nationalgrid

National Grid
Gas Transmission (TO)

Regulatory Financial Performance Report Narrative for 2019/20

August 2020

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National Grid Gas Transmission (TO) RFPR submission narrative – 2019/20

Introduction

The main purpose of this report is to provide a useful summary of National Grid Gas Transmission's (NGGT) financial and operational performance and represents 'Year 7' of the eight- year RIIO regulatory period. This report will explain the Enduring Value Adjustments and their impact on RIIO Financial Performance, provide statements that the appropriate level of data assurance has been met and explain any material changes in performance when compared to the 2018/19 submission.

This narrative supports the submission of the NGGT Transmission Operator (TO) Regulatory Financial Performance Reporting (RFPR) pack. Given the current requirements of the Regulatory Reporting Pack (RRP) narratives overlap with those of the RFPR narrative, published Cost & Outputs RRP narrative is referenced to avoid duplication.

RoRE

Overview

The Return on Regulatory Equity (RoRE) figure is a key measure by which Ofgem compares operational and financing performance across Network Operators (NWOs). This encompasses the costs and allowances associated with a RIIO regulated business, including Totex, financing, tax, incentive performance and company funded innovation costs. A key concept in the RoRE calculation is enduring value. This aims to show the full value the regulated company has earnt during the price control period and therefore adjusts for allowances and incentives that are not related to T1 performance and known true-ups that will impact T1 performance during the T1 close out process.

NGGT (TO) RoRE on a notional basis

(2009/10 Price base)

The overall NGGT (TO) RoRE across RIIO-T1 is 6.66%, a decrease of 0.51%. This is due to a decrease in post-tax financing performance. The change in post- tax financing performance is primarily due the impact of closing the gap between actual and the notional gearing level.

The T1 operational RORE has decreased marginally from 6.07% to 6.04%, this is driven by the marginal decrease in Totex performance with Enduring Value adjustments applied. Further detail on Totex performance is detailed below.

	2019/20	2018/19
Operational RoRE	6.04	6.07
Financing and tax	0.61	1.09
Total RoRE	6.66	7.17

Revenue

(2019/20 Price base)

The Maximum Allowed Revenue (MAR) for NGGT TO in 2019/20 is £706m and is based upon the Revenue RRP. Break down of NGGT TO MAR is provided in the below table.

Licence Term	2018/19 (18/19 Price Base £m)	2018/19 (Restated to 19/20 Price Base £m)	2019/20 (19/20 Price Base £m)	Commentary for year on year variance (Commentary in 19/20 price base unless otherwise stated)
Base Revenue (BR)	688.6	711.6	695.0	• (£7.0m) decrease in opening base revenue (PU) allowances. • (£15.5m) decrease in MOD. Detailed MOD commentary included in **Final Proposals base revenue against adjusted base revenue** section. • +£5.8m relating to TRU in 2019/20 as a result of the movement between forecast and actual RPI in 2019/20 compared to the movement in 2018/19.
Pass Through (PT)	4.7	4.8	(4.2)	• Business rates, licence fees and policing costs are trued up against the ex-ante allowances with a two year lag. The value from 2018/19 to 2019/20 has decreased by £8.9m. • Independent systems costs are trued up within year. The true up value increased by £0.5m between 18/19 and 19/20.
Incentives (OIP)	6.2	6.4	3.7	• The 2019/20 incentive includes the Customer and Stakeholder Satisfaction Incentive and Stakeholder Engagement Reward for 2017/18 performance. The incentive revenue has decreased since 18/19 by £2.7m
Network Innovation Allowance (NIA)	4.2	4.3	4.3	• NIA costs have increased slightly on a year on year basis, due to an increase in the number of sanctioned innovation projects through 19/20.
Network Innovation Competition Funding (NICF)	15.4	15.9	13.8	• As per the Ofgem direction, the NICF revenue term has decreased by £2.1m (19/20 price base) compared to 2018/19. This year funding has been awarded to Cadent (£13.3m) and SGN (£0.5m).
PARCA (PTV)	-	-	-	• The PTV term has been removed from the Revenue RRP and PARCA costs will be retrieved as part of the Base Revenue calculations in the PCFM.
Correction Term (-K)	(11.0)	(11.3)	(6.4)	• The correction term in 2019/20 is based on the £6.2m over-collection of revenue in 2017/18 (as reported in the 2017/18 submission) and subsequently uplifted as per the licence algebra requirements to £6.4m
Maximum Allowed Revenue	**708.0**	**731.7**	**706.0**	

The MAR compares to Collected Revenue of 690.3m, resulting in an under-recovery of £16m. The under recovery was driven by a decrease in volumes offset partly by favourable exit prices. The below table details the forecast MAR used to set charges and the final MAR against collected revenue.

Charge period	**MAR £m**	**Commentary**
April 2019 Charge Setting Statement (Forecast)	704.6[1]	MAR forecast figure for charge setting
October 2019 Charge Setting Statement (Forecast)	705.8[2]	Minimal variance compared to first charge setting driven by higher NIA.
July 2020 RRP submission	706.0	Marginal increase driven by update to final passthrough expenditure data.
Charge period	**Collected Income £m**	**Commentary**
July 2020 RRP submission	690.3	£15.8m Under-recovery due to reduced gas capacity prices.

Reconciliation to statutory accounts

The reconciliation to Statutory Accounts is based on our underlying accounting records, which report revenues separately between reported operating segments. They likewise hold separate information in the case of the TO and SO, which are reported under the same segment within our statutory accounts. As such the reconciling items disclosed in the table are sourced from our accounting records with no specific allocation or methodology adjustments for the RFPR tables.

The change in accounting standards to IFRS 15 *Revenue from Contracts with Customers* was implemented in 2018/19 and reduces statutory revenue for NGGT (TO) in 2018/19 and 2019/20. This created an additional reconciling item between statutory and collected revenue and a reduction in statutory revenue for agency income and a change in timing of revenue recognition for connections and diversions.

Totex Performance

(2019/20 Price base)

Overview

Per the Cost & Outputs RRP20 submission, the Totex forecast for the eight year T1 period is £2,442m compared to allowances of £2,077m, resulting in an underperformance of £365m. T1 Totex has decreased by £59m and allowances have decreased by £42m compared to RRP19 meaning overall forecast T1 performance has improved by £17m compared to RRP19 without the application of

[1] April 2019 Charge setting Statement: Charging Information Provision - April 2019 Final https://www.nationalgrid.com/uk/gas-transmission/charging/transmission-system-charges (Published 1 Feb 2019)

[2] Oct 2019 Charge setting Statement: NTS Charge Setting Information October 2019 Final: https://www.nationalgrid.com/uk/gas-transmission/charging/transmission-system-charges
(Published 1 Aug 2019)

Enduring Value adjustments. The key changes to our allowances and the spend changes are listed below:

Totex Forecast:

- Baseline Capex spend over the eight-year RIIO-T1 period has reduced by £61m, primarily due to a reduction in asset health spend (£50m) and emissions (£18m) offset by increases in Non Operational capex (£1m) and Pipelines (£6m).
- Uncertainty Capex has decreased by £15m, primarily due to decreased spend on Feeder 9.
- Controllable Opex has decreased by £7m, primarily due to a decrease in Closely Associated Indirect spend (£23m) and Faults (£1m) largely offset by an increase in Business Support costs (£2m), planned inspections (£4m) and a pensions adjustment from FY19 (£11m).

Allowances:

Where allowances are to be agreed, the assumption is that allowance is equal to spend.

- In 2018/19 we forecast additional IED allowances of £53m for Hatton and St Fergus. Following Ofgem's decision on the needs case in November 2019, this has been reduced to £9m. This reflects the decision not to approve the need case for St Fergus, and whilst for Hatton the assumption used is that allowance is equal to spend.
- There has been no change to the allowances forecast for Pipeline Diversions (£11.5m).
- Our forecast allowance for Enhanced Physical Site Security includes a return of £24m but a request for an additional £7m for specific sites which is a net decrease of £17m. This broadly aligns to 2018/19.
- There have been no changes to forecast Quarry & Loss allowances since last year's submission.

Further break down of Totex performance can be found in the Performance Summary in the Cost & Outputs RRP narrative.

Totex Table

The R4 Totex table begins with Totex forecasts per the Cost & Outputs RRP in row 12 and 40 and Allowances per the latest published PCFM (November 2019) in row 13 and 41.

Enduring Value adjustments

A number of Enduring Value adjustments are applied to the performance from the Cost & Outputs RRP to give a more accurate view of T1 performance, the methodologies are explained below. The lettering references those within the R4 Totex tab.

a. Allowances in RRP:
   This adjustment aligns PCFM allowances with those included in the Cost & Outputs RRP. The following allowance assumptions are included within the Cost & Outputs RRP and are explained in more detail above:
   - Additional IED allowances for Hatton of £9m
   - Additional Pipeline Diversion allowances of £11.5m

- Return of Enhanced Physical Security allowances £17m. 15% of Enhanced Physical Security allowances are recategorised from Capex to Opex to reflect the 2015 Reopener decision.

b. Peterborough and Huntingdon:
NGGT compressor emissions compliance work at Peterborough and Huntingdon are continuing, however the programme of works has been impacted by COVID-19 working restrictions. There have also been important contractual developments, resulting in the mutually agreed exit from the contract with the Main Works Contractor, which NGGT believe is in the best interest of both parties and the consumer. An adjustment has been included to reflect the uncertainty around site works and potential delays into T2.

c. IED allowances recategorisation:
This adjustment moves IED allowances from Non uncertainty to Uncertainty in order to align the PCFM with the Cost & Outputs RRP.

d. Rephasing adjustments:
We re-phase allowances compared to those in the PCFM. This better matches allowances to the level of incurred or forecasted expenditure, providing a more accurate view of in-year performance. We have presented the impact of the re-phasing allowances the R4 Totex tab. This is appropriate as re-phasing does not affect the overall level of allowances recognised over the RIIO-T1 period, thus does not materially impact the RoRE.

Output Incentive Performance

NGGT has one Output incentive relating to Customer Satisfaction. This is supported by two separate elements of financial incentive:

- Customer and Stakeholder Satisfaction survey (CSAT/SSAT); and
- Stakeholder Engagement incentive scheme (SER).

This year NGGT have continued to apply successful actions to improve response rates and achieved a significant increase from previous years. NGGT CSAT response rate increased to 49% from 34% last year, and our SSAT increased to 56% from 37%. The overall volume of responses was 91 in CSAT, down from 126 in 2018/19 and 98 in SSAT, down from 160 in 2018/19.

Customer Satisfaction Survey

In 2019/20, NGGT achieved a customer satisfaction score of 8.00 against a baseline of 6.90. This has increased by 0.21 since last year’s score of 7.79 and NGGT have achieved a steady year on year increase in customer satisfaction since 2017/18, whilst continuing to engage with a broad range of customers.

In response to customer feedback in 2018/19, NGGT Customer Experience Governance Board sponsored a new agile sprint approach for initiating solutions to underlying issues raised.

Stakeholder Satisfaction Survey

The stakeholder satisfaction score was 8.40 against a baseline of 7.40, an increase of 0.32 from the 2018/19 score of 8.08. NGGT have achieved a significant increase in stakeholder satisfaction this year reflecting the improvement of services across all GT areas and our increasing stakeholder engagement.

Stakeholder Engagement

During 2019/20, NGGT created a company-wide stakeholder engagement strategy and delivery plan that addresses all aspects of how it can effectively manage activity fit for RIIO-T2 business plan execution and beyond. From process design, capability and the skills required, to the systems and data management practices that will enable it, so that it is fit for future. The Stakeholder Engagement incentive (SER) for 2019/20 has not yet been directed.

Forecast Incentive Performance

Forecast output incentives are assumed to be an average of the actual earned incentives in T1 to date. This methodology is used across both the TO and SO.

Innovation

(2019/20 Price base)

Alongside new and innovative ways to maintain and operate the network, NGGT's innovation in 2019/20 has focused on projects that can facilitate the target of 'Net Zero by 2050' and provide a safe, reliant and efficient decarbonised energy system for the future that delivers value for customers. In December 2019, NGGT submitted its Innovation RIIO-T2 Strategy setting out its vision to "innovate to create your network of the future and facilitate UK decarbonisation". NGGT have also recently updated the Gas Network Innovation Strategy in March 2020, alongside the ENA and other network operators.

Network Innovation Allowance (NIA)

Eligible NIA Expenditure is the net costs per 2019/20 Cost & Outputs RRP. This includes internal expenditure but excludes Bid Preparation Costs for the Network Innovation Competition Fund. In line with NIA Governance, Eligible NIA Expenditure is reported net of external funding. In 2019/20 the Gas Transmission Owner spent £4.8m on 31 NIA projects compared to its allowance of £4.9m. NIA annual summaries are published on the National Grid Gas website[3].

Network Innovation Competition (NIC)

The 2019/20 NIC funding was directed by Ofgem on 11 January 2019, NGGT was awarded no funding. In 2019/20 there was no spend on the CLoCC or GRAID projects as they were successfully completed in 2018/19. NGGT was awarded 100% of the Successful Delivery Reward Criteria (SDRC) £1.2m for CLoCC and GRAID.

[3] https://www.nationalgridgas.com/insight-and-innovation/transmission-innovation/network-innovation-allowance-nia

Financing and Net Debt Position

(2009/10 Price base)

Overview

Overall assumed regulatory finance cost at actual gearing for T1 is forecast at £355.2m (including adjustments to be applied for performance assessment), this compares to allowances for the same period of £462.7m thus resulting in £107.4m performance on an actual gearing basis.

On a notional basis, assumed regulatory finance cost for T1 is forecast at £407.3m (including adjustments to be applied for performance assessment) resulting in £55.3m performance at notional gearing. The post-tax view of this performance is £41m

Financing allowance

The financing allowance has decreased by £0.2m from £462.9m to £462.7m.

Financing

(Nominal Price base)

Financing costs per regulatory definition have decreased year-on-year by £13m to £165.8m in 2019/20.

Net debt and derivatives

(Nominal Price base)

Regulatory net debt as at 31st March 2020 has increased by £900.5m to £3,788.2m compared to 31st March 2019. This increase is due mainly to the dividing during 2019/20 (see R11 Dividends tab).

External borrowings increased by £232.6m. Any natural maturities in year were offset by the issue of additional debt. External loans and Finance leases increased by £29.5m, driven by IFRS 16 Right of Use Lease Liability where an additional £15.8m was recognised in 2019/20. Currency SWAPs reduced by £68.6m, interest rate swaps reduced by £4.8m and inflation linked swaps increased by £7.6m.

Changes in assumptions and methodology from 2019

Ofgem methodology for inflation assessment

Ofgem have changed the methodology for inflation element of the interest charge and therefore the formula within table R7, row 37, *Less inflation in interest charge* has been updated. This has resulted in a change in Debt performance within the RORE for all years.

Forecasting methodology

There have been no changes in assumptions and methodology in 2020.

IFRS 16 Right of Use Leases

National Grid adopted IFRS 16 *Right of Use Leases* in 2019/20, hence appears for the first time in the External Loans and Finance Leases table on table 8a (reference B2.4).

National Grid view of financing performance

The RFPR calculation is based on Ofgem's regulatory definition of net debt and financing costs. This includes gains and losses on derivatives. In our view, financing performance should not include derivatives as it is shareholders, not consumers, that bear the costs and risks associated with derivatives. This view aligns with the principle of the financing allowance under RIIO-T1, which does not fund networks for derivatives, instead using a historic tracker to set the allowance.

RAV

(2009/10 Price base)

The RAV table utilises the PCFM published in November 2019 to calculate the adjusted RAV balances. The Opening RAV, Transfer, RAV for net additions (after disposals) and Depreciation lines are based upon the 2019 PCFM updated with Totex per the Cost & Outputs RRP submission.

To calculate the impact of Enduring value adjustments and updates to Totex and allowances, the 2019 PCFM is updated to include; Totex actuals and forecasts per the Cost & Outputs RRP, forecast allowances per Cost & Outputs RRP and Enduring Value adjustments. The enduring value adjustments are explained in the Totex Performance section above.

The closing RAV in 2021 has reduced by £2m from £4,570m in RFPR 2019 to £4,568m in RFPR 2020, reflecting the change in performance since last year's submission.

Tax

(2009/10 Price base)

The forecast tax allowance for 2019/20 is £18.6m and forecast tax performance is -£2.4m at actual gearing and -£0.6m at notional gearing levels. Consistent with prior years, the primary driver of the tax performance is the level of financing performance.

The cumulative tax performance at notional gearing is 0.4% for the period through to 2020 and 0.3% over the RIIO T1 period (0.3% and 0.2% respectively at actual gearing levels).
This performance is primarily a result of the 'dead-band' benefit received on lower corporation tax rates, partially offset by forecasting variances, including capital allowance rate changes.

The allocation of the NGGT tax attributable to TO and SO is in line with the allocations used within our underlying accounting systems and is reflected in the Statutory Accounts. There are no specific allocations made for the RFPR tables.

The forecast tax allowance is derived from the PCFM after applying the enduring value adjustments detailed in R4 Totex.

Dividends Paid and Current Policy

(2019/20 Price base)

National Grid PLC's approach to dividend policy is to make distributions which align with regulatory target capital structures taking into consideration credit metrics and medium term cash requirements.

The Board approved a Final Dividend £1,047m paid in July 2019. £18m of this is attributed to the Gas System Operator. Due to a change in timing of dividend calculations, no dividend was payable in 2018/19.

Pensions

Pension deficit payments were broadly in line with the prior years. The pension scheme valuation is performed tri-annually, the valuation presented in the 2019/20 RFPR is therefore the same valuation as that presented for 2018/19. The next scheme valuation is due during 2020/21.

Data Assurance Statement

The RFPR submissions have been completed in line with the Ofgem Data Assurance Guidelines (DAG) process. This mandates a fully documented 2 level review process. The overall submission and regulatory judgments have been signed off at Director level.

In summary, the following assurances were completed:

1. Assurance Template completed by Data Provider
2. First Level Reviewer
3. Second Level Reviewer
4. Independent Expert Reviewer/ Internal Data Audit
5. Manager & Senior Manager
6. Director Sign Off

Appendix

Comparison to prior year RoREs

The table below compares the T1 RoRE at notional gearing presented in our 2019/20 RFPR submission to the 2018/19 RFPR submission. The T1 operational RORE has decreased marginally from 6.07% to 6.04%, this is driven by the marginal decrease in Totex performance with Enduring Value adjustments applied. Incentive and innovation performance remains static over the T1 period. The decrease in financing performance is as a result of an increase in forecast T1 financing costs. There has been marginal change in T1 tax performance compared to the 2018/19 submission

	2019/20 RoRE per RFPR %	**2018/19 RoRE per RFPR %**
Allowed return	6.80	6.80
Totex	(0.99)	(0.97)
IQI	(0.06)	(0.06)
Incentives & Innovation	0.30	0.30
Operational performance	**6.04**	**6.07**
SO performance	N/A	N/A
Financing	0.32	0.69
Tax	0.29	0.40
Total RoRE %	**6.66**	**7.17**

Table Changes / Restatements

Data tab

Within the Data tab National Grid has updated row 39 MR New Forecasts RPI per the May 2020 publication and cells E24 and F24 per Ofgem's request.

National Grid has also updated the Cost of Debt allowance in 2021 on rows 66 and 68 to reflect the correct values per the PCFM.

R2 Revenue

The 2018/19 MAR value has been restated from £709m to £708m, this is because in 2019 an incentive was unknown and therefore based on forecast (Stakeholder Engagement Reward), the incentive value is now known (directed in November 2019) and has been updated within R5 Outputs incentive table.

R5 Output Incentives

The Stakeholder Satisfaction Output incentive values earnt from the reporting year 2016/17 have changed due to interest rate variations, this has less than a 0.2% impact on RORE. The 2018/19 Stakeholder Engagement Reward values was not directed until November 2019, as noted above, hence was previously based on forecast.

R5 Innovation

In our 2018/19 submission we incorrectly reflected company compulsory contribution on the Unrecoverable Expenditure line, this has now been corrected.

R7 Financing

Formula error corrected as requested by Ofgem. Old, incorrect formula:

Cell D37 = ('R8 - Net Debt'!D54-AVERAGE('R8 - Net Debt'!D8,('R8 - Net Debt'!E10-'R8a - Net Debt input'!T18)))*(Data!C36-1)

Correct updated formula:

Cell D37 =('R8 - Net Debt'!D54-AVERAGE('R8 - Net Debt'!D8,('R8 - Net Debt'!D10-'R8a - Net Debt input'!T18)))*(Data!C36-1)

R10 Tax

The 2016/17 Tax liability per latest CT600 has been restated this year from -£25.9m to -£23.2m due to a genuine revision of the CT600 in relation to that year.

In previous RFPR submissions, an adjustment was included within the table to remove tax relating to GSO incentives, this was an oversight as the tax on incentives is already included within the 'GSO Liability' line, the tables have been updated to correct this.