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Office of Gas and Electricity Markets (Ofgem)
9 Millbank
London
SW1P 3GE

Our ref: BT/ch

19 January 2007

Dear Sirs

Re: Fourth Transmission Price Control Review Financial Models

In accordance with our proposal dated 22 June 2006 setting out the scope of work, PKF have examined the Financial Models (the 'Models') relating to the Fourth Transmission Price Control Review.

Opinion

Our work is subject to the assumptions and comments, which are summarised in Appendix A, and subject to the representations and responses from the Model Author in respect of our Base Case findings reports upon which we have relied. As a result of our review we confirm that the Models, versions 'Elec_Model_061204_PKFv3.xls' and 'Gas_Model_061204_PKFv2.xls' as sent to us on 13 and 6 December 2006 respectively in relation to the electricity and gas transmission price control reviews:

- Are logically constructed, internally consistent and are materially accurate in terms of their formulae, algorithms and calculations;
- Reflect, in all material respects, and are consistent with the Model User Guide Version 'Transmission Price Control Review Manual_070109.doc';
- Function, in all material respects, in accordance with Ofgem's financial, regulatory and economic assumptions, as provided to us (as listed in the Model User Guide) and calculate allowed revenues consistent therewith;
- Reflect, in all material respects, the provisions of the relevant accounting and financial reporting standards of UK GAAP;
- Reflect, in all material respects, the provisions of relevant UK taxation standards and legislation.

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Our work was limited to the matters set out above and accordingly did not include, for the avoidance of doubt, any form of review of the commercial merits, technical feasibility, or the factual accuracy of the input data. Further, we have not considered the validity of the underlying technical assumptions which are outside our expertise.

All comments and opinions above are given solely in respect of the Models versions 'Elec_Model_061204_PKFv3.xls' and 'Gas_Model_061204_PKFv2.xls' as sent to us on 13 and 6 December 2006 respectively and cease to be valid if there are any subsequent changes to the Models.

This letter has been prepared for the information and benefit of the addressees. No party other than the addressees from time to time may place reliance on any matters contained within this letter.

Yours sincerely

A handwritten signature in blue ink that reads 'PKF (UK) LLP'.

PKF (UK) LLP

ASSUMPTIONS AND COMMENTS ON THE MODEL

Background and Model Assumptions

1. We understand that the objective of the Models is to calculate the allowed revenue for the four companies; National Grid Gas Transmission, National Grid Electricity Transmission, Scottish Hydro Electricity Transmission Ltd and Scottish Power Transmission Ltd (the 'licensees') for the five year price control from 1 April 2007 to 31 March 2012 on the basis of the assumptions and input data contained within the Models.
2. The Models are designed foremost as a regulatory evaluation tool to measure pro forma financial performance under regulatory assumptions. They are not designed as operational models. Thus, while they could be used to reflect actual performance by replacing forecasts with actuals, they will not readily allow comparisons of actuals against forecasts.
3. The Models are primarily based on annual periods and provide information at each 31 March.
4. The Models assume all the licensees have a gearing of 60%, although the actual levels of gearing within each licensee will vary.
5. The Models are denominated in millions of pounds sterling except where otherwise stated. They do not provide for or require any other currency denominations.
6. The Models use real inputs which are inflated using the average of the monthly RPI figures for the 12 months ending in March of each year.

Findings and Comments on the Model

7. Below are the key comments arising out of our review of the Models, excluding those matters which have been resolved with the Model Author. We have categorised our findings to reflect the scope of our review.

Model Logic and Assumptions

8. VAT has not been shown in the Models and we have not reviewed the compliance of the Models with VAT legislation.
9. We note that worksheets 'NGET_SO' ' NGGT_SO' within the Electricity and Gas Models respectively are outside the scope of our review.

Review of UK GAAP

10. The Models' balance sheets include values under the heading 'other provisions'. We have been informed that these relate to specific provisions although we have not received any supporting documentation for these provisions.
11. We understand that the depreciation rates within the Models are drawn directly from the licensees accounts. The estimated useful asset lives vary by licensee and we offer no opinion on the accuracy of these rates.

12. We note that the Models' fixed assets have been categorised on the same basis as tax pools. UK GAAP requires these assets to be grouped by 'type of asset'. We have accepted the presentation adopted on the basis that the financial statements are presenting a regulatory and not a statutory position for each licensee.

13. Although we have reviewed the Models under UK GAAP we note that during the review period some licensees may adopt IFRS and this may change the calculation of the financial statements.

Review of Tax

14. The NGET-TO and SHETL sheets in the Models show, respectively, £1.27 billion and £56.3 million of assets qualifying for deferred revenue expenditure allowances throughout the period to March 2012. The Models generally show expenditure of this nature as qualifying for 100% capital allowances but the tax computations treat the assets only as qualifying for refurbishment allowances. On this basis, the timing of tax payments could be expected to be deferred as compared to the position shown by the Models.

15. The Models assume that all pension costs paid in each year are deductible. However, current tax rules provide that where the amounts paid in any year exceed 210% of the previous year's payments, relief for 110% of that excess has to be spread over a period of up to four year. This is relevant in respect of payments by NGET_TO in the year to March 2008 and in consequence, relief for £45 million of payments made in that year would have to be spread over four years. The Models show all relief as falling due in that year thus the timing of tax payments could be expected to be accelerated as compared to the position shown by the Model.

16. In calculating industrial buildings allowances for SHETL, the Models understate allowances by £406,000 in the period 2029 to 2032 hence tax liabilities in that period are overstated by £122,000.

17. The Models assume that all intra-group transactions, including interest payable in respect of intra-group loans, are on arms length terms such that no transfer pricing adjustments are required. The Model Author has confirmed that all such transactions are considered to be on arms length terms. We have accepted the assumption as given and offer no further opinion thereon.

18. As agreed with the Model Author, we have not sought to compare any of the opening tax figures shown in the Models to prior period computations or statutory accounts. We are not therefore in a position to comment on the consistency of the figures with those reported in such documents. As further agreed, we have not reviewed details of any ongoing HM Revenue & Customs enquiries into prior period computations. We are thus equally unable to comment as to whether there are any significant matters under enquiry which may therefore impact either on the validity of those opening figures or on the Models tax calculations generally.

19. The Models apportion each year's capital expenditure amongst the various classes of tax assets by means of hard-coded inputs. Furthermore, where no such inputs are shown, the Models assume that the qualifying additions are equal to the previous year's additions as adjusted for RPI indexation. The Model Author has advised that the assumptions are based on historic information and are consistent with current management assessments. We have accepted all capital expenditure additions as given and offer no further opinion thereon.

20. The Models tax calculations for the year ended 31 March 2005 include certain additions and deductions taken into account in calculating taxable profits. No such adjustments are modelled for



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any future years as the Model Author has advised that these are not anticipated to occur. We have accepted the assumption as given and offer no further opinion thereon.

21. The Models assume that expenditure qualifying for refurbishment allowances attracts a tax deduction of 3% p.a. The Model Author has advised that this is consistent with the rate of tax relief obtained by the main transmission company. We have accepted the assumption as given and offer no further opinion thereon.