NATIONAL GRID GAS TRANSMISSION (SO)

Regulatory Financial Performance Reporting Narrative (2021/22)

August 2022

Contents

National Grid Gas Transmission (SO) RFPR Submission Narrative (2021/22)

Executive Summary

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 1' of the five-year RIIO-2 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 2020/21 submission.

This narrative supports the submission of the 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.

- R5/5a – Financing - The SO element is an allocation of TO net debt and financing cost and is reported in the TO RFPR
- R6/6a – Net Debt - The SO element is an allocation of TO net debt and financing cost and is reported in the TO RFPR
- R9 – Corporate Governance[2] – This is covered in the TO RFPR. NGGT executive directors cover both TO and SO (along with the non-regulated business). Remuneration associated with the regulated businesses has all been captured on the TO RFPR template.

The required sections are the following:

- R1 – RoRE (to show Operational Performance only)

[1] Regulatory Instructions and Guidance (RIGs)
[2] As agreed with Ofgem, post RIGs consultation.

- R2 – Rec to Revenue and Profit
- R3 – Totex - Reconciliation
- R4 – Incentives and Other Revenue
- R7 – RAV
- R8/8a – Tax
- R12 – Pensions and Other Activities

Based on the 2021/22 RRP submission, NGGT SO are primarily delivering operational out-performance through incentive revenue. In 2021/22, NGGT SO achieved £7.95m on incentive revenue (2018/19 prices) and have currently forecast to achieve £5.20m per annum (2018/19 prices) for the remainder of the RIIO-2 period.

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 RIIO-2 performance.

NGGT (SO) RoRE on a Notional Basis

(2018/19 price base)

The NGGT SO RoRE, viewed in isolation, is not a reflective measure of network performance due the relative size of the SO Equity RAV. The NGGT SO RoRE was not a requirement in RIIO-1, so no prior year comparisons are available.

The operational NGGT SO RoRE for 2021/22 is 31.99%, reflecting Totex outperformance and Incentives.

Revenue and Profit

(2021/22 price base)

The final Allowed Revenue for NGGT SO in 2021/22 was £198.14m. However, October 2021 charges were based on the May 2021 'Charge Setting' PCFM, with an Allowed Revenue of £204.07m. The Allowed Revenue reduced by £5.93m between the May 2021 PCFM and the November 2021 Published PCFM, due to amendments to 'Kt' and 'LARt'.

Recovered Revenue for 2021/22 was £205.24m, resulting in an over-recovery in the PCFM of £7.10m against the final Allowed Revenue (£198.14m), which has generated a 'K_t' in 2022/23. However, NGGT SO only over-recovered by £1.17m in comparison to the Allowed Revenue used to set charges (£204.07m). Therefore, the total over-recovery of £7.10m was mainly driven by the amendments to 'K_t' and 'LAR_t'.

Revenue Term		**(£m 2021/22)**
Calculated Revenue (as published)	$SOR_t* \times PI_t* / PI_{2018/19}$	207.20
AIP adjustment term (as published)	$SOADJ_t*$	0.00
Adjusted revenue (as published)	$SOADJR_t*$	207.20
Legacy Allowed Revenue	$SOLAR_t$	(5.58)
K Correction Factor	SOK_t	(3.48)
Allowed Network Revenue	$\boldsymbol{SOAR_t}$	**198.14**

Collected Regulated Network Revenue	$SORR_t$	205.24
(Under) / Over recovery		**7.10**

The below table details the forecast Allowed Revenue used to set charges and the final Allowed Revenue against Collected Revenue.

Charge Period	Allowed Revenue (£m 2021/22)	Commentary
October 2021 Charge Setting Statement (Forecast)	204.07[3]	Allowed Revenue figure used for Charge Setting.
August 2022 Dry Run 1 PCFM	198.14	Final Allowed Revenue for 2021/22.

Charge Period	Collected Revenue (£m 2021/22)	Commentary
July 2022 RRP Submission	205.24	£7.10m over-recovery, driven by change in Allowed Revenue from Charge Setting PCFM (May 2021) to November 2021 Published PCFM.

Reconciliation to Statutory Accounts

(2021/22 price base)

For the purposes of reconciling the regulatory revenue and profit to the statutory accounts, NGGT have allocated reported values between the TO and SO entities, along with the non-regulated businesses[4]. NGGT's statutory financing costs are all aligned to NGGT TO for these reconciliations, and tax charges have been allocated between entities based on historic apportionment[5].

Revenue Reconciliation

The revenue reconciliation aims to reconcile collected network revenue to the NGGT SO turnover, as per the Statutory Accounts. NGGT SO turnover for 2021/2022 was £206.51m

[3] Oct 2021 Charge setting Statement: General Non-Transmission Services Model: https://www.nationalgrid.com/gas-transmission/document/136596/download (Published 26 August 2021)
[4] Supporting reconciliation has been submitted to Ofgem
[5] Statutory tax charge has been allocated to entities using a 4-year average of RFPR data

compared to the collected network revenue of £205.24m. The small reconciling items are driven by income not related to the regulated business.

Profit Reconciliation

The profit reconciliation compares the NGGT SO net profit per statutory accounts (£148.51m) to the net profit related to the regulated business (£115.92m), resulting in a (£32.59m) difference; primarily driven by Shrinkage related costs that have not been included in the 2021/22 RRP (£31.18m).

As per the RFPR guidance, all NGGT financing costs are allocated to the TO, resulting in no statutory or regulatory interest costs being reported within the SO profit reconciliation. Both regulatory and statutory tax values are currently forecast and will be updated in the August 2023 RFPR submission, in line with the CT600 return.

Totex Reconciliation

The totex reconciliation aims to reconcile total NGGT SO expenditure incurred as per the statutory accounts of £332.76m, to the PCFM/ RRP reported Totex of £77.48m.

Firstly, adjustments are identified to reconcile to the total costs per latest RRP submission, (£279.15m). The material movements include deducting £33.40m relating to depreciation, amortisation and profit/loss on disposal, which are not reported within RRP, along with Shrinkage related costs that were excluded from the 2021/22 RRP (£31.18m), partially offset by a non-operational capex movement between TO and SO of £9.70m.

Pass-through and other revenue items including shrinkage (£205.72m), operating margin costs (£8.49m), residual balancing costs (£8.20m) and CDSP costs (£2.68m) are all deducted to reconcile to the reported 2021/22 Totex.

Totex Performance

RRP22 Performance Overview[6]

(2018/19 price base)

Per the Cost & Outputs RRP22 submission, the NGGT SO Totex for 2021/22 was £71.42m compared to allowances of £90.39m, resulting in an out-performance of £18.97m. For the

[6] Some allowance values have immaterially moved since the writing of the RRP narrative due to RPEs, calculated in the Dry Run 1 PCFM update.

five-year RIIO-2 period, Totex is forecast to be £440.57m compared to allowances of £458.14m, resulting in a forecast out-performance of £17.57m.

Totex Actuals/Forecast:

- SO Capital Expenditure for 2021/22 was £20.01m against total allowances of £26.61m. This was primarily driven by IT capex and Cyber Resilience, partly due to additional planning processes being necessary to optimise chosen solutions and drive efficient spend. There has been £1.39m of unfunded costs have been incurred in 2021/22, primarily relating to the implementation of a new ERP system. Capital Expenditure for the five-year period is forecast to be £149.12m against allowances of £139.72m, primarily reflecting spend carried over from RIIO-T1.
- SO Operating Expenditure for 2021/22 was £51.41m against total allowances of £63.78m. This was primarily due to new ways of working and ensuring teams are correctly resourced rather than being reliant on contractors, which positively impacted both direct opex and business support costs. Closely Associated Indirect costs are broadly in line with allowances. Operating Expenditure for the five-year period is forecast to be £291.46m against allowances of £318.42m, reflecting the ongoing impact of the factors noted above.

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

Enduring Value Adjustments

(2018/19 price base)

An Enduring Value adjustment has been applied to the performance from the Cost & Outputs RRP to give a more accurate view of RIIO-2 performance, the methodology for which is explained below.

- Rephasing of Allowances
  NGGT rephase 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 rephasing does not affect the overall level of allowances recognised over the RIIO-2 period, thus does not materially impact the RIIO-2 RoRE.

Accordingly, the below tables summarise NGGT SO's totex position before and after enduring value adjustments:

SO Totex (Prior to Enduring Value Adjustments)					
2021/22			**RIIO-2**		
Totex	*Allowance*	*Performance*	*Totex*	*Allowance*	*Performance*
£71.42m	£90.39m	£18.97m	£440.57m	£458.14m	£17.57m

SO Totex (After Enduring Value Adjustments)					
2021/22			**RIIO-2**		
Totex	*Allowance*	*Performance*	*Totex*	*Allowance*	*Performance*
£71.42m	£91.05m	£19.63m	£440.57m	£458.14m	£17.57m

Incentives and Other Revenue

Other Revenue Allowances

NGGT SO has several Other Revenue Allowances in RIIO-2, performance on each is detailed below:

- Constraint Management Incentive
- Residual Balancing Incentive
- Quality of Demand Forecasting Incentive
- Greenhouse Gas Emissions Incentive
- Maintenance Incentive

Constraint Management Incentive

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 RIIO-2 price control has altered the revenue which we report on, and the revenue that we retain through the Constraint Management Incentive. Under the RIIO-1 price control, revenue from all within day sales plus any Non-Obligated sales were included in the Constraint Management Incentive. In RIIO-2, only 14% of Non-Obligated Capacity revenue is included the Constraint Management Incentive calculation, and the sharing factor applied to revenue retained by National Grid Gas has reduced from 44.36% to 39%.

A further difference between the RIIO-T1 and RIIO-T2 Constraint Management Incentive is the removal of revenue from the following capacity products:

- Entry Interruptible Capacity
- Exit Off-Peak Capacity
- Daily Obligated Entry Capacity
- Daily Obligated Exit Capacity
- System Entry Overrun Charges

As a result of these changes, the Constraint Management Incentive Reward is not directly comparable between 2021/22 and 2020/21.

The 2021/22 Constraint Management Incentive Reward is £5.64m in 2021/22 prices (£5.20m in 2018/19 prices, per Table R4). This equals the annual upper limit on constraint management incentive revenue of £5.20m in 2018/19 prices. The forecast for the remainder of RIIO-2 is £3.40m per annum (2018/19 prices), on the assumption that NGGT SO will achieve incentive performance of just greater than half of the incentive maximum upside (£5.20m).

Residual Balancing Incentive

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 2021/22, 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.

Multiple factors have been identified which, when combined, created the more challenging backdrop for balancing, namely increased Linepack swing and Shipper behaviour. The NTS now accommodates much wider system imbalances in supply and demand throughout/during a gas day, presenting a more challenging environment for Residual Balancing to operate efficiently in. As a result, we continue to enter the market earlier and more frequently particularly during challenging periods.

The associated incentive revenue for 2021/22 is £0.63m in 2021/22 prices, compared to £1.21m in 2020/21 (2020/21 prices). The incentive revenue in 2018/19 prices is £0.58m (per Table R4), £1.02m lower than the annual upper limit on Residual Balancing of £1.60m (2018/19 prices).

NGGT SO have forecasted the Residual Balancing incentive revenue increasing to £0.70m (2018/19 prices) for the remainder of RIIO-2, on the assumption that NGGT SO will achieve just under half of the incentive maximum upside (£1.60m).

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 for the market, 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.

From a demand forecasting perspective, 2021/22 proved to be another challenging year as the global pandemic continued, leading to volatile changes in gas demand usage. The various lock down variations between England, Wales and Scotland and then the lifting of restrictions and new hybrid ways of working added further to the complexity of the forecasts.

In 2021/22 the weighted average error on the D-1 incentive was 8.52 million cubic metres (mcm), against a target of 8.97 mcm (Fixed target of 8.35 mcm + storage adjuster of 0.62 mcm). The weighted average error has increased this year from 8.20 mcm in 2020/21.

D-2 to D-5 incentive weighted average error was 12.37 mcm in 2021/22 against a target of 13.70 mcm. The weighted average error has decreased from 13.52 mcm in 2020/21.

The associated incentive revenue for 2021/22 is £0.19m in 2021/22 prices, compared to £1.11m in 2020/21 (2020/21 prices). The incentive revenue in 2018/19 prices is £0.17m (per Table R4), £1.33m lower than the annual upper limit on Demand Forecasting of £1.50m (2018/19 prices).

NGGT SO have made the prudent decision not to forecast this incentive, reflecting the inherent difficulty to predict future demand.

Greenhouse Gas Emissions Incentive

The aim of the 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 2021/22 was 2,897 tonnes. The total amount of natural gas vented from compressors in 2021/22 was 2,061 tonnes, equating to 71% of the target allowance. This was 9% lower than in 2020/21 (2,296 tonnes).

The average venting through compressors in the last 10-year period including 2021/22 is 2962 tonnes, with a maximum venting of 3928 tonnes (2017/18) and a minimum 2,061 tonnes this year.

NGGT SO recognises the requirement to act responsibly and reduce GHG emissions from their own operations. Furthermore, to demonstrate their commitment through a Net Zero target for its own direct greenhouse gas emissions by 2050.

Therefore, NGGT SO increased their focus in 2021/22 to not only continue to leverage the performance improvements identified in previous years, but also undertake a summer engine inhibiting and washing trial to allow non-critical compressor units not required over the summer period to be temporarily isolated from the network. The process involved spraying the engine internals with an environmentally friendly preservative spray to prevent the deterioration of the engine condition, through good engine healthcare management.

The associated incentive revenue for 2021/22 is £1.63m in 2021/22 prices, compared to £0.00m in 2020/21. The incentive revenue in 2018/19 prices is £1.50m (per Table R4), equating to the annual upper limit.

NGGT SO have forecasted that the Greenhouse Gas Emissions incentive will achieve £0.70m (2018/19 prices) per annum of revenue for the remainder of RIIO-2, on the assumption that NGGT SO will achieve just under half of the annual upper limit (£1.50m).

Maintenance Incentive

The aim of the Maintenance Incentive is to reduce the impact NGGT SO's maintenance activities have on customers, should NGGT SO make changes to their planned maintenance for the forthcoming summer maintenance period (1st April-31st October), or increase the number of maintenance days used. The incentive scope does not include changes which were initiated by customers, only those initiated by NGGT SO. The maintenance incentive is split into three scheme components:

1. **Use of Days - Maintenance Days (including Remote Valve Operations (RVOs))**

   Due to the COVID pandemic and government social distancing requirements, all RVO activities were risk assessed and cancelled against the Summer 2021 Maintenance Plan (2020/21). Therefore, it was a priority to complete all RVO activities in 2021/22, whilst still ensuring minimal impact to customers. This was achieved using mostly 'Advice Notices' and 1 'Maintenance Day', outperforming our target of 11 days or less.

2. **Use of Days - Maintenance Days (excluding RVOs)**

   This is a new element to the RIIO-2 scheme. For 2021/22, the incentive included 133 days of customer impacting works, of which 127 were aligned to customer outages. This demonstrates that 95% of customer impacting works (excluding RVOs) were successfully aligned with customer outages against a target of 95%.

3. **Changes - Minimisation of changes initiated by National Grid to the agreed maintenance plan**

   The aim of the Maintenance Day Changes scheme is to reduce the impact our maintenance activities have on customers should we make changes to our planned maintenance after 1st April for the forthcoming summer maintenance period. The incentive scope does not include changes that were initiated by customers, only those initiated by us.

   In 2021/22, there were zero changes initiated by us during the maintenance period. This is the same as in 2020/21. This demonstrates the conscious effort that has been made to minimise change, despite a large number of our In-Line Inspections and pipeline works impacting customers. Ensuring we minimised the impact of these Inspections was crucial in demonstrating our continued commitment to be flexible to customers' requirements.

In total, there were 154 days of planned maintenance in 2021/22 compared to 131 days in 2020/21. This increase, driven in part by a higher volume of impacting works in the RIIO-2 period, led to an updated benchmark for changes of 11.67 days in 2021/22, which is 7.25% of all Maintenance Days and Advice Notice Days called. This compares to a benchmark of 9.49 days in 2020/21. NGGT SO expect to see this trend to continue with increased maintenance activities throughout the RIIO-2 period.

The Maintenance Incentive has achieved revenues of £0.54m in 2021/22 prices, compared to £0.45m in 2020/21 (2020/21 prices). The incentive revenue is £0.50m in 2018/19 prices (per Table R4), equating to the annual upper limit.

RAV

(2018/19 prices)

The RAV table utilises the AIP 2022 Dry Run 1 PCFM, as indicated by Ofgem in the RIGs, to calculate the adjusted RAV balances. The Opening RAV, Transfer, RAV for net additions (after disposals) and Depreciation lines are based upon the Dry Run 1 PCFM, updated per the Cost & Outputs RRP submission, T1 Close Out and Tax Trigger.

To calculate the impact of Enduring Value movements, the Dry Run 1 PCFM is updated to include these adjustments. The enduring value adjustments are explained in the Totex Performance section above.

The closing RAV in 2022 has reduced by £12.64m from £151.39m in RFPR 2021 to £138.75m in RFPR 2022. This will be impacted by spend/allowance profile and T1 close out adjustments for disposals.

Tax

(2018/19 prices)

Forecast tax allowance for 2021/22 is £3.37m, as per the AIP Dry Run 1 PCFM (incl. enduring value adjustments). In lieu of having a submitted 2021/22 CT600, the NGGT SO adjusted tax liability has been forecast in line with the allowance for the 2021/22 RFPR submission.

The purpose of the R8a- Tax Reconciliation table is to highlight differences between a licensee's CT600 actual corporation tax liability and the calculated tax allowance in the 'Finance & Tax' sheet of the Latest PCFM. Due to the timing of the CT600 submission to HMRC, this sheet is to be reported with a one-year lag. Table 8a therefore remains blank and will be populated in the August 2023 submission.

Corporate Governance

Dividends Paid and Current Policy

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.

The Dividends section has not been completed in the NGGT SO RFPR, but the allocation is provided within the NGGT TO submission.

Executive Remuneration

The Executive Remuneration table has not been completed in the NGGT SO RFPR, but the full requirement is provided within the NGGT TO submission. Commentary regarding NGGT's Corporate Governance and Remuneration Policy is provided within the NGGT TO Narrative.

Pensions

Pension deficit payments decreased to £0.0m in 2021/22. The 2021/22 value is zero as the last non-zero pension deficit contribution due from NGGT to scheme trustees was made in 2020/21, after which the pension scheme is no longer deemed to be in deficit, hence no further deficit contributions have been required.

The pension scheme valuation is performed tri-annually, the valuation presented in the 2021/22 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

Basis of Any Estimates and Allocations

Where allocations between NGGT (TO) and NGGT (SO) have been required, details of the applied basis/methodology have been given within the corresponding section of the narrative.

Table Changes/Restatements

Data tab

Within the Data tab, NGGT has updated the RPI/CPIH inflation (rows 16, 17 and 19) in line with the Dry Run 1 PCFM, as agreed with Ofgem.

Template Amendments

NGGT have amended formulas within subsequent tables to ensure the correct flow of data. These have all been reflected in the change log and agreed with Ofgem.