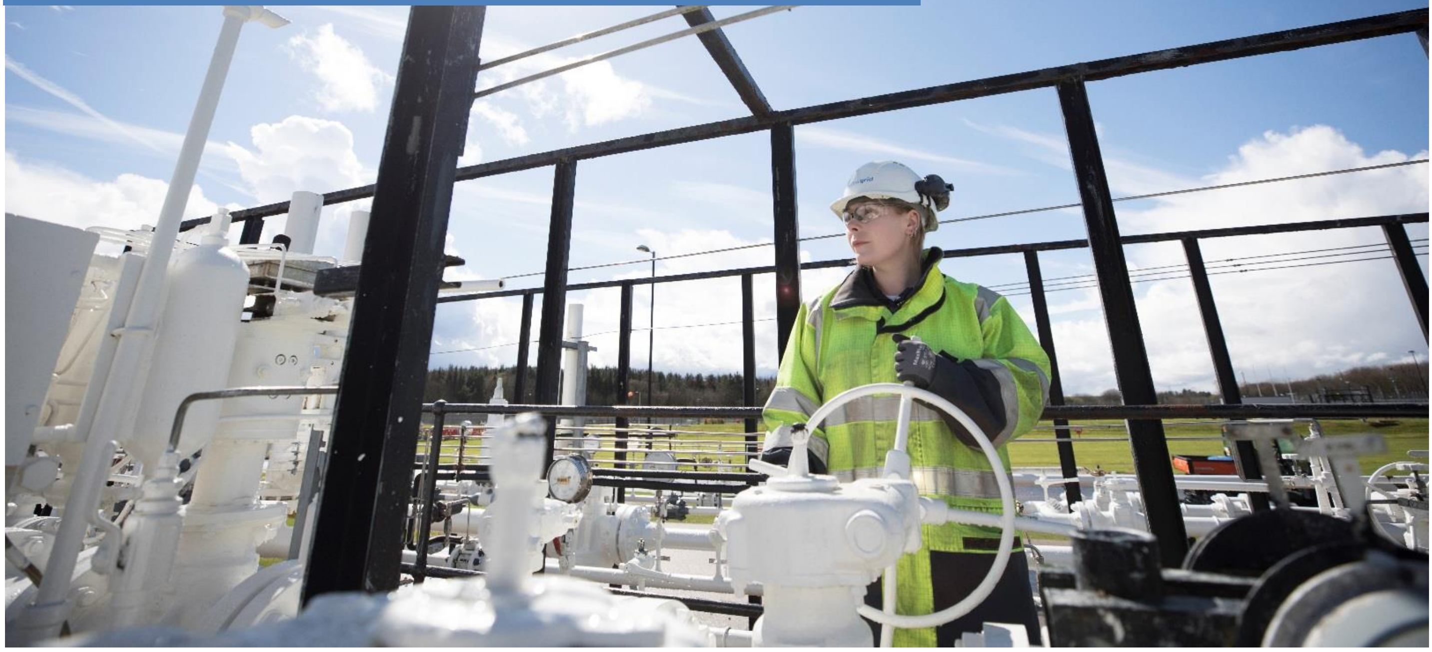
July 2021

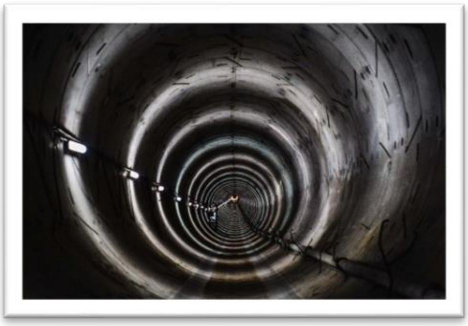
nationalgrid

National Grid
Gas Transmission (TO)

Regulatory Financial Performance Report Narrative for 2020/21

July 2021





Contents

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

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 8' of the eight-year RIIO regulatory period. This report will explain the Enduring Value Adjustments and their impact on RIIO 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 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 RIIO1 performance and known true-ups that will impact RIIO1 performance during the RIIO1 close out process.

NGGT (TO) RoRE on a notional basis

(2009/10 Price base)

The overall NGGT (TO) RoRE across RIIO1 is 6.65%, a marginal decrease of 0.01% in comparison to 2019/20. 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 RIIO1 operational RORE has increased marginally from 6.04% to 6.07%, this is driven by the marginal increase in Totex Performance with Enduring Value adjustments applied. Incentive and innovation performance has remained relatively static over the RIIO1 period. The decrease in financing performance is as a result of an increase in forecast RIIO1 financing costs. There has been a marginal increase in RIIO1 tax performance compared to the 2019/20 submission.

	T1 RoRE per RFPR 2021 %	T1 RoRE per RFPR 2020 %
Allowed return	6.80	6.80
Totex	(0.97)	(0.99)
IQI	(0.06)	(0.06)
Incentives & Innovation	0.30	0.30
Operational performance	**6.07**	**6.04**
SO performance	N/A	N/A
Financing	0.27	0.32
Tax	0.31	0.29
Total RoRE %	**6.65**	**6.66**

Revenue

(2020/21 Price base)

The Maximum Allowed Revenue (MAR) for NGGT TO in 2020/21 is £779.7m and is based upon the Revenue RRP. A full break down of NGGT TO MAR as per the Revenue RRP narrative is provided in the below table.

Licence Term	2019/20 (2019/20 Price Base £m)	2019/20 (Restated to 2020/21 Price Base £m)	2020/21 (2020/21 Price Base £m)	Commentary for year on year variance (Commentary in 2020/21 price base unless otherwise stated)
Base Revenue (BR)	694.9	706.2	766.3	• (£1.9m) decrease in opening base revenue (PU) allowances. • £64.9m increase in MOD. Detailed MOD commentary included in Final Proposals base revenue against adjusted base revenue section. • (£2.8m) 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.
Pass Through (PT)	(4.2)	(4.3)	(7.9)	• Business rates, licence fees and policing costs are trued up against the ex-ante allowances with a two-year lag. The value from 2019/20 to 2020/21 has decreased by (£2.6m). • Independent systems costs are trued up within year. The true up value decreased by (£1.0m) between 19/20 and 20/21.
Incentives (OIP)	3.7	3.7	4.2	• The 2020/21 incentive includes the Customer and Stakeholder Satisfaction Incentive and Stakeholder Engagement Reward for 2018/19 performance. The incentive revenue has increased since 2019/20 by £0.5m.

Licence Term	2019/20 (2019/20 Price Base £m)	2019/20 (Restated to 2020/21 Price Base £m)	2020/21 (2020/21 Price Base £m)	Commentary for year on year variance (Commentary in 2020/21 price base unless otherwise stated)
Network Innovation Allowance (NIA)	4.3	4.3	4.4	• NIA costs have increased slightly on a year on year basis. Under the NIA rollover mechanism, there are 2 NIA projects rolling over to completion within 2021/22 but funded under RIIO1 2020/21 NIA Allowance.
Network Innovation Competition Funding (NICF)	13.8	14.0	7.9	• As per the Ofgem direction, the NICF revenue term has decreased by (£6.1m) compared to 2019/20. This year funding has been awarded to NGN (£6.8m less £0.9m funding return) and National Grid (£1.2m).
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)	(6.4)	(6.5)	4.6	• The correction term in 2020/21 is based on the £4.3m under-collection of revenue in 2018/19 (as reported in the 2018/19 submission) and subsequently uplifted as per the licence algebra requirements to £4.6m.
Maximum Allowed Revenue	**706.0**	**717.5**	**779.7**	

The MAR compares to Collected Revenue of £660.4m, resulting in an under-recovery of £119.3m. The under recovery was driven by reduced income from shippers and DNOs. The below table details the forecast MAR used to set charges and the final MAR against collected revenue.

Charge period	MAR £m	Commentary
April 2020 Charge Setting Statement (Forecast)	780.6[1]	MAR forecast figure for charge setting.
October 2020 Charge Setting Statement (Forecast)	780.1[2]	Minimal variance compared to first charge setting driven reduction in Pass Through, offset by higher NIA.
July 2021 RRP submission	779.6	Marginal decrease driven by reduction in NIA.
Charge period	**Collected Income £m**	**Commentary**
July 2021 RRP submission	660.4	£119.3m Under-recovery due to reduced income from shippers and DNOs.

[1] 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)

[2] Oct 2020 Charge setting Statement: Transmission Services Revenue Model: https://www.nationalgrid.com/uk/gas-transmission/charging/transmission-system-charges (Published 29 Aug 2020)

Reconciliation to statutory accounts

The reconciliation to Statutory Accounts is based on NGGT TO's 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 NGGT's statutory accounts. As such, the reconciling items disclosed in the table are sourced from NGGT'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 (TO) from 2018/19 onwards. This creates 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

(2020/21 Price base)

RRP21 Performance Overview

Per the Cost & Outputs RRP21 submission, the NGGT TO Totex for the eight year RIIO1 period is £2,451.3m compared to allowances of £2,097.8m, resulting in an underperformance of £353.5m. RIIO1 Totex has decreased by £20.0m and allowances have decreased by £4.0m compared to RRP20, meaning overall RIIO1 performance has improved by £16.0m compared to RRP20 without the application of Enduring Value adjustments. The key changes to NGGT's allowances and the spend changes are listed below:

Totex Actuals:

- Baseline Capex spend over the eight-year RIIO1 period has reduced by £33.1m, primarily due to a reduction in spend on Asset Health £24.9m and Emissions £13.7m, offset by Non-Operational Capex (£4.5m) and Pipeline Diversions (£1.0m).
- Uncertainty Capex has increased by (£0.4m), primarily due to Load Related Capex (£2.8m) and Asset Health (£1.4m), offset by Other Capex £3.9m.
- Baseline Controllable Opex spend has increased by (£11.8m), primarily due to an adjustment for IAS 19 pension accrual (£23.0m), together with increases in Other Direct Costs (£0.7m) and Planned Inspections and Faults (£0.5m), offset by Closely Associated Indirect costs £10.5m and Business Support £2.0m.
- Uncertain Opex has increased by (£0.8m).

Allowances:

There are several allowance adjustments within the Cost and Outputs RRP which are detailed below. These also flow through into the RFPR via an Enduring Value adjustment (reference Allowances in RRP), as seen in the Enduring value section of this narrative Where allowances are to be agreed, the assumption is that allowance is equal to spend.

- In 2019/20, following Ofgem's decision on the needs case, the forecast additional IED allowances for Hatton was £9.1m (2020/21 prices) where in the absence of any decision from Ofgem, allowances were set as equal to spend. This has since been adjusted in 2020/21 to £5.6m expected through the RIIO1 Close-Out process, as referenced in the RIIO2 Final Determinations document.
- There has been no change to the allowances forecast for Pipeline Diversions (£11.6m).
- Forecast allowances for Security Resilience includes a return of £24.3m, partially offset by a request for an additional £6.9m for specific sites, resulting in a net decrease of £17.4m. This broadly aligns to 2019/20.
- The allowances for the Enhanced Physical Security upgrade programme, granted in the 2015 Reopener process have been divided between 85% Uncertain Other Capex and 15% Controllable Opex as stated in the Reopener Decision. Thus, forecast allowances include a transfer of £32.7m from Opex to Capex, aligned to 2019/20.
- 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.

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 as per the Legacy MOD1 PCFM (as agreed with Ofgem on 2nd July 2021) in rows 13 and 41. Enduring value adjustments are then applied which includes taking into account allowance assumptions included in RRP21 which are not in the PCFM.

Enduring Value adjustments

(2009/10 Price base)

A number of Enduring Value adjustments are applied to the performance from the Cost & Outputs RRP to give a more accurate view of RIIO1 performance, the methodologies are explained below. The lettering references those within the R4 Totex tab.

a. Allowances in RRP (non-uncertainty & uncertainty rate):
   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 £4.1m as indicated through Final Determinations.
   - Additional Pipeline Diversion allowances of £8.5m.
   - Return of Security Resilience allowances of £18.1m, partially offset by a request for an additional £5.1m for specific sites, resulting in a net decrease of £13.0m.

b. IED allowances recategorization (non-uncertainty & uncertainty rate):
   This adjustment moves IED allowances from Non-Uncertainty to Uncertainty in order to align the PCFM with the Cost & Outputs RRP.

c. 2020/21 Pension Deficit Adjustment:
During 2020/21, a pension deficit contribution (£16.9m) 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 in 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.

d. Peterborough and Huntingdon Allowance Deferral
This adjustment has been added in 2020/21 (£40.0m) to better reflect performance associated to Peterborough and Huntingdon. Spend is now expected to be incurred in 2021/22- 2023/24 and therefore allowances have been deferred to align with this spend and thus provide a more accurate view of performance.

e. Allowance Rephasing Adjustment (non-uncertainty & uncertainty rate):
NGGT 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, 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 saw an unprecedented step change in how organisations engage and serve their customers and stakeholders, due to the impact of Covid-19. Overall, the response rate for the year fell back to 38% for both CSAT and SSAT from 49% and 56% respectively, in the previous year. However, NGGT were able to target a slightly broader range of customer contacts due to focused virtual events this year, such as the Future Use of NGGT's Gas Transmission Network. This meant that the overall response volume only dropped by a small amount from 91 in 2019/20 to 84 this year.

Customer Satisfaction Survey

In 2020/21, NGGT achieved a customer satisfaction score of 8.2 against a baseline of 6.9. This has increased by 0.2 since last year's score of 8.0 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.

NGGT's focus on the customer experience in RIIO1 has helped to improve Customer Satisfaction from 7.2 at its start, to 8.2 at its close. The RIIO1 CSAT question focused on how each customer felt about NGGT generally, whilst RIIO2 CSAT will focus the scoring against specific service experiences, so that

NGGT can continue to target what really matters. NGGT will also offer an opportunity for the customers who need a variety of services to provide a score for each during the year.

Stakeholder Satisfaction Survey

The stakeholder satisfaction score was 8.4 against a baseline of 7.4, a marginal increase from the 2019/20 score of 8.4. NGGT has been able to maintain the increase made in 2019/20, despite the challenges of maintaining engagement levels through the Covid-19 restrictions.

Stakeholder Engagement

During 2020/21 NGGT started to embed the processes and behaviours needed to fulfil their stakeholder engagement strategy. This focused on the processes associated with annual stakeholder led business planning and key account management of those stakeholders who had multiple touchpoints across their UK operations. NGGT also commenced building the foundations needed to more effectively manage the increasing amount of stakeholder data required to fulfil stakeholder commitments in RIIO2. This focuses on developing the enabling systems and a data domain dedicated to customer and stakeholder to help both capture the data accurately and interpret and understand it through analysis.

Forecast Incentive Performance

The Stakeholder Engagement Reward (SER) that relates to 2020/21 is scheduled to be directed by Ofgem later in calendar year 2021. A forecast has been included and is assumed to be an average of the actual earned incentive in RIIO1 to date. The 2020/21 earned incentive for the Stakeholder Satisfaction incentive will then be received through Allowed Revenue in 2022/23.

Innovation

(2020/21 Price base)

Alongside new and innovative ways to maintain and operate the network, NGGT's innovation in 2020/21 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. This included closing out projects from RIIO1, to ensure effective delivery across the business and maximise value, in preparation for the start of RIIO2.

Network Innovation Allowance (NIA)

Eligible NIA Expenditure is the net costs per 2020/21 Cost & Outputs RRP. This includes internal expenditure but excludes Bid Preparation Costs for the Network Innovation Competition Fund as per the licence. In line with NIA Governance, Eligible NIA Expenditure is reported net of external funding. In 2020/21 the Gas Transmission Owner spent £4.9m on 32 NIA projects compared to its allowance of £5.4m. NIA annual summaries are published on the National Grid Gas website[3].

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

Network Innovation Competition (NIC)

In 2020/21 there was no spend on the CLoCC or GRAID projects as they were successfully completed in 2018/19.

Financing and Net Debt Position

(2009/10 Price base)

Overview

Overall assumed regulatory finance cost at actual gearing for RIIO1 is forecast at £360.7m (including adjustments to be applied for performance assessment), this compares to allowances for the same period of £462.6m thus resulting in £101.9m performance on an actual gearing basis.

On a notional basis, assumed regulatory finance cost for RIIO1 is forecast at £415.5m (including adjustments to be applied for performance assessment) resulting in £47.1m performance at notional gearing. The post-tax view of this performance is £34.9m.

Financing allowance

The financing allowance has remained in line with prior year at £462.6m.

Financing

(Nominal Price base)

Financing costs per regulatory definition have decreased year-on-year by £35.5m to £130.3m in 2020/21. Total RIIO1 Financing costs are £1,097.2m.

Net debt and derivatives

(Nominal Price base)

Regulatory net debt as at 31st March 2021 has decreased by £160.2m to £3,628.0m compared to 31st March 2020. This decrease is due mainly to movements detailed below.

External borrowings increased by £395.3m, largely as a result of 2 new issuances in year partially offset by 1 maturity in year. Loans to other group companies have increased by £605m to £1,208.0m year on year, this is as a result of NGGT TO's cash requirements.

NGGT TO's year to year derivative position has moved from £119.3m in 2019/20 to £79.8m in 2020/21, primarily due to NGG having rationalised the derivative portfolio in year, as part of ongoing portfolio planning, which has contributed to changes in year to year values.

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 NGGT's 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 RIIO1, 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 Legacy MOD1 PCFM as 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.

Note the enduring value adjustments includes some close out adjustments, but not all, for example the adjustment to RAV required to take into account for Disposals within the RIIO1 period is not included.

The closing RAV in 2021 has reduced by £9.8m from £4,567.8m in RFPR 2020 to £4,558.0m in RFPR 2021, reflecting the change in performance since last year's submission.

Tax

(2009/10 Price base)

The forecast tax allowance for 2020/21 is £16.8m and forecast tax under performance is (£5.8m) at actual gearing and (£5.1m) 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 0.3% for the period through to 2020/21 and 0.3% at actual gearing. 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 NGGT's 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

(2020/21 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 of £137.0m paid in July 2020. £1.1m of this is attributed to the Gas System Operator. Dividend paid has decreased by £910.0m from £1,047.0m in 2019/20 due to a decrease in distributable reserves.

NGGT's 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.

Pensions

(2009/10 Price base)

Pension deficit payments decreased from £23.8m in 2019/20 to £16.3m in 2020/21. The payment during 2020/21 was driven by a pension deficit payment 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 for 2019/20. 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

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.

R5 Output Incentives

The 2019/20 Stakeholder Engagement Reward value was not directed until November 2020, hence was previously based on forecast, this has now been updated to reflect actual performance.

R10 Tax

The 2018/19 Tax liability per latest CT600 (row 12) has been restated in this year's 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.