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28 May 2013

Dear Sir/Madam

**REQUEST FOR INFORMATION – RATE REGULATION**

National Grid's principal activities involve the transmission and distribution of electricity and gas in Great Britain and northeastern US.

We own and operate the electricity transmission network in England and Wales and we are the electricity system operator for Great Britain. We are the sole owner and operator of gas transmission infrastructure in Great Britain and of four regional gas distribution networks.

In the US, we own and operate electricity transmission and distribution facilities, electricity generation units and gas distribution facilities. We also supply electricity and gas to customers.

These activities are subject to regulation in each jurisdiction.

In response to your request for information issued in March 2013, we have provided an overview of our regulatory arrangements in the attached.

We hope you find this information helpful. We would be happy to discuss this further and provide more detailed information as you require it.

Regards

K. Reppcatt

p.p. Emmanuel Fraser
Head of Financial Reporting

## UK regulatory framework

*Background*

Our licences, established under the Gas Act 1986 and Electricity Act 1989, as amended (the Acts), require us to develop, maintain and operate an economic and efficient networks and to facilitate competition in the supply of gas and electricity in Great Britain.

Our networks are regulated by Ofgem, which has established price control mechanisms that set the amount of revenue that can be earned by our regulated businesses. Price control regulation is designed to ensure our interests, as a monopoly, are balanced with those of our customers. Ofgem allows us to charge reasonable, but not excessive, prices giving us a future level of revenue sufficient to meet our statutory duties and licence obligations, and also to make a reasonable return on our investment.

The price control includes a number of mechanisms to achieve its objectives, including financial incentives designed to encourage us to: continuously improve the cost and effectiveness of our services; manage and operate our networks efficiently; deliver high quality services to our customers; and invest in the development of the network in a manner that ensures long-term security of supply. Our UK Transmission and UK Gas Distribution businesses operate under eight separate price controls in the UK. These comprise two for our UK electricity transmission operations one covering our role as transmission owner (TO) and the other for our role as system operator (SO); two for our gas transmission operations, again one as TO and one as SO; and one for each of our four regional gas distribution networks. While each of the eight price controls may have differing terms, they are based on a consistent framework.

*Price control framework*

Our UK regulator, has introduced a new regulatory framework called RIIO (revenue = incentives + innovation + outputs) that became effective on 1 April 2013 and lasts for eight years. The building blocks of the RIIO price control are broadly similar to the historic price controls used in the UK, however there are some significant differences in the mechanics of the calculations.

Under RIIO the outputs we deliver are clearly articulated and are integrally linked to the calculation of our allowed revenue. The six key output categories are safety; reliability (and availability); environmental impact; customer and stakeholder satisfaction; customer connections; and social obligations (Gas Distribution only).

Within each of these outputs categories are a number of primary and secondary deliverables. The nature and number of these deliverables varies according to the output category, with some being linked directly to our allowed revenue, some linked to legislation, and others having only a reputational impact.

Ofgem, using information submitted by us along with independent assessments, determine the efficient level of expected costs necessary to deliver these outputs. Under RIIO this is known as 'totex', short for total expenditure.

Totex is split between fast and slow money, a new concept under RIIO, based on a specified percentage. Fast money represents the amount of totex that we are able to recover in the current year. Slow money is added to our Regulated Asset Value ('RAV': the value ascribed by Ofgem to the assets held by our regulated businesses in the UK).

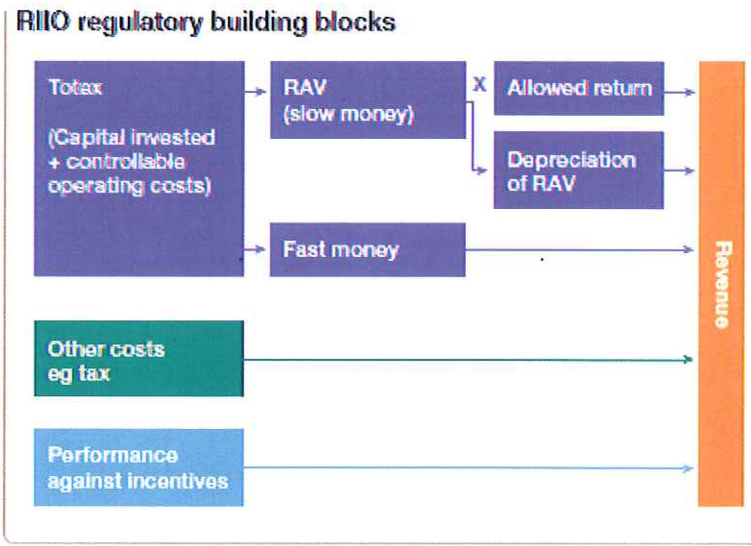
In addition to fast money, in each year our allowed revenue includes depreciation of and a return on our RAV. It also includes additional amounts related to non-controllable costs and incentives.

The incentive mechanisms can increase or decrease our allowed revenue and result from our performance against various measures related to our outputs. RIIO has introduced new incentive mechanisms as a way to provide further incentives to align our objectives with those of our customers and other stakeholders. For example, performance against our customer satisfaction targets can have a positive or negative effect of up to 1% of allowed annual revenues. Incentive revenues will normally affect our allowed revenues two years after the year of performance.

A number of assumptions are necessary in establishing the outputs and associated efficient costs. For example certain future prices may not be known, and assumptions include the volumes of work such as the number of customer connections that will be needed. As a result, to protect us and our customers from windfall gains and losses, there are a number of uncertainty mechanisms within the RIIO framework that can result in adjustments to future allowed revenues if actual prices or volumes differ from the assumptions.

The operation of uncertainty mechanisms and incentives can create volatility in allowed revenue and lead to a disconnect between operational performance and financial performance in any given year.

The above mechanisms are summarised in the diagram below.




*Allowed revenue versus revenue*

The rates we use to bill our customers are calculated based on our allowed revenues and a forecast of the billing volumes for the year. As the actual volumes will be different to the forecast volumes we will collect more or less than our allowed revenues. The difference, referred to as timing differences, are included in the allowed revenue in the following year.

## US regulatory framework

*Background*

In the US, public utilities' retail transactions are regulated by state utility commissions. In our jurisdictions this includes the New York Public Service Commission (NYPSC), the Massachusetts Department of Public Utilities (MADPU), and the Rhode Island Public Utilities Commission (RIPUC).

Utility commissions serve as economic regulators in approving cost recovery and authorised rates of return. The state commissions establish the retail rates to recover the cost of transmission and distribution services, and focus on services and costs within their jurisdictions. FERC regulates the wholesale transactions of public utilities, such as interstate transmission and electricity generation, and provides for the cost recovery of these services.

Utility commissions are also charged with serving the public interest by ensuring utilities provide safe and reliable service at just and reasonable prices. They establish service standards and approve mergers and acquisitions of public utilities. FERC also regulates public utility holding companies and centralised service companies, including those of our US businesses.

We have four sets of electricity rates and six sets of gas rates, covering our electricity distribution operations in upstate New York, Massachusetts, and Rhode Island, and our gas distribution networks in upstate New York, New York City, Long Island, Massachusetts, and Rhode Island. Distribution and transmission electricity services in upstate New York continue to be subject to a combined rate that is billed to end use customers. In New England, retail transmission rates reflect the recovery from our end use customers of wholesale transmission charges assessed to our electricity distribution companies. Wholesale rates for our electricity transmission network in New England and New York and our Long Island generation rates are subject to FERC approval.

*Determining the revenue allowance*

Gas and electricity rates are established from a revenue requirement, or cost of service, representing the utility's total cost of providing distribution or delivery service to its customers. It includes operating expenses, depreciation, taxes and a fair and reasonable return on certain components of the utility's regulated asset base, typically referred to as its rate base.

The rate of return applied to the rate base is the utility's deemed weighted average cost of capital. This represents its cost of debt and an allowed return on equity intended to provide the utility with an opportunity to attract capital from investors and maintain its financial integrity.

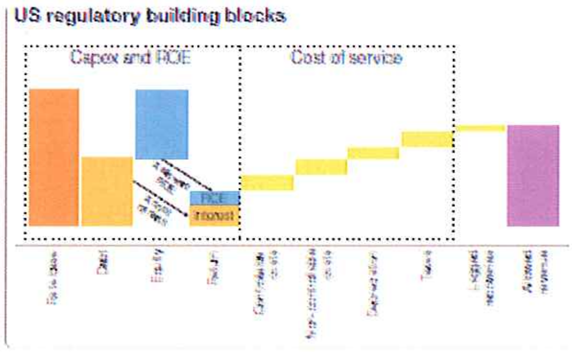
The revenue requirement is derived from a comprehensive study of the utility's total costs during a recent 12 month period of operations, referred to as a test year. Each commission has its own rules and standards for adjustments to the test year.

These are intended to arrive at the total costs expected in the first year new rates will be in effect, or the rate year, and may include forecast capital investments in determining rate year rate base. Often, known and measurable adjustments are made to test year data to reflect normal operating conditions.

Some rate plans include earnings sharing mechanisms that allow us to retain a proportion of the earnings above our allowed return on equity that we achieve through improving efficiency. The balance will benefit customers through reductions in future rates.

In addition, our performance under certain rate plans is subject to service performance targets. We may be subject to monetary penalties in cases where we do not meet those targets.

The below diagram summarises this approach.




*Costs not in the test year*

Our regulators may allow us to recover in the future, costs associated with events outside of our control, such as the costs of restoring services following a storm. Alternatively, we may be allowed to collect amounts in advance of an event to provide the funds to use if an event occurs.

*Amounts billed*

We are responsible for billing our customers for their use of electricity and gas services. Customer bills typically comprise a commodity charge, covering the cost of the electricity or gas delivered, and charges covering our delivery service. Depending on the state, delivery rates are either based upon actual sales volumes and costs incurred in an historical test year, or on estimates of sales volumes and costs, and in both cases may differ from actual amounts. A substantial proportion of our costs, in particular electricity and gas purchases for supply to customers, are pass-through costs, meaning they are fully recoverable from our customers. These pass-through costs are recovered through separate charges to customers that are designed to recover those costs with no profit. Rates are adjusted from time to time to ensure any over- or under-recovery of these costs is returned to, or recovered from, our customers. There can be timing differences between costs being incurred and rates being adjusted.

## Ceasing to provide regulated services

Where we wish to cease providing regulated services, this is achieved in practise by divesting part of the business. A recent example is our disposal of US regulated businesses in the state of New Hampshire. Such transactions require approval by the relevant regulator.

We would not normally be able to recover specific under-recoveries at the date of disposal, nor would we normally be required to repay over-recoveries, when such under- or over-recoveries were to be adjusted in future prices. To the extent such items affect the future cash flows of the acquirer they should in principle be reflected in the consideration we receive for the sale of the business.

In the past, where we were required to divest of businesses, we were able to apply to the regulator to recover certain costs we had incurred in respect of those businesses through revenue from retained businesses. For example, we have been able to recover costs related to some of our historical investments in generating plants that were divested as part of the restructuring and wholesale power deregulation process in New England and New York during the 1990s.