

National Grid Gas Transmission System Operator Regulatory Financial Performance Report Narrative for 2020/21

July 2021



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National Grid Gas Transmission (SO) RFPR submission narrative – 2020/21

Introduction

The main purpose of this report is to provide a useful summary of National Grid's Gas System Operator financial and operational performance and represents 'Year 8' of the eight-year RII01 regulatory period. This report will explain the Enduring Value Adjustments and their impact on RII01 Financial Performance, providing statements that the appropriate level of data assurance has been met and explain any material changes in performance when compared to the 2019/20 submission.

This narrative supports the submission of the National Grid Gas Transmission (NGGT), System Operator (SO) 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.

As per the RFPR Regulatory Instructions and Guidance (RIGs)¹, the following sections are not required for input and thus have not been published or commented on within this narrative.

- R1 – RORE
- R6 – Innovation – Total NGGT (TO+SO) Innovation is reported within the NGGT TO RFPR
- R7 – Financing - The SO element is an allocation of TO net debt and financing cost and is reported in the TO RFPR
- R8 – Net Debt - The SO element is an allocation of TO net debt and financing cost and is reported in the TO RFPR

The required sections are the following:

- R2 – Revenue
- R3 – Rec to Totex
- R4 – Totex
- R5 – Output Incentives
- R9 – RAV
- R10 – Tax
- R12 – Pensions
- R13 – Other Activities

¹ https://www.ofgem.gov.uk/sites/default/files/docs/2021/05/rfpr_-_regulatory_instructions_and_guidance_version_3.0.pdf

Revenue

(2020/21 Price base)

The Maximum Allowed Revenue (MAR) for 2020/21 is £220.8m and is based upon the Revenue RRP. A full break down of NGGT SO's MAR as per the Revenue RRP narrative is provided in the below table:

Licence Term	2019/20 (2019/20 price base)	2019/20 (Restated to 2020/21 Price Base £m)	2020/21 (2020/21 price base)	Commentary for year on year variance (Commentary in 2020/21 price base unless otherwise stated)
Base Revenue (SOPU)	140.9	143.2	109.1	<ul style="list-style-type: none"> • (£1.3m) decrease in opening base revenue allowances (SOPU). • (£32.4m) decrease in MOD. Detailed MOD commentary is included in Final Proposals base revenue against adjusted base revenue section. • (£0.4m) relating to TRU in 2020/21 as a result of the movement between forecast and actual RPI in 2020/21 compared to the movement in 2019/20.
Constraint Management (CM)	14.1	14.3	12.9	<ul style="list-style-type: none"> • The 2020/21 revenue includes the cost adjustment of (£38.5m) plus incentive revenue of £15.5m for 2018-19 performance. • Above values are quoted after WACC and RPIF uplifts have been applied. • The cost adjustment and incentive revenues are subject to a two-year lag from the year of performance. <p><i>Further detail on approach for Constraint Management within RFPR is provided in the Output Incentive section of this narrative.</i></p>
Transportation Support Services (TSS)	(5.9)	(6.0)	(3.0)	<ul style="list-style-type: none"> • The 2020/21 revenue does not include any ex-ante allowance. The cost adjustment is (£5.4m) plus incentive revenue of £2.4m for 2018/19 performance. • Above values are quoted after WACC and RPIF uplifts have been applied. • The cost adjustment and incentive revenues are subject to a two-year lag from the year of performance.
Incentives (SOOIRC)	106.6	108.4	89.8	<ul style="list-style-type: none"> • Further detail on incentive costs and performance is included below.
Correction Term (-SOK)	(12.3)	(12.5)	12.0	<ul style="list-style-type: none"> • The correction terms in 2020/21 is based on the £11.6m under-collection of revenue in 2018/19 (as reported in the 2018/19 submission) subsequently uplifted as per the licence algebra requirements to £12.0m.
Maximum Allowed Revenue	243.4	247.4	220.8	

The MAR compares to collected revenue of £224.2m. The over-collection is mainly due to an increase in revenue from the sale of Exit Capacity and from associated SO charges.

Charge period	MAR £m	Commentary
April 2020 Charge Setting (Forecast)	223.8 ²	MAR forecast figure for charge setting
October 2020 Charge Setting (Forecast)	216.3 ³	Change due to a decrease in forecast of SO External Cost Incentive, primarily Residual balancing costs.
July 2021 RRP submission	220.7	Change due to an increase in final Shrinkage costs and an increase in External Incentive performance compared to the forecast at October charge-setting, hence more in line with original April forecast.
Charge period	Collected Income £m	Commentary
July 2021 RRP submission	224.2	£3.5m Over-recovery due to an increase in revenue from the sale of Exit Capacity and from associated SO charges.

Reconciliation to statutory accounts

The reconciliation to Statutory Accounts is based on 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 the statutory accounts. As such the reconciling items disclosed in the table are sourced from NGGT SO's 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 has reduced statutory revenue for NGGT SO from 2018/19 onwards. 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.

² April 2020 Charge setting Statement: Charging Information Provision - April 2020 Final <https://www.nationalgrid.com/uk/gas-transmission/charging/transmission-system-charges> (Published 31 Jan 2020)

³ Oct 2020 Charge setting Statement: General Non Transmission Services Revenue Model: <https://www.nationalgrid.com/uk/gas-transmission/charging/transmission-system-charges> (Published 29 Aug 2020)

Totex Performance

(2020/21 Price base)

RRP21 Performance Overview

Per the Cost & Outputs RRP21 submission, the overall NGGT SO Totex costs for the RIIO1 period are £788.3m against allowances of £889.9m, resulting in an overperformance of £101.6m. The main areas of difference compared to RRP20 are:

- Capex – NGGT SO have spent £64.9m less than allowances as a result of lower spend on Xoserve and Telemetry separation. The lower Xoserve spend is driven by a change in strategy for Gemini investment and a lower level of EU driven Gemini change work.
- Opex – the underspend to allowances for Opex of £36.6m is largely driven by a higher proportion of Xoserve allowances being allocated to direct Opex following the outcome of the review of agency costs.

Compared to the performance of £100.2m in Cost & Outputs RRP20, the movement has been marginal:

- With Capex, NGGT SO performance compared to last year has reduced by £4.4m, with an increase in forecast spend. This is mostly offset by Opex where NGGT SO performance has improved compared to last year by £4.5m, with a decrease in forecast spend.

Further break down of Totex performance can be found in the Performance Summary in the Cost & Outputs RRP narrative. No additional judgments have been included within the RFPR tables that impact Totex performance.

R4 Totex Table

The R4 table begins with Totex forecasts per the Cost & Outputs RRP in rows 12 (non-uncertainty rate) and 40 (uncertainty rate) and Allowances per the Legacy MOD1 PCFM agreed with Ofgem on 2nd July 2021 in rows 13 and 41.

Enduring Value adjustments

(09/10 Price base)

There are three enduring value adjustments;

- a) Allowance Rephasing Adjustment:
NGGT SO 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. This is appropriate as re-phasing does not affect the overall level of allowances recognised over the RIIO1 period.
- b) Recategorise Central Agency Allowances:
This moves allowances from Uncertainty rate to Non-uncertainty rate in order to align with spend categorisation within the Cost & Outputs RRP.

c) 2020/21 Pension Deficit Adjustment:

During 2020/21, a pension deficit contribution (£9.3m) was paid into the NGUK Defined Benefit Pension Scheme in-line with the agreed deficit recovery plan. The 2020 Pension Deficit Allocation Methodology (PDAM) calculation allocates the entire contribution to the 'post-cut off' pot, rather than predominantly 'pre-cut off' as expected. Therefore, in line with RIGs, the full deficit contribution for the year was categorised as totex within the Cost & Outputs RRP. NGGT are working with Ofgem to agree the correct treatment for this cost and it is expected to be resolved during the next PDAM valuation, therefore an adjustment has been included to remove this and accurately reflect performance.

Output Incentive Performance

NGGT SO has a number of Output Incentives, performance on each is detailed below.

- Constraint Management
- Transportation Support Services
- Shrinkage Incentive
- Quality of Demand Forecasting Incentive
- Residual balancing
- Greenhouse Gas Incentive
- Maintenance Incentive

a) Constraint Management Incentive Scheme

The Constraint Management Incentive is designed to drive NGGT SO to maximise available network capacity and minimise constraint management costs through the efficient and economic planning and operation of the National Transmission System (NTS).

NGGT SO therefore releases as much capacity as possible and develops effective constraint management strategies. This benefits NGGT SO's customers, and ultimately end consumers, as the costs of commercial constraint management actions to Industry are mitigated or minimised and balanced against NTS investment, whilst maximising NTS capacity.

Running a constraint-free network provides choice for NGGT SO's customers to land and utilise the cheapest gas and has a positive impact on the market. A robust Constraint Management Incentive drives an effective strategy which delivers value to Industry and end consumers, who share in the benefit of strong performance.

The 2020/21 Constraint Management Incentive Reward was £14.0m in 2020/21 prices (£10.3m in 2009/10 price base) and is subject to a 2-year lag, therefore will be paid in 2022/23. This includes a revision to Constraint Management Performance (CMOPPM) as provided by Ofgem in their 'Windfall Adjustment Letter', due to 2020/21 performance having been impacted by changes to NGGT SO's charging regime in October 2020. The approach and value is currently under consultation with Ofgem and is not necessarily final. Following consultation, the intention is for Ofgem to direct the value of the Constraint Management Performance Measure (CMOPPMT) earned in 2020/21 within the RIIO2 Licence.

Both the cost and revenue elements of Constraint Management are included within the incentive performance in R5. NGGT SO believes this is the intent of the reporting pack given that these values flow directly into the Maximum Allowed Revenue within the R2 tab. The absence of including these elements would result in an incorrect Revenue value and thus would not reconcile to the Revenue RRP.

b) Transportation Support Services Incentive Scheme

The Transportation Support Services (TSS) scheme incentivised NGGT SO to minimise the cost of procuring specific tools to support gas demand in the South West as an alternative to network investment. This incentive ceased in October 2018 with no spend incurred during 2020/21.

Both the cost and revenue elements of Transportation Support Services are included within the incentive performance in R5. NGGT SO believes this is the intent of the reporting pack given that these values flow directly into the Maximum Allowed Revenue within the R2 tab. The absence of including these elements would result in an incorrect Revenue value and thus would not reconcile to the Revenue RRP.

c) Shrinkage incentive

The aim of the Shrinkage incentive scheme is to minimise the costs incurred in NGGT SO's role as National Transmission System (NTS) Shrinkage Provider. These costs are recharged back to users as part of NTS commodity charges.

The overall volume of shrinkage gas and electricity procured for the combined elements of Shrinkage (Compressor Fuel Usage (CFU), Unaccounted for Gas (UAG) and Calorific Value (CV) shrinkage) was 4,754 GWh gas equivalent in 2020/21. This represents an increase in overall volume of 218 GWh gas equivalent from 2019/20 (5% increase). This is largely due to an increase of 409 GWh gas equivalent in the volume of CFU, and 179 GWh in the volume of CV shrinkage, outweighing a decrease of 371 GWh in the volume of UAG. Whilst volumes have increased year on year, costs have reduced in comparison to 2019/20 due to a reduction in market prices.

The volume of CFU was 36% higher than in 2019/20, driven by particularly high compressor use in January 2021, increased supplies at Bacton terminal and high NTS demand caused by cold weather.

Furthermore, the CV shrinkage volume was over four times higher than in 2019/20, although this component remains a relatively small part (around 5%) of overall shrinkage. This increase was caused by frequent occurrences of CV capping in the North and North-East Local Distribution Zones, where gas of different calorific values from different entry points converged, and some energy associated with the gas of higher calorific value could not be billed. No practical mitigation was identified to prevent this happening.

This is offset by a reduction in UAG volume, which was 11% lower.

In managing the NTS Shrinkage incentive scheme, NGGT SO incurred costs of £66.6m, not including meter reconciliation revenues. This comprised of £12.8m for electricity compressor (ECC) costs, and £53.8m for gas and other costs. This is lower than equivalent costs for 2019/20 (£82.7m), with lower

overall market prices outweighing higher volumes. The total Shrinkage costs stated in this narrative differ from the Cost and Output RRP narrative as the value includes meter reconciliations.

This results in a Shrinkage Incentive Revenue value of £3.9m compared to £7.1m in 2019/20 (2020/21 price base), reported as £2.9m in 2009/10 prices per Table R5. The decrease from 2019/20 is driven by the volume efficiency part of the incentive, which incentivises NGGT SO to reduce the volumes of Compressor Fuel Usage (CFU) and Calorific Value (CV) shrinkage.

d) Residual Balancing Incentive Scheme

The aim of the Residual Balancing incentive scheme is to incentivise NGGT SO's residual balancing activities in two ways:

- The Linepack Performance Measure (LPM) incentivises NGGT SO to minimise differences in Linepack volumes between the start and end of each gas day. This is to ensure that any system imbalances within the day are resolved, and that any associated costs are levied across those system users responsible for that day's imbalance.
- The Price Performance Measure (PPM) evaluates the impact NGGT SO has on the market in its Residual Balancing role by measuring the price range of its trading actions compared to the System Average Price (SAP). This incentivises the System Operator to minimise the impact it has on market prices.

In 2020/21 NGGT SO continued to manage the risks posed to the system both within the day, whilst also adopting a proactive approach by using trend analysis and forecasting to assess the future risk to the NTS. NGGT SO earned an incentive of £1.2m in 2020/21 prices (£0.9m in 2009/10 prices per Table R5).

e) Quality of Demand Forecasting Incentive

The national demand forecasts published by NGGT SO for day ahead (D-1) and for two to five days ahead (D-2 to D-5) are a key tool for the UK gas industry in ensuring the economic balancing of gas supply and demand. Timely and accurate forecasts aid in ensuring efficient operation from both a physical and commercial perspective, ultimately reducing operating costs which directly impact on end consumers gas bills. NGGT SO strives to continually optimise its forecasting processes, to deliver greater accuracy and increased consumer benefit.

In 2020/21 the average error on the D-1 incentive was 8.2 million cubic metres (mcm) against a target of 8.8 mcm (fixed target of 8.5 mcm + storage adjuster of 0.3 mcm). The average error has decreased this year from 8.6 mcm in 2019/20. The associated incentive revenue for 2020/21 is £1.1m compared to £1.0m in 2019/20.

D-2 to D-5 incentive average error was 13.5 mcm in 2020/21 against a target of 13.7 mcm. The average error has increased from 12.9 mcm in 2019/20. The associated incentive revenue for 2020/21 is £0.1m compared to £0.6m in 2019/20.

Together, this results in a total incentive value of £1.2m in 2020/21 prices (£0.9m in 2009/10 prices per Table R5).

f) Greenhouse gas incentive

The aim of the Green House Gas (GHG) incentive scheme is to incentivise NGGT SO to reduce the amount of natural gas vented from their compressors (primarily methane), and to reduce the effect of their operational activities on the environment. This is important to NGGT SO, their customers and stakeholders.

The emissions allowance is set each year by Ofgem, the allowance for 2020/21 was 2,897 tonnes. The total amount of natural gas vented from compressors in 2020/21 was 2,296 tonnes (excluding station vents. This was 7% or 177 tonnes lower than in 2019/20 (2,473 tonnes) and 601 tonnes lower than the target set for 2020/21, the third consecutive year where NGGT SO have not exceeded their allowance. This has resulted in a zero-cost penalty as NGGT SO has not vented above the target.

The average venting through compressors in the RIIO1 period including 2020/21 was 3,016 tonnes, with a maximum venting of 3,893 tonnes (2017/18) and a minimum 2,296 tonnes (2020/21).

Although the volume vented has decreased from 2019/20, there has been an increase in the within-day and end-of-day variability follow patterns and less steady state operation, resulting in additional compressor use. Despite this, the volume vented has decreased due to aligning maintenance outage periods following operational requirements to make best use of the gas held within the compressor.

The focus for 2020/21 was to further improve venting performance from previous years and build on the initiatives to reduce controllable emissions identified through project work completed from 2017 through to 2020. Specific strategies to focus on key controllable areas to reduce Static and Dynamic Seal emissions with collaboration between Operational Sites and Control room activities.

NGGT SO earned an incentive of £0.0m in 2020/21 prices (£0.0m in 2009/10 prices per Table R5).

g) Maintenance Day Changes Incentive Scheme

The aim of the Maintenance Day Changes incentive is to reduce the impact NGGT SO's maintenance activities have on customers, should NGGT SO make changes to their planned maintenance after 1st April for the forthcoming summer maintenance period. The incentive scope does not include changes which were initiated by customers, only those initiated by NGGT SO.

In total, there were 131 days of planned maintenance in 2020/21 compared to 152 days in 2019/20. For 2020/21, the incentive only included maintenance days for Remote Valve Operations (RVO); the In-Line Inspections (ILIs) element of the scheme ceased in 2015/16. Due to the COVID pandemic, all RVO activities were cancelled prior to the 2020/21 maintenance season. This element of the incentive was essentially null and void for 2020/21 and therefore, the incentive revenue earned for 2020/21 in respect of Maintenance Days is £0.0m.

The benchmark for Maintenance Day Changes is 7.25% of the total maintenance and advice notices issued and for 2020/21 this was 9.49 days. There were zero changes initiated by NGGT SO during the maintenance period for 2020/21 which was a decrease from 6 changes in 2019/20. This reduction demonstrates the conscious effort that has been made to minimise change, despite a large volume of In-Line Inspections impacting customers. Ensuring NGGT SO minimised the impact of these Inspections was crucial in demonstrating continued commitment to be flexible to customers'

requirements. NGGT SO earned £0.4m in incentive revenue for Maintenance Changes in 2020/21 (£0.3m in 2009/10 prices per Table R5).

RAV

(2009/10 Price base)

The RAV table utilises the Legacy MOD1 PCFM agreed with Ofgem on 2nd July 2021 to calculate the adjusted RAV balances. The Opening RAV, Transfer, RAV for net additions (after disposals) and Depreciation lines are based upon the Legacy MOD1 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 Legacy MOD1 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 RII01 closing RAV in 2020/21 has increased marginally from £114.3m in RFPR 2020 to £115.3m in RFPR 2021, reflecting the change in performance since last year's submission.

Tax

(2009/10 Price base)

Forecast tax allowance for 2020/21 is £2.6m and forecast tax performance is £2.3m at both notional and actual gearing levels. Ignoring the impact of financing performance, residual tax performance continues to be minimal.

The allocation of the NGG tax attributable to TO and SO is in line with the allocations used within their 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, this is the same PCFM used to calculate the RAV in table R9.

Dividends

NGGT's (TO+SO) dividends are allocated based on retained cash. The non-regulated businesses are included within the allocation because the RAV on which NGGT's dividend is based off includes metering. The dividend allocated to non-regulated entities is based on their retained earnings; this differs from the level of earnings retained by the regulated entities. The remaining dividend is then split between the Transmission Owner and System Operator based on the RAV from the previous RFPR submission. As per the RIGs, the Dividends table has not been completed in the NGGT SO RFPR, but the allocation is provided within the NGGT TO submission.

Pensions

(2009/10 Price base)

Pension deficit payments increased from £1.4m in 2019/20 to £8.9m in 2020/21. This is because during the year a pension deficit was paid into the National Grid UK Defined Benefit Pension Scheme in-line with the deficit recovery plan agreed with the pension trustees. The 2020 Pension Deficit Allocation Methodology (PDAM) calculation allocates all of this deficit contribution to the 'post cut-off' pot, rather than predominantly 'pre-cut-off' as expected. As such, in-line with the RIGs, the full deficit contribution for 2020/21 is considered as part of the totex spend in the year. Ofgem's Pension Finance team have been made aware of the impact of the latest PDAM on the treatment of the deficit payment in 2020/21 by the National Grid Pensions team, with a commensurate reduction in deficit allowances (i.e. negative allowances) proposed from 2024 onward, following the next PDAM reset.

The pension scheme valuation is performed tri-annually, the valuation presented in the 2020/21 RFPR is therefore an update to the valuation presented in the 2019/20 submission. The next scheme valuation is due during 2023/24.

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

Basis of any estimates and allocations

Where allocation between NGGT (TO) and NGGT (SO) has been required, this has been done on a RAV basis, including Dividends.

Appendix

Table Changes / Restatements

Data tab

Within the Data tab National Grid has updated the 2020/21 Financial Year Average RPI and Year End RPI and the M3 New Forecasts RPI per the May 2021 publication as agreed with Ofgem.

R10 Tax

The 2018/19 Tax liability per latest CT600 has been restated in this year's NGGT TO submission from £45.9m to £53.0m due to a resubmission of the CT600 as a result of a change in tax treatment relating to an intercompany bond. Consequently, this has meant a small update to the Amount attributable to NGGT SO (row 29) from £2.8m to £2.9m.