

Business Review

National Grid Transco is an international energy delivery company. The newly merged Group has made excellent progress in bringing together two businesses both focused on the safe and efficient delivery of energy.

Introduction

Overview of National Grid Transco

In the UK, through Transco, we own, operate and develop Britain's natural gas transmission and distribution systems which deliver gas to around 21 million consumers. Through National Grid Company, we own, operate and develop the high-voltage electricity transmission system in England and Wales. In the US, National Grid USA's distribution networks serve approximately 3.2 million electricity customers in the Northeast and 550,000 gas customers in upstate New York.

Other electricity interests include interconnectors in the UK, US and under construction in Australia, and joint ventures operating in Argentina and Zambia.

We have also transferred our network skills to related markets in the UK and US.

Our UK gas distribution operation comprises eight regional Networks in Britain.

Immediately following the Merger, the Group combined the management of National Grid's UK electricity and Transco's gas transmission operations. In spring 2003, we brought together our UK and US transmission activities. This follows the creation of GridAmerica, which is expected to become operational in autumn 2003 and to commence management of the transmission operations of three major power companies in the midwestern US. However, while we are reporting separately on UK transmission, our US transmission activities are reviewed as part of our US electricity and gas networks.

History and development of the business

On the restructuring of the electricity industry in England and Wales in 1990, National Grid Company assumed ownership and control of the transmission network and certain parts of the interconnectors with Scotland and France from the Central Electricity Generating Board. National Grid Company became a wholly-owned subsidiary of National Grid Holding plc, the predominant shareholders in which were the 12 Regional Electricity Companies (RECs) which owned and operated the local distribution systems. Each REC disposed of substantially all of its holding in National Grid Holding plc in either 1995 or 1996. National Grid Holding plc was re-named The National Grid Group plc in 1995 and in July 2000 became National Grid Group plc. National Grid's initial investments in electricity activities outside the UK were in Argentina and Zambia in 1994 and 1997 respectively.

National Grid entered the US electricity market in 2000 with its acquisitions of New England Electric System (NEES) and Eastern Utilities Associates (EUA). National Grid further expanded its operations in the US with the completion of its merger with Niagara Mohawk in January 2002. All these companies now form part of National Grid USA. A new holding company for National Grid was introduced through a scheme of arrangement to effect the merger of Niagara Mohawk. Immediately after the scheme became effective, the new holding company was re-named National Grid Group plc.

In October 2002, National Grid Group plc merged with Lattice Group plc and was re-named National Grid Transco plc. Lattice was one of the three successor companies to what was formerly British Gas plc. Its principal business was Transco, the owner and operator of the substantial majority of Britain's gas transportation system.



Far left 'Live line working' enables highly trained engineers to undertake routine maintenance to overhead lines, minimising the need to switch off the power supply.

Left Using the latest laser guided tunnelling equipment, Transco engineers work to replace existing gas mains with new polyethylene pipe beneath one of London's busiest trunk roads. The specially constructed 48-inch tunnel was used to insert the new 450 mm pipe with minimum disruption to the public.

The UK gas industry was nationalised in 1948 and the British Gas Corporation was established in 1973. British Gas was incorporated as a public limited company in April 1986 and the Government sold substantially all of its shareholding in it to the public in December 1986. In 1997, Centrica, which was then primarily a supplier of gas to end users, was demerged from British Gas which was re-named BG. BG retained the gas transportation and storage businesses, the majority of the exploration and production business as well as the international downstream and a number of smaller businesses. In December 1999, BG completed a financial and restructuring programme which resulted in the creation of a new parent company, BG Group, and involved separating its UK regulated business, Transco, from its other businesses. This created a 'ring-fence' around Transco designed to ensure its financial, organisational and managerial independence. In October 2000, Lattice was demerged from BG Group and comprised Transco, together with start-up telecommunications and non-regulated infrastructure services businesses.

Restructuring programmes

Prior to the Merger, Transco and National Grid were each in the midst of restructuring programmes. In the UK, these programmes were designed to meet and, where possible, outperform the regulatory targets set by Ofgem. In the US, as part of the acquisition process, National Grid negotiated rate settlements with regulators in the states where the companies it acquired had substantial operations.

Transco embarked on its extensive restructuring programme following settlement of its price control review which took effect in April 2002. Since then, controllable costs have been reduced by 6.3% in real terms and we have delivered on our initial target of reducing the monthly rate of operating expenditure to the corresponding regulatory target by March 2003.

'Staying Ahead' was launched in National Grid in the UK in January 2002. It set out a vision of continuous improvement and of being world class in all aspects of the business. It also set out the strategic context for the vision, linking it to benefits for the business and for the individual. We have reduced Transmission Owner controllable costs by 22% in real terms since 1 April 2001. We therefore remain confident that we will achieve the planned 30% real reduction over the period to March 2006.

Following the merger of our gas and electricity transmission operations in the UK, we have re-examined the challenges facing this business and concluded that the Staying Ahead vision remains valid for the combined UK transmission business. We have therefore extended the principles of Staying Ahead across the merged UK transmission organisation.

In the US, National Grid USA has entered into long-term rate plans that project certain synergy savings and efficiency gains. The Group has set the goal of a 20% reduction of controllable costs in US operations over the three-year period ending 31 March 2005. By the end of 2002/03, integration savings were being delivered ahead of schedule, with controllable costs having been reduced by 6.5% thus far.

Merger benefits

The newly merged Group has made good progress in bringing together two businesses both focused on the efficient delivery of energy. Our Group corporate centre functions were combined on the day we completed the Merger, and we are in the process of moving the majority of our UK business services staff to Warwick as we further consolidate locations. We brought together our UK gas and electricity transmission businesses and we are realising savings and efficiencies. We are now confident of achieving at least £135 million annualised synergy savings, the great majority of which will be achieved by March 2004.

UK gas distribution

Background information

The UK gas distribution business of National Grid Transco is operated by Transco and comprises the majority of Britain's gas distribution system. The gas distribution system is organised into eight regional Networks and consists of approximately 172,000 miles of distribution pipelines. Gas is transported on behalf of approximately 70 active gas shippers from the National Transmission System to around 21 million consumers and also to third party pipeline systems. As well as gas transportation, Transco is responsible for the safety, development and maintenance of the transportation system and operates the national gas emergency service.

Regulation

Transco is the holder of a gas transporter licence for England, Wales and Scotland in respect of its gas distribution, transmission and metering businesses. From 1 April 2002, the UK gas distribution business became subject to a separate five-year price control formula. The formula takes into account, among other factors, operating expenditure, replacement expenditure, capital expenditure, cost of capital at a real pre-tax rate of 6.25% and transportation volumes. The price control is structured so that 65% of revenue is fixed and 35% varies with volumes. In addition, pass-through is given in respect of some of the formula rates the Group is liable for and Ofgem's licence fees. We are currently working with Ofgem on disaggregating the control into a separate price control for each Network.

In setting the price control, replacement expenditure costs were divided 50:50 between regulatory capital and regulatory operating expenditure. This ensures that the cost of the metallic mains replacement programme does not fall wholly on today's customers, but is shared with future customers who will also stand to benefit from the further improvements in safety and operational integrity. The regulatory treatment of replacement expenditure

contrasts with the accounting treatment where all such costs are expensed (see critical accounting policies – replacement expenditure on page 37).

The distribution mains replacement incentive scheme provides that if Transco outperforms cost targets, it keeps 33% of the savings as additional allowed revenues but, if it underperforms, it may recover only 50% of its additional expenditure through additional allowed revenues. In 2002/03, Transco generated an estimated additional £15 million of allowed revenues through outperformance of the cost target.

Financial performance

UK gas distribution turnover for the year ended 31 March 2003 was £2,089 million compared with £2,013 million in 2001/02 and £2,070 million in 2000/01.

UK gas distribution adjusted operating profit for the year ended 31 March 2003 was £554 million, compared with £548 million in 2001/02 and £663 million in 2000/01.

The £6 million increase in adjusted operating profit comparing 2002/03 to 2001/02 was mainly a result of the following:

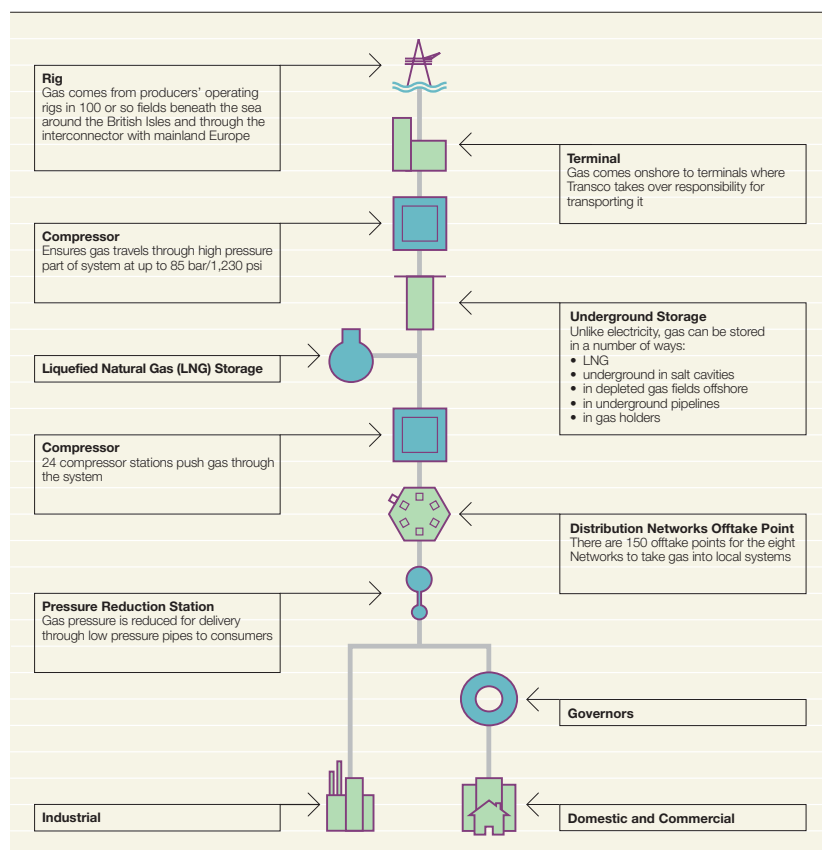
- colder weather that increased turnover by £10 million;
- a £26 million reduction in controllable operating costs; and
- an offsetting increase in replacement expenditure of £37 million with the commencement of the long-term programme to replace all metallic distribution mains within 30 metres of a building (see critical accounting policies – replacement expenditure on page 37).

Principal factors behind the £115 million decrease in operating profit comparing 2001/02 to 2000/01 were:

- warmer weather that reduced turnover by £78 million;
- a £92 million increase in replacement expenditure; and
- a £50 million provision for shipper related liabilities in 2000/01.

UK gas

Transco transports gas for around 70 active shippers from coastal terminals to consumers' meters, delivering gas to around 21 million consumers. Transco also operates the 24-hour 365 days a year national gas emergency service.



Operating performance

Gas throughput was 708 TWh in 2002/03 compared with 697 TWh in 2001/02 and 733 TWh in 2000/01. If the weather had corresponded to seasonal normal temperatures, it is estimated that gas throughput would have been 730 TWh in 2002/03 compared with 727 TWh in 2001/02 and 726 TWh in 2000/01.

While there has been underlying growth of 2.0% in demand from domestic users (2001/02 1.0% demand growth), 2002/03 saw a 1.6% reduction in underlying demand from business and other large

users (2001/02 1.0% reduction). This is attributed to higher relative gas prices compared to competing fuels and to the recession in manufacturing.

The Quarterback system, which provides mobile workforce technology to field operations in the eight Networks, is on schedule for roll-out in late summer. Cumulatively to 31 March 2003, £20 million had been spent on this system. In addition, we have implemented in-vehicle technology (VeSaS) to manage the performance and utilisation of our large vehicle fleet better and we are undertaking further improvement of our supply chain

Right Construction of a new 43-mile, 48-inch high pressure pipeline between St Fergus Terminal and Aberdeen Compressor Station in Scotland is part of our investment programme to meet increased gas demand.

Far right National Grid Company's control room for England and Wales, where supply and demand are balanced on a second-by-second basis in what is perhaps the most sophisticated and liberalised wholesale electricity market in the world.



deliveries by reducing and rationalising our logistics network.

Investment in the network

Capital expenditure on the reinforcement and extension of the gas distribution network was £380 million in 2002/03 compared with £455 million in 2001/02 and £360 million in 2000/01. During the year ended 31 March 2003, 220,000 new connections were made to the gas distribution network and there was a net increase of 60,000 in the number of consumers.

Transco has successfully completed its programme to replace certain medium pressure ductile iron mains and has now commenced the long-term programme, agreed with the HSE in 2001, to replace all metallic mains within 30 metres of buildings. This amounts to a potential 57,000 miles of mains. Ofgem has allowed £1.5 billion (2000 prices) of investment in the UK gas distribution price control, covering the first five years of the programme.

Fixed assets

The gas distribution system in Britain comprises approximately 172,000 miles of distribution pipelines. Agreements with landowners or occupiers are only required for those pipes that cross private land, which are mainly local transmission mains. These agreements largely comprise perpetual easements or Scottish equivalents. Transco owns the freeholds of the substantial majority of its operational sites where there are larger operational plant and gas storage facilities. Around 80% of office buildings, depots and stores occupied by the UK gas distribution business are leased from another National Grid Transco company, SecondSite Property. Other offices and depots, including Transco's principal offices at 31 and 35 Homer Road in Solihull, are leased from third parties.

UK electricity and gas transmission Background information

The UK transmission business comprises the high-voltage electricity transmission

system in England and Wales and the gas transmission system in Britain. It owns and operates electricity assets consisting of approximately 4,500 miles of overhead line, about 400 miles of underground cable and some 340 substations at around 230 separate sites. Day-to-day operation of the electricity transmission system involves the continuous matching of generation output with demand, ensuring the stability and security of the power system and the maintenance of satisfactory voltage and frequency. The business also owns and operates the national gas transmission system comprising approximately 4,100 miles of high pressure pipe, six beach terminals and 24 compressor stations, connecting to Transco's eight distribution Networks and third party independent systems for onward transportation of gas to end consumers.

The UK transmission business now comprises four separately regulated businesses:

- Electricity Transmission Owner;
- Electricity System Operator;
- Gas Transmission Owner; and
- Gas System Operator.

The Transmission Owner (TO) activity involves the ownership and maintenance of the physical assets, developing the networks to accommodate new connections/disconnections, managing a programme of asset replacement and investment to ensure the long-term reliability of the systems.

The System Operators (SO) undertake a range of activities necessary for the successful delivery in real time of secure, reliable and efficient energy and the continuous balancing of supply and demand. The electricity and gas SOs are subject to a number of separate regulatory incentive schemes, many of which are rebased on an annual basis. We also own and operate the electricity interconnectors between England and Scotland and between England and France.

In February 2003, the UK Government published a White Paper outlining its proposals for future energy policy. This highlights four goals in terms of reducing carbon emissions, maintaining reliability and security of energy supplies, continuing to promote a market-based framework for the energy sector and ensuring affordable warmth for consumers. Gas is acknowledged as continuing to form a large part of the energy mix beyond 2020 and the Government sets an aspirational target of 20% renewables by 2020, as well as aiming for significant increases in energy efficiency.

The White Paper recognises the importance of robust and flexible infrastructure for the transmission and distribution of both gas and electricity to realise the Government's policy objectives. In the case of gas, Transco's National Transmission System will need to adapt to the growing proportion of gas imports from a variety of landing points and LNG sources. It will further need to do so in a timescale which will accommodate new patterns of gas transmission in Continental Europe and the UK. In the case of electricity, the White Paper recognises that regulatory arrangements are crucial to the ability to deliver the necessary network infrastructure to support a major increase in renewable generation.

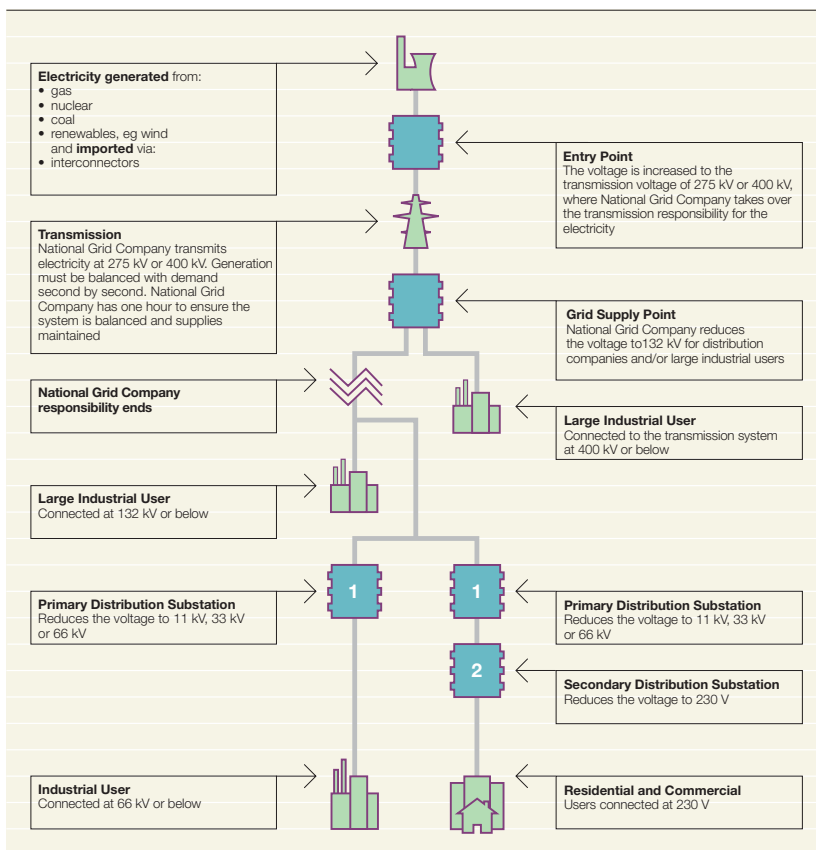
Under the proposed European Directives on electricity and gas liberalisation, July 2004 has been set as the deadline for the introduction of full competition in the industrial and commercial sectors of Europe's gas and electricity markets; and July 2007, as the deadline for full domestic competition. Another draft Directive proposes common standards relating to the security of gas supplies and coordination of emergency arrangements in the event of a supply disruption. Work on contingency planning in the event of such incidents in the UK has already taken place.



Left At Transco's national control centre, gas pressures and flows are monitored to ensure the continuous balancing of supply and demand.

UK electricity

National Grid Company transports electricity and balances the system on a second-by-second basis, delivering electricity from generators and interconnectors to 12 regional electricity companies for local distribution to over 24 million consumers and directly to a small number of large industrial users.



Regulation

The electricity and gas TOs are regulated by separate five-year RPI-X price controls, currently until 2006 for electricity and 2007 for gas.

Electricity

National Grid Company is the sole holder of an electricity transmission licence for England and Wales and owns and operates the high-voltage electricity transmission system. We have a statutory duty under the Electricity Act 1989 (as amended by the Utilities Act 2000) to develop and maintain an efficient,

coordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity. Under the terms of the transmission licence, National Grid Company recovers costs, including a return on capital employed, through charges to generators, distributors, suppliers and directly-connected customers for use of and connection to the transmission system. Use of system charges are levied in respect of the provision of transmission assets/infrastructure (the TO activity) and for operating the system (the SO activity).

TO Revenue from transmission network use of system charges and charges for connections made before March 1990 is controlled by a revenue restriction condition set out in the transmission licence. The current regulatory price control, which was introduced on 1 April 2001 and is expected to remain in force until 31 March 2006, takes into account, among other factors, operating expenditure, capital expenditure and cost of capital at a real pre-tax rate of 6.25%. National Grid Company is permitted to set charges for connections to the transmission system made since March 1990 to recover the costs directly or indirectly incurred in providing connections, together with a reasonable rate of return on such costs.

SO As System Operator, National Grid Company is responsible for the operation of the high-voltage electricity transmission system across England and Wales including the procurement and use of balancing services. Revenue from charges for provision of balancing services is regulated under an incentive scheme, where benefits of cost savings in system operation are shared with customers. Legislation is being prepared to introduce the British Electricity Transmission and Trading Arrangements (BETTA), following which a single system operator for the entire GB transmission system (the 'GBSO') will be appointed. The Department of Trade and Industry has announced that it is minded to award the GBSO role to National Grid Company.

Gas

The UK gas transmission business is undertaken under the terms of Transco's gas transporter licence. From 1 April 2002, the UK gas transmission business became subject to two separate five-year price control formulae in respect of its TO and SO activities. The formulae, which last until March 2007, take into account, among other factors, operating expenditure, capital expenditure, cost of capital at a real pre-tax rate of 6.25% and transportation volumes. In addition, pass-through is given



Left National Grid USA's training centre in Massachusetts houses more than a dozen classrooms, conference rooms and hands-on skills training areas. The centre includes outdoor 'laboratories' where students train on overhead and underground electricity distribution equipment such as transformers, poles and a working substation.

in respect of formula rates and Ofgem's licence fees attributable to the gas transmission business.

The SO price control includes a series of incentive arrangements such that if performance exceeds the targets set in the licence, Transco retains a share of the benefits, and vice versa. The incentives primarily cover the costs of managing capacity constraints, the costs of purchasing shrinkage gas and Transco's own operating costs. Investment incentives are also included in the licence and are expected to increase in significance over time.

Financial performance

Total adjusted operating profit for the UK electricity and gas transmission business for the year ended 31 March 2003 was £846 million, compared with £781 million in 2001/02 and £756 million in 2000/01. For the year ended 31 March 2003, this includes:

- £551 million from electricity transmission;
- £274 million from gas transmission and LNG; and
- £21 million from interconnectors.

UK transmission performance last year underlines our ability to operate and manage complex transmission networks in an incentive-based regulatory environment. Specifically, we have:

- earned SO incentive scheme profits of £49 million in electricity and £12 million in gas; and
- delivered TO controllable cost reductions of 14% in electricity.

Electricity transmission

Financial performance

UK electricity transmission turnover for the year ended 31 March 2003 was £1,341 million, compared with £1,285 million in 2001/02 and £1,316 million in 2000/01.

UK electricity transmission adjusted operating profit for the year ended 31 March 2003 was £551 million, compared with £523 million in 2001/02 and £486 million in 2000/01.

The £28 million increase in adjusted operating profit in 2002/03 was mainly as a result of the following:

- reduction in TO controllable costs of 14%, totalling 22% since the commencement of the current price control, keeping us on track to deliver cost reductions in excess of 30% over the price review period; and
- SO incentive scheme profits of £49 million, including £45 million from the Balancing Services Incentive Scheme (BSIS).

The increase in adjusted operating profit of £37 million comparing 2001/02 to 2000/01 was due to improved SO incentive scheme performance and reductions in TO controllable costs.

Operating performance

The winter of 2002/03 saw the highest demand for electricity ever recorded on the transmission network in England and Wales, with a record 54.4 GW on 10 December 2002. This compared with the previous peak recorded on 3 January 2002 of 51.5 GW.

We have more than halved the electricity losses incurred due to plant failure and improved the average annual availability of the electricity network for use from 95.4% to 95.8%. System availability at winter peak demand was 98.8% in 2002/03, compared with 98.3% in 2001/02.

Gas transmission

Financial performance

UK gas transmission turnover for the year ended 31 March 2003 was £567 million, compared with £528 million in 2001/02 and £501 million in 2000/01.

UK gas transmission adjusted operating profit for the year ended 31 March 2003 was £274 million, compared with £238 million in 2001/02 and £227 million in 2000/01.

The £36 million increase in adjusted operating profit in 2002/03 was mainly

as a result of higher income from system entry capacity auctions.

The £11 million increase in adjusted operating profit comparing 2001/02 to 2000/01 was also as a result of an increase in income from system entry capacity auctions, partly offset by an increase in the price of gas used in operating the system.

Operating performance

The winter of 2002/03 also saw the highest demand for gas, with a record maximum demand of 450 mcm on 7 January 2003. This compared with the previous peak recorded on 2 January 2002 of 427 mcm.

There has been an increase in 2002/03 of more than 17% in the mean time between compressor failures building on the 27% increase achieved in 2001/02. We have also reduced by a third the time compressors are taken out of service by improving the efficiency with which maintenance is carried out or enhancements made.

Investment in the networks

Capital investment on the reinforcement and extension of the UK electricity transmission system and interconnectors in 2002/03 was £391 million, compared with £381 million in 2001/02 and £364 million in 2000/01.

Capital investment on the reinforcement and extension of the gas transmission network in 2002/03 was £182 million, compared with £239 million in 2001/02 and £228 million in 2000/01.

Interconnectors

Operating profit from the UK interconnectors for the year ended 31 March 2003 was £21 million, compared with £20 million in 2001/02 and £44 million in 2000/01.

Fixed assets

Agreements with landowners or occupiers are required for the overhead lines and



Far left St Fergus Terminal, Scotland, is one of six beach terminals receiving gas and where the gas flow is monitored and quality checked before it is transported throughout Britain via Transco's National Transmission System.

Left Niagara Mohawk, which serves 550,000 gas customers in upstate New York, has a programme under way to replace older bare steel and cast iron mains that may be at risk of corrosion.

underground cables which make up our electricity network in England and Wales. Approximately 80% of agreements are in the form of terminable wayleaves. The remaining 20% are in the form of perpetual easements under which rights have been granted in perpetuity in return for a lump sum payment. The sites at which we have electricity substations are split between freehold and leasehold. Of the leasehold sites, the large majority are substations located on the premises of generators and are held on long-term leases for nominal rental payments. Of the remaining sites, most are held as ground rents (market price payable for land only) from the respective landlords, who include electricity distribution companies.

National Grid Company also owns the freehold of its control centre in Berkshire and the learning and development centre at Eakring in Nottinghamshire. It has major offices in Coventry (leasehold), Warwick (leasehold) and Leeds (freehold).

The gas transmission system in Britain comprises approximately 4,100 miles of high pressure national transmission pipelines. Transco's interest in these pipelines is legally protected although the legal protection is slightly different in Scotland from that in England and Wales.

In England and Wales, Transco's interest in the pipelines is legally protected by both private easements, entered into with third party landowners, and by statutory rights. 99% of all associated sites are owned outright through a freehold purchase process, with the remainder covered by long-term leasing arrangements.

In Scotland, Transco's interest in the pipelines is protected by deeds of servitude as well as statutory rights. 95% of all associated sites are owned outright through a disposition purchase process. The remaining associated sites are owned through a feudal disposition where an outright purchase has been made but the previous owner retains specified rights, for example mineral or forestry rights.

Transco has three Commercial Lettings, at St Fergus to Shell and Mobil, and at Theddlethorpe to ConocoPhillips. Any land issues impacting on normal agricultural activity local to pipelines and their associated easement or servitude are covered by national agreements with the National Farmers Union, the Country Land and Business Association of England and Wales, and the Scottish Landowners Association.

US electricity and gas networks Background information

In the US, National Grid Transco, operating as National Grid USA, is one of the leading electricity distribution and transmission service providers in the northeastern US, by reference to energy delivered and length of transmission network, and one of the ten largest utilities in the US, as measured by the number of electricity distribution customers. Electricity distribution serves approximately 3.2 million customers over a network of 72,000 miles. Electricity transmission maintains a network of 14,000 miles, which includes a high-voltage direct current (DC) transmission line of 139 miles. Gas distribution serves around 550,000 customers over a network of 8,000 miles.

National Grid USA provides electricity distribution and transmission and gas distribution in New York through its subsidiary Niagara Mohawk Power Corporation. It provides electricity distribution in New England through its subsidiaries Massachusetts Electric Company, Nantucket Electric Company, The Narragansett Electric Company and Granite State Electric Company. It provides electricity transmission in New England through its subsidiary New England Power Company.

US regulatory environment

Federal and state mandates have encouraged the separation of generation from transmission and distribution in order to promote competition and reduce prices to customers. National Grid USA has divested substantially all its generation

assets and operates primarily in the transmission and distribution sectors.

The company provides electricity distribution in upstate New York and New England and gas distribution in upstate New York. The company also provides electricity transmission in upstate New York and New England. Broadly speaking, distribution service is regulated by a state's public utilities authority and transmission service is regulated by the Federal Energy Regulatory Commission (FERC).

As a result of our ownership of several US public utility companies, National Grid Transco is a registered public utility holding company under PUHCA – the Public Utility Holding Company Act of 1935. The implications of registration as a holding company include, among other things, various conditions and limitations relating to financing, subsidiary company transactions, ownership of non-utility businesses and the requirement for SEC consent for further US utility acquisitions. The non-US operations of the Group are exempt from full regulation under PUHCA.

Distribution rate regulation

Multi-year rate plans cover substantially all the company's gas and electricity distribution revenue. National Grid USA's rate plan for a given jurisdiction is set with that state's public utilities authority. Although each state operates independently and the rate plans are different, the plans have common elements. Key among them is the flow-through to customers of the commodity costs of generation, along with the recovery of costs associated with the divestment of generating assets, called 'stranded costs'. Comprehensive service quality standards are a feature of the company's rate plans, with the risk of penalties for failure to meet certain goals and, in some cases, the potential for reward if services exceed standards. Efforts to control costs are rewarded through shared savings mechanisms that allow the company to retain a portion of the savings achieved. In certain



Left National Grid USA performs regular maintenance on a 72,000-mile distribution network in order to maintain reliable electricity services to 3.2 million customers in the northeastern US.

jurisdictions, earnings are shared with customers upon reaching a particular percentage return on equity. The plans permit National Grid USA, or the relevant state, to seek adjustments to rates in the case of extraordinary events.

Massachusetts distribution rates (Massachusetts Electric Company and Nantucket Electric Company)

Under the Massachusetts Electric distribution rate plan approved by the Massachusetts Department of Telecommunications and Energy, distribution rates were reduced by \$10 million on 1 May 2000 and will remain frozen until the end of February 2005. From March 2005 to the end of December 2009, distribution rates will be indexed to the average of distribution rates of similarly unbundled investor-owned utilities in New England, New York, New Jersey and Pennsylvania. Massachusetts Electric has agreed that increases in its distribution rates will initially be capped at 90% of the regional average. Based on a pre-determined formula, annual savings related to Massachusetts Electric's acquisition by National Grid that are achieved up to the end of 2009 will be calculated and shared equitably with customers from January 2010 until May 2020.

Nantucket Electric's distribution rates are linked to Massachusetts Electric's rates and became effective on 1 May 2000.

Rhode Island distribution rates (The Narragansett Electric Company)

Under the rate plan for Narragansett Electric approved by the Rhode Island Public Utilities Commission (RIPUC), distribution rates were reduced by approximately \$13 million on 1 May 2000 and will remain frozen until 31 December 2004. During the rate freeze, Narragansett Electric is permitted to retain earnings up to 12% return on equity. Any earnings between 12% and 13% will be shared equally with customers. If earnings exceed 13%, the excess will be divided between customers and the company, with customers receiving 75%.

From 1 January 2005, distribution rates will be set by the RIPUC in accordance with Narragansett Electric's cost of service. From that date until the end of 2019, the company will be able to include in its cost of service half of any proven savings achieved since the merger of two former distribution companies that belonged to Eastern Utilities Associates (EUA – which became part of the Group in 2000) with Narragansett Electric. Narragansett Electric will file evidence of the EUA merger savings with the RIPUC in 2003 and these savings will be subject to further verification in 2007.

New Hampshire distribution rates (Granite State Electric Company)

The current rates for Granite State Electric are subject to regulation by the New Hampshire Public Utilities Commission and became effective in July 1998.

New York distribution rates (Niagara Mohawk Power Corporation)

Niagara Mohawk's distribution rates are regulated by the New York State Public Service Commission (NYPSC).

As part of the regulatory approval process for the acquisition of Niagara Mohawk, a 10-year rate plan was approved by the NYPSC on 28 November 2001, which became effective on 31 January 2002. Electricity delivery rates were reduced by \$152 million and are subject to only limited adjustments for a period of 10 years. However, Niagara Mohawk will continue to be able to adjust rates to recover the full commodity costs of generation. Under the plan, after reflecting its share of savings related to the acquisition, Niagara Mohawk may earn a return on equity of up to 11.75%, or 12.0% if certain customer education targets are met. Returns above this level are then subject to a sharing mechanism with customers.

The 10-year rate plan also provides for a freeze on gas delivery rates until the end of 2004, but permits Niagara Mohawk to pass through to customers gas commodity and transportation costs.

Niagara Mohawk may earn a threshold return on equity of up to 10%, or 12% if certain customer migration and education goals are met, and is required to share with customers earnings above this threshold.

Transmission rate regulation

A portion of the electricity transmission business is regulated at the federal level by the FERC where the company is allowed to recover the costs of providing transmission services, with a return on capital. In New York, the transmission business is regulated by the state with provisions similar to the distribution regulation outlined in the distribution rate regulation section on page 16.

Regional Transmission Organisations (RTOs)

The transmission sector in the US is undergoing fundamental structural change. In its Order 2000, the FERC required electricity utilities to file proposals for transferring to RTOs the management of transmission assets and the tariffs setting out the rates, terms and conditions of transmission service. National Grid USA is currently a member of two independent system operators (ISOs), ISO New England Inc. and New York ISO, which administer the markets and provide oversight of transmission in their respective regions. The FERC has not yet determined the shape of the RTO or RTOs that will cover the New England and New York regions. Within the New England and New York regions, National Grid USA is discussing with other transmission owners the possible formation of an independent transmission company (ITC) within an RTO. This ITC would manage transmission assets and tariffs within a for-profit business model, as opposed to a typically not-for-profit RTO. In other regions of the US, National Grid USA's participation may involve the acquisition and operation of the transmission assets of participants in RTOs.

The electricity markets and transmission grid in the midwestern US are currently managed by the Midwest Independent

System Operator Inc. (MISO), which has been approved by the FERC to operate as an RTO. In June 2002, National Grid USA announced the formation of GridAmerica as a result of an agreement with Ameren, First Energy, Northern Indiana Public Service Company and MISO. Under the agreement, GridAmerica is to act as an ITC within MISO, managing the transmission assets of the companies within MISO on an annual fee basis. The agreement allows the transmission-owning companies to sell their assets to GridAmerica for cash and stock. Pending final federal and state approvals, the company expects to begin managing the transmission systems of the three utilities in autumn 2003.

Financial performance

The following average exchange rates have been used in translating the US financial results for the following periods:

2002/03	£1 = \$1.590
2001/02	£1 = \$1.440
2000/01	£1 = \$1.483

Turnover for National Grid USA was as follows:

- electricity distribution: £3,446 million in 2002/03, compared with £2,282 million in 2001/02 and £1,854 million in 2000/01;
- electricity transmission: £407 million in 2002/03, compared with £278 million in 2001/02 and £243 million in 2000/01; and
- gas distribution: £446 million in 2002/03, compared with £104 million in 2001/02 and none in 2000/01.

The summary above includes two months of results for Niagara Mohawk (this acquisition was completed on 31 January 2002) in the comparative figures for the year ended 31 March 2002.

Adjusted operating profit for National Grid USA was as follows:

Group undertakings:

- electricity distribution: £513 million in 2002/03, compared with £266 million in 2001/02 and £215 million in 2000/01;

- electricity transmission: £128 million in 2002/03, compared with £87 million in 2001/02 and £72 million in 2000/01; and
- gas distribution: £58 million in 2002/03, compared with £17 million in 2001/02 and none in 2000/01.

Joint ventures and associate:

- Nuclear generation and other joint ventures: £2 million in 2002/03, compared with £6 million in 2001/02 and £8 million in 2000/01.

The summary above includes two months of results for Niagara Mohawk (this acquisition was completed on 31 January 2002) in the comparative figures for the year ended 31 March 2002.

Operating profit increased by £363 million (net of exchange rate) in 2002/03 over 2001/02 primarily due to the first full year of results from the Niagara Mohawk acquisition. Exchange rate impact on the 2002/03 results was a loss of £34 million based on the 2001/02 average exchange rate. This analysis excludes ten months of Niagara Mohawk operating profit since there are no comparable figures for the prior year.

Operating profit increased by £72 million (net of exchange rate) in 2001/02 over 2000/01 primarily due to the first two months of results from the Niagara Mohawk acquisition. Exchange rate impact on the 2001/02 results was a gain of £11 million based on the 2000/01 average exchange rate.

National Grid Transco's electricity deliveries grew in the US, normalising for weather and billing days, in 2002/03 by 0.6% and in 2001/02 by 0.3%. This was despite a weak economy that has seen companies in many industries reduce in size or even close down, resulting in a downturn in commercial demand for energy which is expected to continue. In 2002/03, the Group was aided by weather that was hotter than normal during the summer and

colder than normal during the winter, causing an increase in energy use to run air conditioning and heating systems. This amounted to £34 million more turnover than normal in the 2002/03 financial year. By contrast, 2001/02 weather was cooler than normal during the summer and warmer than normal during the winter, causing a decrease in energy use to run air conditioning and heating systems. This amounted to £2 million less turnover than normal in 2001/02 exclusive of Niagara Mohawk.

Pension and post-retirement health costs adversely impacted the 2002/03 results, increasing by £8 million over 2001/02 exclusive of Niagara Mohawk.

Beginning with the acquisition of Niagara Mohawk, the Group developed a goal for its US operation to reduce controllable costs by 20% in real terms by the 2004/05 financial year. Substantial progress was made in 2002/03, reducing these costs by 6.5% in real terms.

Operating performance

We work toward service quality standards that the state regulators expect us to achieve. If we fall below a prescribed standard, we can incur a penalty. If we do better than the standard, we can in certain cases achieve an incentive. In the area of reliability, which measures the frequency and duration of outages, we had mixed results, with Niagara Mohawk and Narragansett Electric meeting their targets but Massachusetts Electric falling short and incurring a £3 million penalty. Massachusetts Electric, however, partially offset the penalty with £0.7 million in incentives for above average performance related to customer service.

On the other hand, gains in customer satisfaction, and billing accuracy and efficiency have been realised through the Automated Meter Reading (AMR) project. With AMR the company is now able to read a customer's meter automatically using



Left National Grid USA has introduced Automated Meter Reading (AMR), which allows customers' meters to be read using radio signals transmitted to a computer in a company van. This enables up to 15,000 meters to be read compared with 400 meters per day by a meter reader.

radio signals transmitted to a computer in a company van, rather than walking to every meter. AMR enables up to 15,000 meters to be read compared with 400 meters per day by a meter reader. New England distribution completed its AMR installations in December 2002. New York distribution began its AMR installations in October 2002. AMR provides accurate monthly reads, which means fewer customer calls about bills, fewer regulatory complaints and fewer re-reads of meters.

Investment in the networks

Capital investment on the reinforcement and extension of the electricity and gas networks in 2002/03 was:

- electricity distribution: £209 million, compared with £141 million in 2001/02 and £94 million in 2000/01;
- electricity transmission: £49 million, compared with £38 million in 2001/02 and £30 million in 2000/01; and
- gas distribution: £40 million, compared with £3 million in 2001/02 and none in 2000/01.

Electricity distribution included spending to establish AMR of £39 million in 2002/03 compared to £29 million in 2001/02.

The summary above includes two months for Niagara Mohawk in 2001/02.

Nuclear facilities

National Grid USA no longer holds an ownership interest in any operating nuclear facility. During the past financial year, the Group sold its interests in the Seabrook Nuclear Generating Station and the Vermont Yankee Nuclear Generating Station. As part of these transactions, the respective buyers assumed the decommissioning liability for these plants. The majority of the net proceeds from the sales will be credited to customers through contract termination charges.

National Grid USA holds minority interests in three nuclear power companies (the Yankees): Yankee Atomic Electric Company, Maine Yankee Atomic Power Company and Connecticut Yankee Atomic Power Company. Each of the Yankees owns a nuclear generating unit, all of which have been permanently shut down. The company is liable for its share of the decommissioning costs of these shut down nuclear generating units. Decommissioning costs include the costs of decontaminating and dismantling the units, spent fuel storage, security, insurance and other costs. National Grid USA pays its share of these projected costs through power purchase agreements with the operators. It is permitted to recover prudently incurred decommissioning costs from its customers through contract termination charges.

Although the US Department of Energy is responsible for the disposal of spent nuclear fuel, it has not established a depository for it, nor has it estimated a date by which it will. Many utilities, including the Yankees, are plaintiffs in ongoing litigation related to the Department of Energy's failure to accept spent nuclear fuel. Any recovery from the proceedings, after litigation expenses and taxes, will be returned to customers through contract termination charges.

Fixed assets

Substantially all National Grid USA's properties and franchises are subject to the liens of indentures under which mortgage bonds have been issued. The majority of transmission lines are located on rights of way that the National Grid USA companies maintain under perpetual easements or fee ownership (freehold). Substations are principally located on properties owned in fee. National Grid USA owns in fee the offices in Westborough and Northborough, Massachusetts and in Syracuse and Albany, New York.

Other businesses

The Group has successfully exited from most of its alternative telecoms network (altnet) businesses during 2002/03. Significant progress has also been made in re-focusing the portfolio of other non-regulated businesses.

The adjusted operating profit for Group undertakings within other activities for the year ended 31 March 2003 was £117 million compared with £179 million in 2001/02 and £203 million in 2000/01. Included within the other activities are the businesses below.

Metering

Our UK Metering businesses provide installation, maintenance and meter reading services to gas shippers, including British Gas. The businesses have a national footprint and established skills in managing a large asset base and workforce.

The major focus during 2002/03 has been to respond to the challenges of competition, which is developing in the UK metering market. Currently, nearly all Britain's approximately 20 million domestic gas meters are owned by Transco, which receives revenue regulated under its price control. In the competitive market, newly installed meters are provided by the metering companies that install them.

Our priorities are to continue to provide the services for our currently installed base of gas meters, and to take advantage of the opportunities in the emerging competitive market for new gas and electricity meters.

In January 2003, National Grid Transco announced that its Metering business, OnStream, had been awarded a five-year contract with British Gas Trading (Centrica) to provide competitive metering services in four UK regions for around 11 million domestic gas and electricity customers.



Left Gridcom's towers can accommodate multiple telecommunications operators by site sharing. It actively promotes such site sharing to UK mobile operators to prevent a proliferation of masts and lessen the impact on the environment.

Gridcom

Gridcom provides communications infrastructure solutions to fibre and wireless network operators in the UK and northeastern US. In the UK, the merger of the mobile infrastructure activities of National Grid and Lattice has been successfully completed. In the US, the newly established Gridcom business and NEESCom are now operating under the same management team.

Gridcom builds, leases and operates sites for the base stations and radio masts needed by mobile operators, leveraging the Group's project management skills and electricity and gas infrastructure. In the US, it also offers dark fibre and related facilities to telecoms operators.

Demand has been depressed during 2002/03 in both UK and US markets, because of delays in the roll-out of 3G (third generation) mobile phones and the operators' major reductions in capital expenditure.

Fulcrum Connections

Fulcrum Connections was established in July 2001 in response to Ofgem's drive to introduce competition into the gas connections market. During 2002/03, it has provided gas connection services on behalf of Transco to around 130,000 new domestic and industrial consumers.

Fulcrum's short-term objectives are to improve performance against its contract with Transco in readiness for the development of competition. Transco is

working with Ofgem to remove the barriers to the development of competition in the connections market. In view of this, the management of Fulcrum has begun a programme to reduce fixed costs and improve management controls.

SecondSite Property

SecondSite Property's principal activity is the management, clean-up and disposal of surplus non-operational properties (including former Transco and National Grid sites in the UK), largely comprising contaminated former gas works. SecondSite aims to tackle the historic legacy of gas manufacture on our sites so that they can be reclaimed and returned to beneficial community use.

During the year ended 31 March 2003, SecondSite Property Portfolio Ltd disposed of 66 properties and generated £85 million in disposal proceeds, compared with 67 properties and £107 million in 2001/02 and 75 properties and £140 million in 2000/01.

Advantica

Advantica provides technology-based solutions to Transco, other utilities and pipeline operators worldwide. Following last year's acquisition of software and technology company Stoner, the company now operates in the US as well as Europe.

After a review, Advantica has been defined as non-core and its management has taken action to reduce costs, prepare the company for disposal and to seek a purchaser for the business.

Discontinued operations

Exit from altnet businesses

During 2002/03, we successfully completed our exit from a number of altnet businesses in the UK and South America – 186k, Silica Networks and Manquehue net. We reduced our interest in Energis Polska and progressed our exit from Intelig, Urband and Bulldog. We will not provide any additional funding to these businesses over and above existing provisions and remain confident that we will complete our exit from them within the provisions that we have announced.

Sales

During 2002/03, we sold The Leasing Group and put Lattice Energy Services up for sale. Connections +, which formed part of Lattice Energy Services, was sold in April 2003.



Far Left Schoolchildren visiting National Grid Company's recently renovated Bramley Frith Environmental Education Centre near Basingstoke in Hampshire, UK, where they learn about environmental issues and biodiversity. The new facilities include a number of energy-efficient features, plus offices, a library and a staff workstation.

Left Paper-making at National Grid Company's Pelham Centre for the Environment, Hertfordshire, UK. In addition to term-time visits, schoolchildren can attend holiday play schemes where activities boost their awareness of the natural world.

Operating responsibly

Achievements

- Introduction of Framework for Responsible Business
- Top quintile in BitC's 1st Corporate Responsibility Index
- Constituent of FTSE4Good and Dow Jones Sustainability Indices

In merging National Grid and Lattice we recognised that it was essential to build on the approach to corporate responsibility that both companies had been developing in recent years. In doing so, we have implemented an approach which represents a step change in how companies can operate responsibly. Our approach has gained external recognition through our listing in the top fifth of Business in the Community's (BitC's) 1st Corporate Responsibility Index and the FTSE4Good and Dow Jones Sustainability Indices.

We recognise that as one of the world's largest utilities we have long-term responsibilities that form an important part of our wish to create value for our shareholders. We believe it is important to inform our shareholders and the wider community, not just about what we do as a business but *how* we do business. In this section of the Annual Report and Accounts we include material on the non-financial components of our business. Fuller details of policies and materials referred to in this section can be accessed via our website, www.ngtgroup.com. The material in this section of the report has been independently verified by an external consultant, URS Verification Ltd, and their verification statement is published on page 110.

Our Framework for Responsible Business

Our Framework for Responsible Business (the 'Framework') defines the sort of business we are, sets the context in which we operate, and helps us achieve the right balance between economic, environmental and social factors.

We have built our Framework around three goals that clearly define our desire to be a company with a long-term future:

Sustainable growth

- We are constantly looking to expand and grow our business by transferring our skills to new markets. Growth needs to be sustainable if we are to bring long-term value to our shareholders and others.

Profits with responsibility

- For our business to be sustainable, we must be profitable. However, increasing our profitability at any cost is neither sustainable nor acceptable. We therefore have to be responsible in the way in which we generate our profits.

Investing in the future

- As a responsible business, our commercial success enables us to invest in the future in a way that benefits our shareholders, our employees, the environment and society. This investment is a reflection of our desire to be a long-term business.

Driving our governance

Achievements

- Governance approach linked to Framework for Responsible Business
- Implementation of new Group-wide policies
- Establishment of new Board Risk and Responsibility Committee

In a climate where the governance arrangements in large companies are increasingly under scrutiny, the Board has implemented a transparent approach, driven by our Framework and underpinned by a suite of policies. Our assurance processes are intended to provide the Board with a rigorous assessment of the robustness of management controls.

Our Group-wide policies

In December 2002, the Board approved Group-wide policies, procedures and an external position statement, on electric and magnetic fields, supporting key areas of

the Framework. The policies establish common principles by which we will manage these issues across all our operating businesses. Where we are involved in a joint venture, we will encourage our partners to adopt policies and practices consistent with the principles we have established.

Board Risk and Responsibility Committee

Overall responsibility for matters of corporate responsibility rests with the Board which has established the Risk and Responsibility Committee chaired by James Ross, Deputy Chairman, to ensure that these areas are reviewed in appropriate depth. The Committee has responsibility for reviewing the non-financial risks, strategies, policies, management, targets and performance of the Group, and where appropriate our suppliers and contractors, in the following areas:

- Occupational and public safety
- Occupational health
- Environment
- Equality and diversity
- Human rights
- Business ethics
- Role of the Group in society

The Risk and Responsibility Committee works closely with the Audit Committee to enable the latter to provide assurance to the Board that all risks to the Group have been thoroughly assessed and managed through sound systems of internal control. Independent external advisors support the Committee on matters of safety and the environment.

Providing assurance

Assurance is provided through a number of related routes. Central to this is the integration of risk management within the Group. Further details are provided in the section on Corporate Governance and Internal Control on page 41.

We have also established a Group-wide safety and environmental audit programme. This programme assesses the robustness of management controls

put in place to ensure our safety and environmental performance is in line with our policies. Progress in implementing this programme is reviewed quarterly by the Risk and Responsibility Committee.

In addition, the Board and the Executive Directors separately receive a monthly report on the safety and environmental performance of the businesses in the Group. This report also highlights any emerging risks where Executive action may be warranted.

At the year end, our Directors and senior managers sign a formal letter providing their personal assessment of compliance with Group-wide policies, the extent to which risks are being managed and any weaknesses in management controls that may have been identified.

A safe way of working

Achievements

- Group-wide Safety and Occupational Health policy now in place
- Independent review of safety management in all major operations completed
- Significant reduction in rate of Lost Time Injuries compared with 2001/02

We believe that safety is paramount and that all work-related injuries and illnesses are preventable. We strive to safeguard the public in all we do. A new Group-wide Safety and Occupational Health policy was approved by the Board in December 2002. The policy establishes our strategic aims and each of our businesses will be audited to ensure it is transferring the policy into practice.

Our management of safety

During 2002/03, our operations have not resulted in any fatalities to our employees or contractors, and the rate of injuries resulting in lost time has decreased by up to 46% across our major operations compared with 2001/02. However, 269 of our employees were involved in accidents which led to their taking time off work.

As with all our incidents, these are being investigated to ensure that lessons are learned and communicated throughout the Company. We monitor Lost Time Injuries across the Group and report the data monthly to the Executive Committee and Board.

We recognise that to deliver the Group goal of zero injuries we need to create a safety culture where everyone is able to challenge constructively unsafe behaviours wherever they occur.

We have audited the progress made in safety management since the review of our National Grid operations in New England and the UK by DuPont Safety Resources in 2001.

In both organisations, strong management commitment to safety has clearly been recognised by employees and improvements can be seen in most of the elements of safety management. The goal of zero injuries is widely recognised. Nearly all employees involved in the audit stated that they could influence their own health and safety and the safety of others, and that they participate in decisions concerning safety. It was concluded that the businesses need to refocus efforts in some key areas such as learning through accident investigations and reporting near misses, but that the steps taken are beginning to have a positive influence on attitudes to safety.

We invited DuPont to carry out a safety assessment on Transco in January 2003. DuPont noted a number of areas where best practice could be rolled out across other businesses and other areas where further work is required. They recognised areas of good safety governance involving employees from different staff grades and sound contractor management in our gas transmission business. The Risk and Responsibility Committee will review the progress we have made during 2003/04. DuPont will be carrying out a similar review of Fulcrum Connections' safety management systems in 2003. We are

now well placed to drive forward best practice across the Group against standard benchmark measures.

Protecting the public

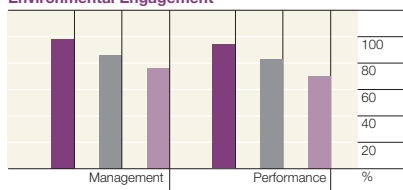
We believe safety is paramount, and we aim to safeguard the public in everything we do. We keep our approach to safe working under continuous review. We continue to invest significant capital resources in maintaining the gas distribution infrastructure in the UK. Our long-term programme aimed at replacing metallic mains with modern polyethylene pipes should reduce further the risk of gas leaks from the network. We also make significant resources available to the public in both the UK and US to explain the risks associated with both gas and electricity and to ensure the public uses both sources of energy safely.

Despite our best efforts, regrettably three members of the public died as a result of gas explosions associated with Transco's operations in the UK during the year. The verdict at the inquest into the explosion at Clitheroe on 1 April 2002 in which one person died was one of accidental death. On 3 October 2002, an explosion at West Bridgford, Nottingham resulted in the deaths of two people. HSE investigations are continuing.

In December 2002, an explosion occurred at a property in Hedgerley injuring one person. In January 2003, an explosion damaged a property in Chipping Norton. The HSE has indicated that it is minded to prosecute Fulcrum Connections following a gas explosion damaging a property in Breistfield, Yorkshire in August 2002.

As a result of a fatal accident in Larkhall, Lanarkshire in December 1999 in which four people died, the Crown Office in Scotland served an indictment on Transco in February 2003. This charges that company with culpable homicide with an alternative charge of a contravention of Sections 3 and 33 of the Health and Safety at Work Act 1974.

Results of 7th BiE Index of Corporate Environmental Engagement



© Business in the Community
 Management
 National Grid Transco
 Electricity sector
 All participants
 Performance
 National Grid Transco
 Electricity sector
 All participants

Charging the company with culpable homicide is unprecedented under Scots law and therefore before a full trial can proceed, a number of fundamental legal issues associated with the indictment are required to be resolved.

Working with contractors

Contractors are selected from an approved vendor list that requires submission to a safety and environmental review.

For the purpose of safety management, contractors are treated like, and receive safety briefings alongside, direct employees. Our contractors recognise that we have high safety standards and, especially for large projects, safety is at the forefront from tender to project completion.

We encourage the sharing of best practice between our major engineering contractors. Our UK gas transmission contractors have established a 'Pipeline construction group health and safety forum'. The forum is chaired by a director of one of the member companies.

We have, during the financial year, removed contractors from jobs because of our concerns over their ability to operate safely.

Environment

Achievements

- Group-wide Environment policy and a position statement on EMF now in place
- In 'Premier League' of 7th BiE environmental index
- Group-wide environmental audit programme implemented

As a result of the Merger we took the opportunity to review our Environment policy. It sets the principles by which we manage our key environmental risks. Our businesses differ in the impact they may have on the environment, so each is establishing a plan through which it will manage the environmental risks relevant to its operations. In March 2003, we were one of 18 companies (out of over 200)

placed in the 'Premier League' of Business in the Community's 7th BiE Index of Corporate Environmental Engagement.

Our approach to environmental management

We were not prosecuted by any environmental regulatory body for an environmental offence during this financial year.

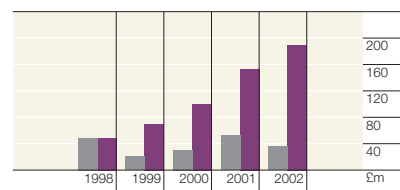
The operation of environmental management systems (EMSs) in our businesses provides the Executive Directors with direct assurance that our approach is robust and properly focused on significant environmental risks and liabilities. In the US, our New England electricity transmission system is certified to ISO 14001 and our New York electricity transmission system conforms to ISO 14001 and will receive a registration audit in June 2003. Our US electricity and gas distribution businesses have developed EMSs that conform to ISO 14001. We are evaluating the merits of seeking ISO 14001 registration for our US distribution businesses. The majority of our UK operations are certified to ISO 14001. Over 80% of our employees operate with ISO 14001 certified or compatible systems.

Electric and magnetic fields

All electrical equipment and appliances produce electric and magnetic fields (EMFs). This includes household appliances as well as the power lines used in transmission and distribution of electricity. At higher frequencies, mobile phones and the masts used for transmission also produce EMFs.

In December 2002, we published our position statement on EMFs making a clear commitment to playing a constructive and proactive role on this issue. The balance of scientific evidence indicates that EMFs do not lead to adverse health effects. However, we recognise that some people have concerns about EMFs and we make information and advice available whenever requested. We comply

UK contaminated land spend 1998 – 2002



■ Annual
 ■ Cumulative

with the standards, guidelines and regulations in force on EMFs in the countries and states in which we operate.

Contaminated land

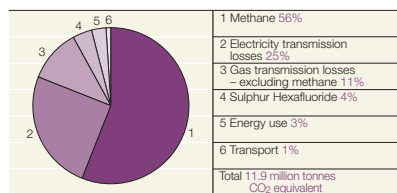
We continue to manage our inherited portfolio of potentially contaminated land. This contamination has mainly arisen from the historic manufacture of gas from coal and oil, and from older electrical substations where there is a risk that the ground may have been contaminated with oil in the past through accidental spillage or leakage from equipment. The sites of former manufactured gas plants can sometimes have a complex mix of contamination dating back to the 19th century.

In the US, we have responsibility for 135 contaminated sites and are actively conducting environmental assessments and, where necessary, remediations at more than 80 of these locations. In the last year, we have completed remediations at two sites and implemented risk reduction measures at 29 other locations. Sites are prioritised through the application of state and federal regulatory requirements, which typically focus on preventing human or environmental exposures.

In the UK, we operate one of the largest clean up programmes in the country through SecondSite Property. With around 525 sites to reclaim, not all sites can be cleaned up at once. We apply a rigorous approach to the identification, assessment, control and remediation of these sites. SecondSite Property, therefore, sets its priorities with care, following a national approach presented to the Environment Agency and communicated to the relevant local authorities. We continue to give priority to addressing statutory obligations on our sites and seek agreement with environmental regulators on standards and timetables. Over the past five years, we have spent £190 million on site clean up in the UK.

Over the past year, we have completed remediation work at 32 sites in the UK.

Sources of greenhouse gas emissions



Indicative breakdown based on a combination of calendar and financial year data. Source data collated and verified by AEA Technology plc.
Electricity transmission losses exclude New York operations.

Climate change

We actively manage our activities to reduce their impact on climate change.

Across our operations the largest source of greenhouse gas emissions is methane leakage from the Transco distribution network. Most leakage is associated with the joints on older cast iron parts of the low pressure gas network. Cast iron currently makes up 37% of the distribution system and, as this pipe is replaced by polyethylene, the level of methane emissions will be gradually reduced.

Methane emissions arising from leakage and venting from our UK and US gas networks account for approximately 56% of our greenhouse gas emissions. A detailed analysis of our greenhouse gas emissions is available on our website.

Sulphur Hexafluoride (SF₆) is an extremely effective electrical insulant and has very significant advantages over alternative materials. It is non-flammable, a critical requirement in the high-voltage applications for which we use it, and because of its effectiveness, takes up less volume than an equivalent insulating volume of an oil alternative. We have some 431 tonnes of SF₆ in our electrical equipment and until a new proven technology becomes available our use of this material will continue. Equipment filled with SF₆ can leak and requires replacement. We estimate that the loss of SF₆ to the atmosphere over the last year was 21.6 tonnes, equivalent to approximately 517,000 tonnes CO₂. Through monitoring SF₆ losses we are able to prioritise our repair programme.

While not a significant contributor to our overall greenhouse gas emissions inventory, we consider transport to be a key sustainability issue of strategic and operational importance. During the year, our fleet mileage (including contractor movements for SecondSite Property) was approximately 211 million miles, equivalent to 47.7 million litres of fuel. We encourage our businesses to consider actively the

alternatives to business travel, such as videoconferencing and teleconferencing. Both these technologies are applied widely across the Group. Our total mileage was equivalent to some 143,000 tonnes CO₂.

Our people

Achievements

- Group-wide Human Resources policy now in place
- Whistleblowing policy and arrangements in place
- Group intranet site launched

We have reviewed our Human Resources policies and condensed them into a high level Group-wide policy. We aim to foster a learning environment where all our employees can realise their full potential. Each business is updating procedures to cover the areas of Diversity, Learning & Development, Performance Management, Reward Framework, Recruitment & Selection and Flexible Working. Whilst achieving the standards set in the Group policy, these procedures will reflect local cultures and practices.

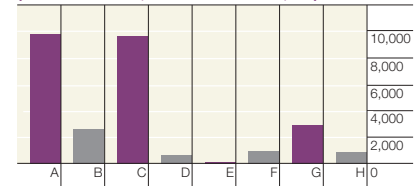
We have established, through e-mails, intranets, cascade briefings and in-house magazines, effective methods for communicating with employees on matters of concern to them. Regular consultation with staff and their trade union representatives takes place using both formal and informal mechanisms.

Restructuring our business

Prior to the Merger, both National Grid and Transco were undergoing substantial restructuring. Alongside this, as part of the Merger process, we have combined our Corporate Centres, and our UK operational headquarters. As stated in our Framework, we wish to ensure we have the right number of people to deliver our business in the long term. Throughout this process, we have consulted with trade union representatives and our employees and we aim wherever possible to achieve redundancies through early retirement or voluntarily.

People working in our businesses

(Total headcount, 31 March 2003: 27,308)



A National Grid USA 9,720
B Transmission UK 2,567
C Distribution UK 9,568
D Gridcom 619
E SecondSite Property 94
F Fulcrum Connections 948
G Other corporate activities and UK services 2,916
H Businesses for sale 876

In the US, restructuring as a result of the merger between National Grid and Niagara Mohawk in 2002 was accomplished using a competency-based selection model. Employees were assessed on eight competencies that closely aligned with our US business objectives and company values. Displaced employees were provided with comprehensive outplacement assistance.

Ethical standards

National Grid USA's existing Standards of Conduct will be matched by a UK Code of Conduct. These document our employees' responsibilities with regard to ethical and legal issues. We provide our employees with a confidential helpline through which they can discuss any concerns or report behaviour that does not align with our standards.

Our US Ethics Office has responsibility for answering questions about the Standards of Conduct, receiving and evaluating reports of misconduct and ensuring that allegations are fully and promptly investigated. We aim to adopt this approach in the UK.

Equality and diversity

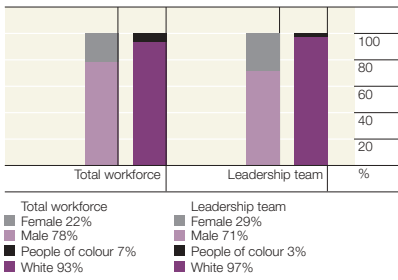
We are committed to being an equal opportunity employer, encouraging diversity and avoiding any discrimination on the grounds of race, colour, religion, political opinion, nationality, gender, disability, sexual orientation, age, social status and origin, indigenous status or other status unrelated to the individual's ability to perform his or her work.

We are currently considering the reporting processes that will enable us to ensure our approach to equality and diversity is operating in practice.

Employee share ownership

We encourage share ownership among our employees as a means of aligning employee and shareholder objectives. We operate a Sharesave Scheme in the UK. Approximately 81% of eligible employees participated in the scheme in 2002.

Equality and diversity



Left In a pilot project with the children's charity NCH, National Grid Transco Foundation aims to raise the educational achievements of young people in care. At an NCH Family Centre in London, the Foundation has installed self-contained learning workstations for cared for children.

Approximately 84% of US employees are investors in the Group through the employee incentive thrift plans.

Working with others

Achievements

- Helped our customers save 2 billion kWh of electricity in the US
- 74,500 children visited our environmental centres
- 40% reduction in complaints received from Transco's consumers

National Grid Transco has a diverse range of external stakeholders including customers, consumers, suppliers, contractors, Government, non-governmental organisations, regulators, grantors and action groups. In our dealings with external audiences we strive to be open and constructive. In this section, we report on how we have developed our relationships with a number of these key audiences over the past year.

Our customers

In the US, we work closely with our customers to improve their energy efficiency and five of the programmes offered by our New England electricity distribution companies were among the 31 nominations selected as the nation's best by the American Council for an Energy-Efficient Economy. The programmes were recognised for their effectiveness and innovation in helping customers achieve greater levels of energy efficiency in their homes, businesses and facilities. During 2002, National Grid USA's customers have saved more than 2 billion kWh of electricity as a result of participating in these programmes.

In the UK, Transco has continued to focus on service delivery to the 21 million gas consumers. Throughout 2002, Transco has surveyed and measured consumer views on its key consumer products and services. This indicates that consumers are generally satisfied with the quality of service being provided. The introduction of a complaint management improvement

package, supported by information from the consumer satisfaction programme, has continued to support our focus on reducing levels of complaints received from consumers.

Our suppliers

As a Group with a capital programme of over £1.5 billion we recognise the positive impact that good procurement practices and standards can have on the quality of our supply chain. We aim to create strategic supplier relationships. These provide the opportunity to work with suppliers to improve their performance and provide key suppliers with an appreciation of our business needs, while maintaining or improving safety standards. The safety, health, environmental and quality performance of suppliers is considered as part of the tendering process. Where possible we aggregate and maximise our Group-wide collective buying power. In 2002/03, savings of some £17 million and £10 million were achieved in our supply chain in the UK and US respectively.

Governments

We engage actively with the Governments in our countries of operation. Over the past year in the UK we have provided written and oral evidence to a number of Commons Select Committees on subjects such as: 'Towards a non-carbon fuel economy'; pre-legislative scrutiny of the Electricity (Trading and Transmission) Bill; and the Impact of Streetworks legislation. In addition, pre-Merger, both National Grid and Lattice provided submissions to the UK Government Review of Energy Policy and hosted an industry conference to discuss infrastructure and security of supply issues.

Local communities

We believe it is possible to create both shareholder value and social value – these aims need not be in conflict. We place great emphasis on the relationships we have with the local communities we serve and the wider social needs of the societies in which we operate. Investing in projects that have a social value is important to the

Group but we are not able to support all the projects and programmes proposed to us. The principal focus of our investment is on three themes:

- Regenerating local communities
- Improving the environment
- Education and skills

Following the Merger, we undertook a review of our community investment in the UK against our three themes to ensure the balance of activities is appropriate for the new Group. The US community investment programme will be reviewed against the three themes over the coming year.

In the UK, we have established the National Grid Transco Foundation as a focus for bringing our business expertise, knowledge and resources to bear on pressing social and environmental issues faced by communities throughout the UK. It is also the vehicle through which our UK employees can become actively involved in working in partnership with communities and voluntary organisations at local, regional and national levels.

During 2002/03, we invested about £5.5 million and about £3.4 million respectively in the UK and US in our community investment programmes.

Grantors

The continued safe and reliable operation of a national infrastructure, such as the electricity transmission network in England and Wales, involves maintaining good working relationships with the owners and occupiers of land on which our assets are installed and over, or under, whose land our lines cross. The owners and occupiers provide us with rights to enable us to operate, inspect, maintain, repair, replace and remove our equipment. We have more than 19,000 different land owners and occupiers throughout the country – whom we call 'grantors'. We provide a point of contact for all grantors and our quarterly grantors newsletter 'Gridline' provides them with timely and relevant information.