sales in order to preserve value. We still believe that this is the appropriate course of action and we therefore expect property performance to be relatively flat at the full year. However, in this half lower property disposals accounted for a GBP14m decrease in operating profit compared to this time last year.

Overall that brings total half year operating profit for the Group to over GBP1.1b.

Now I said I'd come back to bad debt, which is an issue affecting our US Distribution operations. Disappointingly bad debt write offs as a percentage of billed revenue increased to 1.87% as at September 30, 2009 compared to 1.51% in March. However this is broadly in line with our North-East US peer group. As you know our exposure is limited through our substantial and improving bad debt rate plan allowances and we continue to work with customers in these difficult times to help them pay their bills.



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The increase in write-offs was caused by higher customer account balances following cold weather and the spike in commodity prices last winter, together with the impact of the recession. But the increase in write-offs was provided for last year. Accounts receivable were also down and so the overall impact of bad debts on our half year P&L is minimal and is expected to be flat at the full year.

We're on track for a step improvement in efficiency this year. In the first half this has been predominantly driven by service quality improvements in Electricity Distribution and Generation, together with back office efficiency savings in the UK, plus KeySpan synergy savings continuing to come through in the US. Going forward we will continue to see cost pressures associated with our growing asset base. However, as Steve has already mentioned we will continue to drive better productivity and expect to see our efficiency metric improve this year to well below 8%.

Net financing costs were GBP504m down GBP20m on the prior period. Lower interest rates favored us by GBP109m. RPI deflation on our index-linked bonds, mainly a non-cash item, benefited us by GBP149m. These were partially offset by higher net pension interest, also a non-cash item, of GBP100m, and other items including the financing of our investment program and exchange rate effects which amounted to GBP138m.

We expect to see our effective tax rate for the full year to be around 29%, similar to last year. However our effective tax rate of the first half of the year was just over 14%. This very low rate reflects a net credit of GBP67m and the first half mix of UK/US results.

Despite weakening since the last year end the dollar remains relatively strong compared to the prior period. For the first half of the year the average exchange rate has been \$1.55 to the pound, compared to \$1.92 in the prior period. Whilst this has increased our operating profit by GBP53m, our dollar denominated debt hedge means what total earnings were reduced by GBP7m.

As Steve headlined earlier, EPS was 22.5p. This is up 31% on the prior year and is driven by the factors I've already covered and let me go through them. Increased operating profit, lower financing costs, as well as a lower half year tax rate. The half year dividend per share is 13.65p, up 8%, in line with our policy to increase dividends by this amount each year to March 2012.

Operating cash flow for the half year was over GBP1.6b, up GBP747m on the prior period. The main factors behind this were higher operating profit, working capital improvements and lower pensions payments. On this last point and, as you would expect, our pension deficit has grown on an accounting basis because of lower discount rates driving up the liability. As you'll recall back in May, I went through the strengths of our regulatory arrangement for pensions and you'll find further details on these in the appendix, and Steve will also touch on this again in a moment.

Opening net debt was GBP22.7b. As you can see the two main items were operating cash flow, which I've covered, and CapEx. Cash CapEx was GBP1.5b at the half year. Our plans remain on track and we expect to invest GBP3.4b across our business this year. Closing net debt for the half year at GBP22b was GBP0.7b lower than on April 1, 2009, reflecting strong cash flows and the weakening of the US dollar since then.

We are in a sound financial position. Our funding program for this year, as I said, is complete and we've also successfully pre-funded approaching half of next year's program at GBP1.3b. As we expected we've maintained our credit ratings and these have been confirmed by Moody's, Standard & Poor's and Fitch on a stable outlook. We expect our credit metrics to strengthen significantly during 2009/'10.

With 16 rated entities and five debt shelves, funding opportunities continue to exist across the whole of our business. For the first time in a decade we've been active issuing debt from our US operating company and we've achieved some very attractive rates on over \$2b of bonds. For instance, last week we issued a 30-year \$800m bond for Massachusetts Electric, with a coupon of just 5.9%. In addition to this, in recent months we've issued two dollar bonds from Niagara Mohawk. The 10-year bond was the lowest dollar coupon achieved by a utility since mid 2005, whilst the five-year bond was the lowest since May 2003.



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We've largely locked in our floating interest costs for 2009/'10 and for 2010/'11. Finally we've benefited from RPI deflation on our index-linked bonds and all this means our effective interest rate for the full year is set to fall below 5%.

So in summary, a very strong set of half year results, with EPS up 31% and our dividend up 8%. We are in a sound financial position. We will continue to benefit from low interest rates and our operating cash flows are expected to be significantly ahead of last year. Finally we're trading in line with our expectations and our outlook for the full year is positive.

I'll hand you now back to Steve.

Steve Holliday - *National Grid plc - Chief Executive*

Thanks Steve. Now I'd like to talk about three things this morning, regulatory progress both here in the UK and in the US, the overall growth potential of the utilities sector and our disciplined approach to capital investment. But before I give you an update on our US regulatory filings, it's worth taking a quick look at the context behind we have so many of them over the next few years, and we're not alone. The number of rate cases being filed across the United States is at an all-time high, with 22 new cases in the last quarter. Many of our peers are requiring the same changes as we do.

For National Grid, we're at the end of a number of fixed 10-year arrangements. We consciously and very publicly ramped up our CapEx program and what I want to do is just take you back how it's evolved over this period of time because very of our regulated entities had adequate performance for a long time of that 10-year period. They earned returns of 11% average from 2000 through to 2006. During this six year period volumes were growing, hence increasing revenues. Our cost efficiency programs were also enhancing returns. However, already CapEx was higher than had been assumed in the rate plans and was eroding those returns. But net-net through this period things were satisfactory, we were earning adequate returns.

In the latter part of the 10-year period things changed substantially. Volumes, firstly, leveled out and they subsequently declined, reducing revenues. We consciously were still ramping up our capital expenditures on essential work, essential to make sure these networks were delivering a safe and reliable service. As the recession set in our customers had trouble paying their bills and bad debts have increased. And finally, over recent years there's been a significant step up in the cost of pensions and the post-retirement healthcare, further hitting returns. The combination of all of those factors have deteriorated returns to what is a very clearly unacceptable position, an average of 8%.

So it should come as no surprise that as soon as we were able, as soon as the rate plans expired we filed new plans. But over the recent years, as we have prepared for this opportunity to file we've developed a real depth of understanding about the levers that are required to ensure that we can earn long term acceptable returns in the United States. These new filings aim to get the recovery of the costs that we need to run the business. They incorporate the invested capital so it becomes part of the rate base and earns a return. And you'll find that the new plans are much shorter in duration, reducing future uncertainty.

But, having established a base of adequate returns above our cost of capital, we need structural change. Changes in the framework to make sure that the performance does not erode again. First, decoupling, we've got to eliminate this connection between volumes and our revenues. Removing that link will encourage energy efficiency. It's an essential objective in all of the states in which we operate.

Next, the need for capital. Capital investments are required to grow, as we replace ageing assets and rebuild the systems that are required for the future. And with the inherent lag in the US regulatory framework we have to make sure we get timely recovery of those investments through trackers for CapEx. And it's important to have annual true-up mechanisms for the commodity portion of bad debts and for the healthcare and pension costs. And these are becoming widely accepted practices because they remove step changes in the bills that otherwise customers will see.



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For National Grid this is about building a long, sustainable regulatory framework in the United States, and we have been very busy since May. For Long Island generation, 4% of our US business, we've agreed appropriate recoveries of costs, we've agreed the debt/equity levels, we've agreed an ROE with the Long Island Power Authority. That settlement has now been filed with FERC and we expect the Commission approval some time in December.

As planned we've filed the electricity rate case in Massachusetts, 10% of our US business, on May 15. And for the 4% of our US business on Rhode Island, we filed that electricity on June 1.

In the Massachusetts rate case we're seeking to increase revenues by \$111m per year. Following a process of public hearings, giving evidence to the regulator, answering over 1,500 information requests, we're not expecting to receive an order by the end of November. Providing a satisfactory outcome, the new rates will then become effective on January 1 next year.

On Rhode Island, where we're seeking an annual increase of \$73m, there's been a similar process. The Commission's decision is expected mid-February. Again, providing a satisfactory outcome, the new rates will then become effective on March 1 next year.

In other filings we've now got approval to build the first 5 megawatts, of a total of 50 megawatts of solar generation in the regulated rate base in Massachusetts. If we decide to go ahead with that investment it will earn the same return as that that is awarded in the pending distribution rate case.

We were disappointed that we didn't receive any funding from the Department of Energy for our Smart Grid pilots. However, we have regulatory support to continue to pursue pilots in both New York and Massachusetts. In this past period both of those states have approved our enlarged energy efficiency programs. These are helping to meet the state climate objectives and they provide us, National Grid, with an opportunity to earn enhanced incentives.

Turning to next year, our main focus in the second half of this year and through into 2010 is on the filing of Niagara Mohawk's electricity case, which is 23% of our US business. We'll file that early in the New Year. This case, like the others, will seek an adequate ROE, full recovery of our costs, revenue decoupling, capital trackers and the annual true-ups for bad debts and pension costs.

And we've now finalized our plans for the Massachusetts gas rates cases that we'll file later in 2010. And that represents the final 16% of our US portfolio.

Our small New Hampshire gas business, on which we were previously able to agree all structural changes, but not the return on equity, last week the Commission denied our motion for a reconsideration of the inadequate 9.54% ROE. So it's worth me reiterating the remarks I made in May, because it's for both our customers and our shareholders, it's essential that we're able to deliver the right outcomes in these cases and earn long term sustainable returns. We're now going to consider all the options associated with that small piece of our US business.

Let me return to the UK, where for many years appropriate investments have successfully been designed into the regulatory frameworks. We continue to work very closely with Ofgem on a number of important and both organizations have key roles to play in the delivery of future energy policy. A really good example of that is around transmission access reform, where we've jointly developed a temporary regime which allowed us to offer to advance the connection dates for some 1,500 megawatts of renewable generation.

We also continue to work with Ofgem on reforming the regulatory frameworks to make them fit the challenges ahead. RPI minus X at 20, enhanced incentives for investment, and of course preparing for the fifth transmission price control. Evolutionary reform is vital. We're making progress but things are moving too slowly. To meet security of supply and environmental targets in 2020 we've got to have brave and timely decisions on these new frameworks. They've got to be frameworks that encourage and incentivise these essential investments.



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Ofgem have also been working on pension allowances as part of the UK's electricity distribution review. Their third consultation on this subject reaffirms their commitment to fund deficits provided they are managed efficiently. And future pension costs will be benchmarked as part of overall remuneration packages. It's a sensible approach.

As Steve's already told you, our capital program is right in line with our plans. Back in May I showed you this slide. Let me remind you about our disciplined approach. It has made sure that 99% of this year's investments have locked in returns. 75% of these projects generate cash in this financial year. Only 1% of that investment is currently unremunerated. It's this discipline that's essential for the success of the business, both today and with all future investments.

In November 2006 when I set our strategy to clearly focus on the UK/US on electricity and gas and on transmission and distribution, it was the right thing to do in 2006. 2009, an enormous amount has changed. At that time there was an anticipated \$10 trillion of essential investment required by utilities across the globe over the coming 15 years. 60% of that \$10 trillion was in our focus area of electricity and gas networks, and it was primarily addressing ageing networks and ensuring that adequate capacity was available. If I can remind you, 20% of that investment, the largest portion, was in the United States.

Since then there have been major policy developments to address climate change concerns, security and diversity of supply concerns, and an increasing realization around the risk of ageing assets. The UK's commitment to carbon targets and energy security is clear. Both the government and the opposition have signaled a desire to ensure the delivery of the required infrastructure to meet these targets.

In the US major federal climate change and energy policy is emerging. However, most of the tangible progress is and will continue to be driven at the state level. Last year, Massachusetts passed the Green Communities Act enabling the trebling of expenses on energy efficiency and mandating decoupling. In August this year, New York passed a very aggressive energy plan. There are clear moves to open the doors for new investments.

More recently the announcements here in the UK, the government's announcements around the National Policy Statements, Ofgem's indication of an additional GBP1b of likely transmission investment in the near term, and clear signals in the US that Smart Grids and transmission investments are on the radar. Clarity is beginning to emerge, although I think it's still early days.

In 2009 we have a clearer view of the overall potential opportunities for our business. We now estimate the potential investment in gas and electricity networks here in the UK between now and 2020 is some GBP70b. And across the entire United States the investment requirement in electricity alone is \$1 trillion, between now and 2030.

So it will come as no surprise in 2009 our focused strategy remains as appropriate as it was back in 2006. Not only does investment need to be made to replace ageing assets, but we need to make sure that we can meet ambitious government energy policies. And so we will continue to focus on growth, here in the UK and in the US on transmission and distribution on gas and electricity. Let me be very, very clear, we will only invest when projects pass our rigorous criteria of delivering attractive, predictable, sustainable cash flows and hence returns to investors.

And let's focus on in the next six months. We'll keep tight control on our operating costs, tight control around our capital expenditures. Operationally we're determined to drive the improvements we want in customer satisfaction. We look forward to agreeing and implementing the new US rate plans, and continuing to work with Ofgem to shape the right future regulatory frameworks here in the UK. You can expect a strong year.

And with that, Steve, the rest of the team and I would be delighted to take your questions. Thank you.



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QUESTIONS AND ANSWERS

Steve Holliday - *National Grid plc - Chief Executive*

John. There's a microphone coming.

John Musk - *Nomura - Analyst*

Hi there, good morning. It's John Musk at Nomura. Can I ask a couple of numbers questions first? And starting on the Gas Distribution business, can you just give a bit more detail on the over and under recovery in the UK and US in the first half? Just so we can understand what we should be doing with those movements.

Steve Holliday - *National Grid plc - Chief Executive*

Sure. Let me take the first bit and Mark might like to comment. There are lots of movements going on here as Steve alluded to, but the two big ones is, the move that was agreed in the price control that the revenues in the UK would no longer be linked to volumes and would be smoothed across the year from a business that used to be very seasonal.

And the big shift this year, shifted therefore GBP100m essentially of earnings that would be in the second half into the first half. And the business is exactly the same. It's just smoothed across the whole year now. But that step change has been then counteracted by a significant under-recovery in the United States from a whole number of factors which means net-net, the timing impact is actually a negative.

Mark, would you like to pick up some of the bits and pieces in the US?

Mark Fairbairn - *National Grid plc - Executive Director*

Yes, morning John. So, as Steve said, in the US we are substantially under-recovered on the first half to the tune of about GBP132m. There are, again as Steve said, many things going through those overs and unders. There's about 40 different categories of cost going through. I'll just give you an example of two so that you can put things in context.

One of the things going through here is that we are required to partially hedge the commodity cost for our consumers so that they're not exposed to the full volatility of the daily commodities market. Obviously with US gas prices now being at a very low price, those hedges are below water. We're allowed to recover the cost of putting that hedging program in place. But in the first half of the year they're below water. We'll then recover that shortfall in the second half and so you'll see that'll contribute to that timing difference first half to second half.

Now another example relates to New York State, where New York State asked us to increase effectively a tax that we collect on their behalf through consumers' bills. They required us to effectively pay the tax to them before we're able to recover it from customers. So we've got a gap on timing. That's again going through this first half under-recovery. On that example I don't actually expect to recover all of it in the second half so there will still be an exposure.

So two examples. Again, as Steve said, net-net, we do expect to substantially recover the majority of the GBP132m by year end. But, if you remember, we were about GBP50m over-recovered last year end in the US because of the cold winter and therefore the high volume. I would -- you could probably use that, some over-recovery in the second -- in the full year last year as a sort of proxy I guess for the shortfall we would expect to see in the full year in the US going forward.



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Steve Holliday - National Grid plc - Chief Executive

Thanks Mark.

John Musk - Nomura - Analyst

Sorry, I just had one further question separately on net debt, which was just how should we see that moving towards the end of the year from the GBP22b where we are now?

Steve Holliday - National Grid plc - Chief Executive

We expect it to be pretty -- it's, of course it's subject to exchange rate movements in particular, but if exchange rates stay pretty much where they are today then we'll close the year pretty much where we are at the half year.

Steve Holliday - National Grid plc - Chief Executive

Peter?

Peter Atherton - Citigroup - Analyst

Morning. It's Peter Atherton from Citigroup. A couple of questions please. Just on the slide where you show the recovery of the CapEx, there's GBP0.6b there which you say will be recovered over the next few years. How much of that would be eliminated by the rate filings in the US or are we going to see that as a recurring number in your accounts?

Steve Holliday - National Grid plc - Chief Executive

No, the whole intention of these filings, Peter, is to get a tracker. So the largest delay we would see is a 12-month delay. But some of the structures -- in the 10-year plan you've got a 10-year delay potentially from year one to the end of the plan. And we want to get that down to at worst we have a one-year lag on when that gets into rate base and earns a return. That's what the tracker's intended to do.

Peter Atherton - Citigroup - Analyst

Sorry, just to be precise on that, so if you get everything you've asked for and all the rate cases, this time next year that GBP0.6b will have disappeared?

Steve Holliday - National Grid plc - Chief Executive

It will go down to -- we'll be earning return on that in the second year of investment, [the bond] the first year. That's absolutely right.

Peter Atherton - Citigroup - Analyst

Great, thanks. And the second question's on the interest rate. I think you said in the statement that you're now locked in the low interest rates for next year. Can you just take us through how you've done that and what will happen if, say, during 2010 we see a substantial bounce back in inflation bond yields and things, what would be the outlook then for 2011?

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Steve Lucas - National Grid plc - Finance Director

Yes. We've got about half our portfolio in long-term fixed. And you've seen examples of that, for instance, in the issuance we've done so far this year. And we've pretty much left that issuance as long term fixed. About another 30% floats and 20% is index-linked. We're not going to hedge the index-linked away because we've got this situation of the nice offset with index-linked revenues in the UK and there's a hedge there. So that's something we want to keep structurally in place.

What we've done with the floating rate portion, Peter, is we have taken out short-term hedges to lock that in to all of this year and all of next year. Clearly there are two components that will move. One is whatever interest rates we get on debt we issue. That will be whatever it will be, if you like. And then the outcome in terms of the P&L impact of movements in RPI affecting the value of index-linked debt. And it's probably worth taking a moment here because we didn't actually expect to ever have to do these calculations.

All but one element, one bond in our index-linked portfolio can both go down as well as up. And that means that when you get deflation, what we owe at the end of the period is less than what you owed at the beginning of that period. And we take that difference through P&L. That difference in the first half alone was GBP150m. So it's clearly the biggest driver behind the drop in our effective interest rates.

If you can tell me what RPI is going to be at the end of March, then I could tell you what that component will be for the second half. Our best guess is that the second half will be, if you like, neutral so we'll still carry through the benefit we saw from the first half. But that's a volatility component that acts as a long-term hedge against the UK index-linked revenue.

Peter Atherton - Citigroup - Analyst

Okay. Thank you.

Mark Freshney - Credit Suisse - Analyst

Thanks. Mark Freshney from Credit Suisse. I just have two questions. Firstly on New Hampshire gas. You're talking about considering all options because clearly the ROE was disappointing. Would that not -- if you were to, for example, sell the business, would that send like a negative impression to the bigger New York and Massachusetts regulators?

And just secondly on the ROEs you're receiving in the US, given your conversations with regulators, do you think there's a risk that if trackers and real-time true-ups are put in place that they might use that as an excuse to lower ROEs? Just interested in your thoughts.

Steve Holliday - National Grid plc - Chief Executive

Yes. It's a good question. Let me do the first one and then I'll start on the second, and Tom can comment as he's in the hot seat with these discussions.

The ROE New Hampshire at 9.54 is inadequate. That is not an adequate ROE for us to continue to run that business in the interest of customers and invest for the future in the interest of both customers and shareholders. We appealed it and they've rejected that appeal. We need to think about whether it is ever going to change, Mark, quite frankly. If that is what they want in New Hampshire, then I'm not sure that's a business that suits National Grid and the standards that we set on safety, reliability and effectiveness of running these businesses and the need to invest for the future.

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If we dispose of it, then the business will be worth what it is worth. But it's a very important issue, I think, that people understand it isn't about getting the terms just for investors here, it's also making sure these networks are adequately invested for the future. So we will go through an analysis in the next few months about what the right option for us and customers in New Hampshire is. And on the broader issue, that's one of the reasons I wanted to show you that chart, to actually address this question.

The reality of volumes in the US, as you can see from National Grid, it would be an extrapolated picture across the whole of the United States, volumes were growing quite rapidly during the last 10-year period, the first half of that. And that meant that extra revenues were coming in and were supporting these businesses actually. So decoupling actually doesn't reduce the risk of these businesses, it actually says you've lost that underpin any more. The only way you can have the return that lowers the double-digit return is to put in a decoupling mechanism. So it's crucial to the business it gets it.

And of course the broader context of this, as you've seen in the Energy Act where Massachusetts is, people want to invest in energy efficiency, we do on behalf of our customers as well, you've got to decouple to unlock what otherwise would obviously be a major barrier to energy efficiency on behalf of the utilities.

The broader issues aren't about enhancing the return either. I purposely talked about protecting the return. These are the right returns. And without those protection mechanisms what will inevitably happen without the absence of a 10-year fixed plan, which is not what we are entering into now, it will just be re-filing, re-filing, re-filing. So if we want some stability on behalf of everybody, the regulators as well, to not be filing continuously then some of these trackers are important.

Tom, I'm sure you can add some comments in terms of your discussions more recently on those very issues.

Tom King - National Grid plc - Executive Director

Yes. I think the thing that I will focus on is the ideology and philosophies between the commissions to address does this lead-over into other commissions? And I would say no. When you step back and look at the philosophy of New Hampshire, they have an antiquated approach to determining the ROE. They use one model. And they're unique in that. When you look at the other states that we're operating in, they use two to three other models. We bring an expert witness from the outside in that talks about the investor expectation, trends in the US market and industry standard returns.

We provided all of that data to New Hampshire. And New Hampshire still came back and said we have a view, we have a philosophy, our returns are low, or we expect low returns to we're going to continue to set low returns. So that leads to Steve's point is we have to consider our options and whether New Hampshire's a state we should be continuing to do business in.

The other states are aggressive on their energy policies. They want to attract capital. They want investment and they want to create the future networks. We're not seeing that from New Hampshire. So I don't think you can look at New Hampshire's decision and extract that to the other states. The other states are moving in a different direction.

Mark Freshney - Credit Suisse - Analyst

Thank you.

Steve Holliday - National Grid plc - Chief Executive

Bobby?



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Bobby Chada - Morgan Stanley - Analyst

Thanks. It's Bobby Chada from Morgan Stanley. Two questions. First of all, if I could follow up with Tom, in New York specifically, I wonder if you could talk a bit about how the relationship with the regulators has evolved over the last couple of years, given it's the most -- the biggest jurisdiction and the most important rate case.

And secondly, just thinking about the US business, what do you think a reasonable expectation is for medium-term growth in the rate base?

Steve Holliday - National Grid plc - Chief Executive

Okay. As Tom is standing up to answer that question that's addressed to him, I'll be slightly cheeky, if I may. That's why we hired Tom, for exactly those reasons. We did not have the relationships that we need for the long-term sustainable, attractive returns in these businesses in the US. That's why Tom joined us, and why Tom has strengthened the regulatory team with Lisa Crutchfield as well and others. We had to move that forward, and it has moved forward. But you can answer it in great detail, Tom.

Tom King - National Grid plc - Executive Director

I'll avoid great detail because I know we probably have lots of questions that want to be asked. There's no question that you see a marked difference in the relationship. That's by face-to-face sitting down, trying to understand what New York's key priorities are, where do they want to place the energy policy and how can we partner with them to ensure energy policy advances. We have a unique role, as one of the largest utilities, to be very cognizant of bill impacts but, at the same time, help advance investment, sensitive to bill impacts but advance New York on the national scene from an energy standpoint.

If you follow New York, New York has fallen behind from a leadership standpoint. You have the leadership both within the Governor's office, the energy office, as well as the Commission that wants to fundamentally change that. And so we approach the relationship with how can we help partner and help you achieve that success. So that's where the relationship is, and clearly balancing the bill impact, sensitivity to customers and at the same time advance policy. And I feel good about that. I think we've really been able to establish that as National Grid, as a company as a whole, both in the gas and the electric business.

From the sustainable growth side of things, I think that was your question, even before you talk about the future and the future of networks, Smart Grid, etc., you have aged infrastructure. So if you go back to the slide that Steve had on the significant amount of investment within the US, that has to happen or we run the risk of failure. And we're in a commission that doesn't want to see failure. They're very focused on reliability. And they're going to continue to support us to make those investments. So that's one sustainable aspect of it.

The next opportunity is to define Smart Grid, to find renewables, transmission to reach those renewables and New York has very aggressive policies around that. So there is significant growth opportunity to invest in the New York infrastructure both on gas and electric, but renewables will happen within New York and they will support that. And all of it will be balanced on the timeframe, the amount of investment and the bill impact. So we'll work together to find the right balance within that. But I think you'll not only see the sustainable aspect of it, you'll see quite a bit of growth in the investment.

Steve Holliday - National Grid plc - Chief Executive

But the first, if I can add, the first thing is to get the base business delivering adequate returns. That's why the focus is where it is right now.

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Ajay Patel - UBS - Analyst

Ajay Patel from UBS. My question's around cost cutting and the shorter rate plans. Ultimately we had this target of 14% reduction in controllable costs. And I'm just trying to understand how that cost-cutting target and the relationship with the regulator -- with the commissions work in the sense of is a large proportion of that cost cutting sitting at the operating level or is some at the Group level? So how sustainable -- how long can you keep these cost-saving benefits for, any color you can give me?

Steve Holliday - National Grid plc - Chief Executive

I think that's a key question. How long do investors see the benefit of those cost cuts? And the answer is in the US, not long actually. Not long at all, because 14% is across the whole of National Grid, don't forget, so the whole of the UK, US, all the lines of business. So it depends on the rate plan, the arrangements about how long you retain those benefits. But I take you back to my slide. Cost cutting in the US did contribute to enhancing ROEs for a period, for a period. Not hugely, 20, 30 basis points, but it did. Shorter rate plans, you don't have that benefit.

Frankly, that's not what I, Tom, Nick and Mark are worried about right now. We need to earn the basic acceptable returns. And can we get enhancements on top of there? Yes, because there are many incentive arrangements. I talked about energy efficiency effects coming into play. And there's a little bit of cost advantage in there as well. But it is not a huge enhancement of returns going forward. It's not. The focus is about though running these businesses efficiency on behalf of customers, as well.

And Tom's point about therefore it is the natural impacts on bills have got to take place. To get the costs into the business in the first place and the capital provided for, customers' bills are going to need to go up. So everything we're doing on efficiency will help customers in the long run. Marginal enhancements in returns in the short term, yes, but not a huge prize.

Ajay Patel - UBS - Analyst

Thank you.

Andrew Mead - Goldman Sachs - Analyst

It's Andrew Mead at Goldman Sachs. I just had two questions on the US rate cases. Just trying to understand, and not saying we're going to go this way, but in terms of the appeal process, your appeal, is it on one individual item or is it the whole package you have to go for? Did you have the structural stuff you wanted, but you didn't like the rate of return?

Steve Holliday - National Grid plc - Chief Executive

Sure. And that's one of the advantage of US. You don't open up -- the UK it's the whole case. In the US we can talk about individual items. We can file for an individual item. We can file for CapEx changes, leaving everything else the same. You don't have to open up the whole case.

Andrew Mead - Goldman Sachs - Analyst

But can then the Commission come back and say -- and barter with something else instead, in terms of like rate of return and things?

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Steve Holliday - National Grid plc - Chief Executive

No. We have a hearing on a particular issue. So the issue in New Hampshire was we asked them to reconsider the return on equity in isolation. And that's the process that went through. It's just the reconsideration of that one element.

Andrew Mead - Goldman Sachs - Analyst

And just one other question, just maybe on your slides on the US rate cases, is it -- can you take it that the 10% ROE you're showing there, is that the minimum that you'd ever find acceptable?

Steve Holliday - National Grid plc - Chief Executive

I think we've, Tom, I and the whole team have been very explicit that double-digit returns are necessary in this business to be able to run these businesses appropriately for both customers and shareholders in the future. And that's not changed.

Tom King - National Grid plc - Executive Director

Steve, just one quick thing to add to the question, both on several of our gas cases, on Massachusetts and their gains at their one-year rate cases, and the intent is to -- knowing that it may take us one or two cases to get the performance where we need it to be, that will be back in for the following year, moving forward on the next rate case. So the objective is that we're not locking in to either cost or returns within a long time period. We're going to reset the base and ensure that we've got a sustainable framework that takes us forward.

Steve Holliday - National Grid plc - Chief Executive

Back there with Ed.

Ed Reid - Cazenove - Analyst

Hi. Ed Reid from Cazenove or maybe JP Morgan now. But two questions. Firstly on offshore wind, I believe you have tendered to be part of the offshore transmission build-out. And I was just wondering how much that would be in terms of capital. And obviously it's competitive so you can't give me what kind of returns you are looking for, but just sort of how it would compare with their regulated returns.

And then secondly on UK transmission, I guess going forward the CapEx program is likely to increase in UK transmission. I just wondered if you could give us some idea of sort of magnitude.

I actually had a third question but I'll wait for you to answer the first two.

Steve Holliday - National Grid plc - Chief Executive

That's very kind of you, Ed. I think I can only remember two parts. Nick can come in here. Obviously it's -- I'm amused, as you say, National Grid has qualified for the auction for offshore transmission. So we managed to get over that bar. As there are a number of, I think nine now is the number who've qualified for that. And that first phase is the transitional assets which is about just over GBP1b worth of assets. But if you look at the long-term offshore transmission and look at the figures that others publish in terms of the total amount of capital, it's potentially anything between GBP12b and GBP15b over the long term.

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Nick, why don't you update Ed in terms of both the auction process on the first thing and then talk more broadly about transmissions?

Nick Winser - *National Grid plc - Executive Director*

Yes. Ofgem have confirmed it's about GBP1b in the round two offshore auction. That plays out now through to May. You're right that we can't speculate as to what sort of returns people will look for in that process. I think clearly it's not the same, if you like, regulatory contract as those onshore. It is different in a number of respects. And I guess all of the bidders, including us, will be looking very carefully at that and thinking about what that means in terms of the hurdle rates for that investment. So we will be taking part and we'll see that play out through to May.

In terms of the longer term in transmission, there clearly is a lot of investment out there. In particular the work we've taken through ENSG, this multilateral meeting that we've got, including DECC and Ofgem and various industry players. That's been a useful process. We've seen quite a significant change here where we're, as well as relying on very clear user commitment being signaled by generators, other providers, we're also seeing an overlay now of, because it makes sense to make some strategic investments and some of those are quite large.

None of the regulatory frameworks for that are settled at the moment. Ofgem's recently talked about another GBP1b of, if you like, it's drip by drip funding at the moment as they see how that fits in with RPI minus X at 20, changes to the philosophy if there are some to come.

As far as we're concerned, we want to play our part in taking forward significant new investments to connect up wind, to connect up the [nukes] in particular, and ultimately through connecting up to CCS probably, cold CCS. So we want to play our part, but it will be absolutely critically determined by whether we get the right regulatory frameworks. And we're in very significant debates with Ofgem all the time really on what that would need. And you can see that playing out.

So this is a time of looking forward and thinking yes, there is quite an exciting set of investments to make, but to be cautious about it's got to really make sense for our investors for us to go ahead with those investments. And the extent that we get those appropriate regulatory frameworks will be important to us taking those forward in a timely way.

Steve Holliday - *National Grid plc - Chief Executive*

Thanks, Nick.

Ed Reid - *Cazenove - Analyst*

And my third question was actually around that. It's kind of a soft question, but it seems like you have a huge range of opportunity. And when you look at how you choose to invest in those opportunities, I'm trying to think, do you look at it and say there is a fixed amount of capital that we would want to invest and you rank the opportunities? Or would you say that it has to beat a hurdle rate and you'll find the capital for those opportunities if they're attractive enough? Does that make sense?

Steve Holliday - *National Grid plc - Chief Executive*

Yes, it does make sense. And I'll go back to what I was saying actually, we're very rigorous around this, very disciplined around this. We will be selective. So there is, quite rightly as you say, an enormous array of opportunities here, not all of which will be appropriate for National Grid and its investors to take part in. But we will look very much at hurdle rates and look at what's the maximum capacity that we believe is appropriate for our business, both financially and humanly actually, how much commitment can you take on? And those decisions will be made with a great deal of rigor.

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And that will include thinking through, so how do we finance these investments in the future. And we're not there yet. But as Nick's alluded to, as I've said, things are beginning to emerge, aren't they? But I think it's still too early. We don't have enough solid information on all of these investments and all of the likely returns. As they come forward we'll start to apply our rigor and then we'll decide selectively which ones are right for National Grid.

Jose Javier Ruiz Fernandez - *Exane BNP Paribas - Analyst*

Jose Javier Ruiz from Exane BNP. Just two questions. The first one is if you could share with us a little bit of flavor about Massachusetts Electric so the market will get a little bit about New Hampshire, which is the next decision.

And secondly, following up on this EUR1b in offshore renewables, the fact that it's in 80% of the investment in Scotland and it looks like a natural extension of the Scottish network, what is your advantage, your competitive advantage in these two auctions? Thank you.

Steve Holliday - *National Grid plc - Chief Executive*

In Massachusetts, we're waiting now. Don't have long to wait, just November 30. So I can't speculate what's going to come out, but we will have a decision on November 30. As I alluded to, without running you through all of the details of, it is a very thorough process. It really is. We've been through a thorough process. They have all the information, have all of our closing statements, if you will, and we're waiting for that decision. Rhode Island, as I indicated, is slightly behind. Actually that's going to be a decision in February probably next year, so early in the new year. We're going to put those rates into play in March.

In terms of the offshore, not quite right, there is quite a bit in the south as well actually, when you look at the overall assets in this first phase. Don't forget, we are the system operator already for the offshore, the whole offshore review, England, Wales and Scotland. And the way these interconnect as they are at the moment, and one of the technical issues is about just how much they need to become interconnected and how much they become integrated into the system actually.

But we have no problem at all with owning assets that come and tie into Scotland, not in any sense or form. So we're not necessarily going to constrain our bidding process to geography. It'll be many other issues that will cause the recommendation to come forward, as Nick was alluding to, which one of these might make sense for National Grid.

Peter?

Peter Atherton - *Citigroup - Analyst*

Peter Atherton from Citigroup again. Just back to this CapEx point, whilst obviously there is some discretion in future plans, there is a core CapEx requirement which is likely to be higher going forward than it has been at the moment. So roughly you're spending GBP3.5b a year in your current plan. Where do you think that core is likely to be post 2012? Are we talking GBP4b, GBP5b, GBP6b and then discretionary on top of that?

Steve Holliday - *National Grid plc - Chief Executive*

This great desire to speculate on the longer-term future. It's very clear what we have locked in today. We have locked in, through our regulatory arrangements here and in the US, the GBP3b to GBP3.5b number through until 2012. To be very clear, our balance sheet's handling that. Strong metrics expected at the end of this year and the stable outlook that we had from the rating agencies.

Beyond 2012, going through a whole set of new regulatory discussions, but the answer to that question will come through those discussions, won't they? But you know as well as I do, many speculators outside of our Company, as well as the way that

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we look at it, what are the requirements that are likely to be on the replacement of aging assets, the need to reinforce the system for the new nuclear stations, the need to reinforce the system for offshore transmission as well. It's very likely that we're going to see post 2012 an arrangement that will mean that we will be investing more than we are today. That's all got to go through a series of regulatory negotiations and discussions to allow that to happen.

Peter Atherton - Citigroup - Analyst

Thanks. And can I ask the EDF question because nobody asked it as well? What are your intentions regarding the EDF Distribution Networks?

Steve Holliday - National Grid plc - Chief Executive

Well if there's a process run for the EDF wires business, they are a distribution electricity business in the United Kingdom. So if I go back to our strategy, they clearly fit into our strategy. And we'll probably have a look at them. But when I use those words have a look at, I would remind you that we had a look at German transmission last year, a couple of assets in Germany. We applied what we're talking about, the rigorous criteria that we've got, and we decided that we would not even put a bid in on the German transmission assets. So if the process goes ahead, we'll have a look.

Andrew Moulder - CreditSights - Analyst

Yes. It's Andrew Moulder at CreditSights. Since Peter has opened the EDF can, I'd just like to ask what would be your priorities in funding that business? GBP4b in terms of the RAV is a reasonable acquisition for Nat. Grid. Would you still be looking at confirming your rating commitments? I guess the UK OpCo rating commitment probably wouldn't change, but presumably you'd fund it at the HoldCo level. So what would you see happening at the HoldCo? What would you regard as an acceptable compromise I guess in terms of funding and acquiring new assets?

Steve Holliday - National Grid plc - Chief Executive

It's interesting to jump from we'll have a look at it to a question that then says so how are you going to fund it, if I may. However, I'll still answer your question. We've been very clear, Andrew, about our balance sheet. We will optimize our balance sheet. We sat prior to 2005 on quite a bit of cash in our balance sheet. It was inefficient. We've taken the balance sheet to a place that is efficient. The metrics are improving this year. We still think it's optimizing our cost of capital. That is not the same as meaning we're sitting on a lot of cash in the balance sheet, therefore.

So we've always been very clear between us and our investors and hopefully yourselves, major acquisitions are very different. Major acquisitions will have -- so that whole decision around testing whether it's the right thing to do also has to test so what's the financing strategy for that, for National Grid and the longer-term shape of our balance sheet. Very different from the comments I make about the day-to-day operation of the business, clearly. But let's not get ahead of ourselves.

Andrew Moulder - CreditSights - Analyst

No, I think, to be fair, I wasn't actually asking how you'd fund it, I was asking what your priorities would be in funding it. Would it be, from a credit point of view, preserving the ratings of the Group or would you be happy for the ratings to change?



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Steve Holliday - *National Grid plc - Chief Executive*

Yes, that's my whole point. The business -- the optimization of the balance sheet that we've got today is the position that we would extrapolate through all investment opportunities, be they small organic investment opportunities or acquisition opportunities. There's no plan to change.

Steve Lucas - *National Grid plc - Finance Director*

And there's no plans to change the rating commitment

Andrew Moulder - *CreditSights - Analyst*

Thanks. Thank you.

Unidentified Audience Member

Just another question from myself. The -- normally at year end you put up a chart showing the return on combined regulatory equity from the various businesses which comes out around about 12%, maybe 13%, from memory. Would that be kind of your hurdle rate? When you're looking at new investments in the US, would you necessarily look at returns to be above that level or would you consider that perhaps maybe if they're slightly lower risk you would accept a lower return? Effectively, what are your hurdle rates for new investments?

Steve Holliday - *National Grid plc - Chief Executive*

Yes, I knew the question was going to come. I wish the chart did say lots of 12s in it at the moment. My memory is it doesn't unfortunately, which is part of why we've got these re-filings going on. In the US, to have a business that is set up pretty much with a 50/50 equity and debt level and a return in double digits, we believe is appropriate for us. We can invest in that, earn a return on our cost of capital.

If you transfer that back to the UK, clearly the regulatory arrangements that we have in place in the UK have allowed us to continue to invest in the UK and generate good returns. That's a good way of looking at the regulated hurdle rates. Outside of regulation, things like the Isle of Grain and our metering businesses, for example, they are higher-risk businesses. They don't have the regulatory arrangements in place. So we do, and indeed you will see that in our Isle of Grain, superb results that are coming through from phase 2 already. They had higher hurdle rates than our regulated businesses, several hundred basis points higher.

Unidentified Audience Member

Thank you.

Steve Holliday - *National Grid plc - Chief Executive*

You'll have a second one, Andrew.

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Andrew Moulder - *CreditSights - Analyst*

No, no. I'm not going to go back to EDF. You killed me there. I just wondered, on the -- in the US, on the rate plans, you say you're negotiating rate plans with all of these various structural changes and I just wonder why are you actually looking for shorter-term rate plans? If you feel you've addressed the structural issues, why not go for a long-term? Why not have a nice 10-year plan sitting in place so we've got good clarity over the next 10 years? Is it something you're asking for or perhaps the US PUCs are not happy to grant a 10-year-rate plan? What's the thinking in terms of short-term?

Steve Holliday - *National Grid plc - Chief Executive*

The thinking's very, very clear. Tom hinted at it and I think I covered it in my presentation hopefully. Don't -- with hindsight, those 10-year plans are quite impressive. They worked really well for six years. And I'm not sure now, with hindsight, whether the courage to do a 10-year plan. Six years they worked really, really well. They have not worked in the latter part of that period. We don't have the confidence to have a crystal ball that can predict everything that's going to come along and potentially impact these businesses that far ahead. So we do not want to enter into those long-term plans.

There's so much change in this industry right now. The capital tracker's great when you're getting it back a year afterwards. It's not as good as getting it when you're investing it. But just supposing the CapEx requirements literally go through the roof, that's going to drag the returns down on those plans still. So there's too much uncertainty for us to have the confidence on behalf of investors, in fact also the customers, to enter into a really long long-term plan.

You will -- as Tom says, we've done some one-year plans. You may well see us in the next few years do some three-year plans. But until these businesses start to earn appropriate returns and start to invest, then our confidence will be capped down at the one to three-year period, it really will. And that's what's hurt us. That long plan that looked good for a long time has not worked and we're not going to go in and take that risk on behalf of investors again.

Any final question? Okay, thank you very much for your time this morning. Appreciate it.

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