National Grid Electricity Transmission

Regulatory Financial Performance Report Narrative

August 2020

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National Grid Electricity Transmission RFPR submission narrative – 2019/20

Introduction

The main purpose of this report is to provide a useful summary of National Grid Electricity Transmission's (NGET) 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.

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.

NGET RoRE on a notional basis

The overall NGET RoRE has increased marginally by 0.15% to 10.67%. The increase is primarily due to an increase in Totex performance as well as tax and financing performance.

	RIIO-1 in 2019/20 %	**RIIO-1 in 2018/19 %**
Allowed return	7.00	7.00
Totex performance	2.03	1.94
IQI	0.29	0.29
Incentives & innovation	0.21	0.23
Operational RoRE	9.52	9.45
Financing and tax	1.15	1.06
Total RoRE	10.67	10.52

Revenue

(2019/20 Price base)

Allowed Revenues are directly sourced from the Revenue RRP submitted to Ofgem and in accordance with the RFPR RIGs, NGET have not completed the forecast section for allowed revenue.

Collected revenue and the maximum allowed revenue (MAR) for 2019/20 is explained below and is based upon the Revenue RRP where the MAR differs to the RFPR tables due to the assumed levels of forecast output incentives yet to be directed by Ofgem.

Transmission Network Revenue is £1728.5m (including Pre vesting) compared to the final MAR of £1716.9m, this results in an over-recovery of £11.5m. Table comparing tariff setting and final MAR (Maximum Allowed Revenue) and collected income is below:

Item	£m	Commentary
TNUoS Charge setting forecast	1,728.5[1]	MAR figure set for charge setting on 31st January 2019 for the year 2019/20
TNUoS revenue collected	1,728.5	Actual revenue collected in 2019/20
MAR	1,716.9	MAR as per the 2019/20 Revenue RRP submission
Over/(Under) Collection	11.5	Over collection amount that will be adjusted via the K term in the 2021/22 MAR.

TNUoS Charge setting forecast of £1,728.5m was set for charges on 31st January 2019 for the year 2019/20. 2019/20 charges were set to recover Maximum Allowed Revenue of £1,728.5m. TNUoS tariffs were set to recover £1,697.6m with the expectation that £30.8m would be recovered from pre-vesting connection charges. £1697.6m was recovered from use of system and terminations, and £30.8m from pre-vesting income.

Reconciliation to Statutory accounts

The reconciliation to Statutory Accounts is based on NGET's underlying accounting records, which report revenues separately between reported operating segments. As such the reconciling items disclosed in the table are sourced from NGET'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 reduced statutory revenue for NGET in 2018/19. This created an additional reconciling item between statutory and collected revenue. This has resulted in a reduction in statutory revenue for agency income, and a change in timing of revenue recognition for connections and diversions. Prior to the legal separation of ESO at the start of 2019/20 financial year, the statutory

[1] https://www.nationalgrideso.com/charging/transmission-network-use-system-tnuos-charges

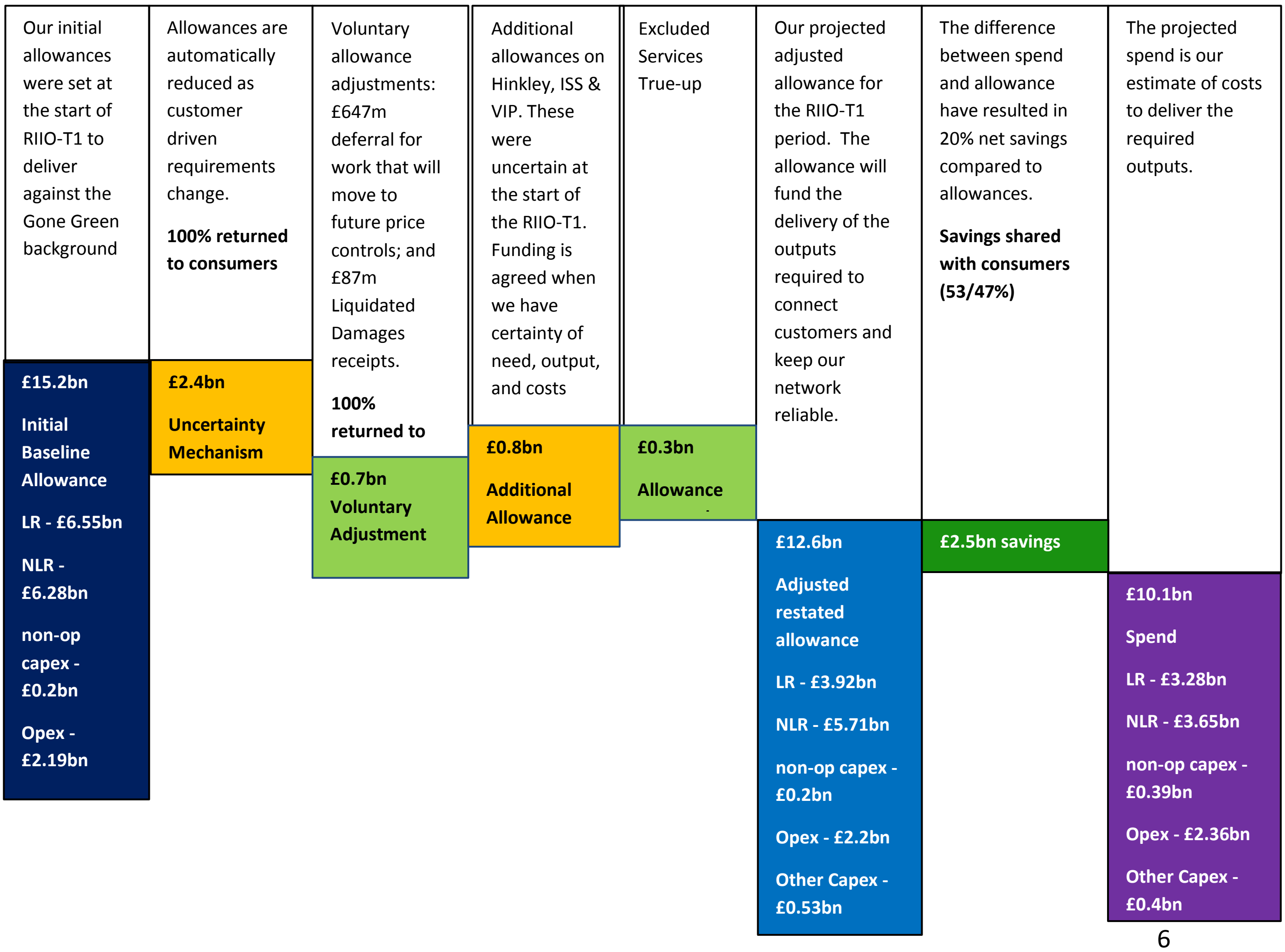
accounts included revenues associated with ESO and had to be adjusted in preparing the RFPR tables. As NGET's financial year 2019/20 did not include these revenues the reconciliation has been simplified.

Totex performance

(2019/20 Price base)

NGET's overall total expenditure forecast for the RIIO T1 period is £10.08bn against forecast allowances of £12.92bn (£12.56bn including the adjustment of £276m for forecast excluded services true-up, and £87m that we intend to return to consumers following receipt of liquidated damages relating to delivery of the Western HVDC link). This total is a £2.43bn reduction of costs below allowances (2019/20 prices).

The graphic below shows the eight-year Totex forecast for the Transmission Owner business and highlights how the price control mechanism has worked for end consumers. When customer needs change and investments are no longer required, NGET will amend plans accordingly and an uncertainty mechanism automatically reduces allowances. This means that consumer bills will not be as high as they were forecast to be at the start of RIIO-T1. NGET also made a voluntary deferral of allowances for Outputs deferred into future price controls and intend to make a further adjustment to reflect liquidated damages receipts relating to the Western HVDC Link. In addition, the Totex Incentive Mechanism has incentivised NGET to innovate and deliver more efficiently. This will reduce customer charges by a further £1.32bn which will lower the consumer bill.



Enduring value adjustments

(2009/10 Price base)

The overarching principle of enduring value adjustments is to recognise performance that relates to the T1 period, the methodologies are explained below. The lettering below references to the lettering within the RFPR R4 Totex tab.

a) The following assumptions are made within the Cost & Outputs RRP submission:
   - Where a decision is yet to be made on VIP (Visual Impact Provision) and LEI (Landscape Enhancement Initiatives), NGET have assumed allowances equal to the spend forecast.
   - SWW construction allowances (for projects not included in the baseline) will be set at 100% of the actual and future expenditure included in the RRP and phased in-line with actual and forecast expenditure. This applies to the Hinkley Seabank project as phasing of allowances has not yet been agreed, as well as Moorside and Eastern HVDC.
   - Allowances for the Western HVDC SWW project have been included as per final proposals.
   - Actual and future load related UM projects delivering an output in RIIO-T1 receive allowances in-line with the current UCA funding mechanism.
   - Actual and future load related UM projects delivering an output in RIIO-T2 years 1 and 2 will receive allowances in-line with the current UCA funding mechanism. Note this differs from the allowances presented in the PCFM which are based on the licence definition and fixed per the forecast of outputs presented in the 2017/18 RRP submission. Presenting the allowances in this way in the RRP provides a more accurate view of the actual allowances for outputs being delivered.
   - Actual and future load related UM projects delivering an output in RIIO-T2 years 3 and beyond do not have confirmed allowances included, but funding is anticipated as part of the T1 close out process.
   - Termination claims for wider works, demand and generation volume drivers (TPWW/TPG/TPD) will be settled based on the values submitted in the Cost & Outputs RRP.

b) Western Link Allowance Rephasing:

   NGET re-phase allowances in line with expenditure. This better matches allowances to the level of incurred or forecasted expenditure, providing a more accurate view of in-year performance. Re-phasing does not affect the overall level of allowances recognised over the RIIO-T1 period, thus does not materially impact the RORE.

c) Western Link Liquidated Damages:

   NGET has received liquated damages in relation to Western Link, this is included as a credit to totex within the Cost & Outputs RRP. The current expectation is that these will be returned to consumers and NGET will not gain hence the Enduring Value adjustment removes the benefit

d) Western Link Uncertainty:

   NGET may carry out additional remediation or enhancement on Western Link and hence incur more spend, therefore any performance will only be recognised once there is no risk of future spend.

e) Cartel Settlements:

Legal Settlements received relating to cable cartel are included within the Cost & Outputs RRP Totex as a credit. These receipts do not affect allowances. The largest settlement received in the RIIO-T1 period to date was for £95m in 2015. The Enduring value adjustment removes the benefit of these receipts in T1 to be consistent with previous Ofgem RORE calculations. The rationale for not considering these receipts as RIIO-T1 performance is that the expenditure to which the settlement relates pre-dated RIIO-T1.

f) Excluded Services True up:

In-line with the assumptions in Final Proposals, exit connection revenues and costs are subject to a true-up mechanism. The Cost & Outputs RRP submission of allowances does not adjust for the position whereby NGET's net expenditure is lower than the base allowances given for this type of work. NGET have included an estimate of the true-up value within enduring value estimates which aligns with the view provided in the Cost & Outputs RRP narrative.

g) T1+2 Load Related Output performance:

Actual and future load related UM projects delivering an output in RIIO-T2 years 1 and 2 have allowances set to actual and forecast spend in T1. This judgment ensures that performance is only recognised when outputs have been delivered.

h) Power Control Devices Uncertainty:

As smart wires are an innovative and one of a kind technology, the success of these new devices is unknown at this stage, therefore performance that arises as a result of these will only be recognised when the outputs have been successfully delivered.

i) Non Lead Asset Uncertainty:

Within non-lead assets NGET has planned spend to maximise cost-efficiency. This has meant deferring elements of spend on non-lead assets to T2. The judgment NGET are applying in the RORE is to defer the performance on certain non-lead assets to T2 where spend on other unfunded works has not been substituted. As this is a judgment and inherently uncertain, NGET have applied £30m as the value, this being the mid-point of a range between £20m-£40m.

j) Re-phasing Allowances:

NGET 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. NGET have presented the impact of the re-phasing allowances as a single line on 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

Historic incentive performance is directly sourced from the Revenue RRP submitted to Ofgem. NGET's incentive performance for 2019/20 is explained below. Forecast incentives are based on average of historic performance during T1 to date unless otherwise stated.

This year the Electricity Transmission business has again continued to deliver strongly on the five primary RIIO output areas: Safety, Reliability, Customer Satisfaction, Connections and Environment.

Network Reliability Incentive

The total energy not supplied in 2019/20 was 54.5MWh. When compared with the incentive neutral point of 316 MWh, this year's performance was relatively strong, although the total incentivised lost energy was greater than that of 2018/2019 (12.06 MWh). This result is an outperformance compared to the neutral point (c83%) and represents an overall level of network **reliability of** 99.99997%, which stakeholders say continues to be so important to them.

The 2019/20 earned incentive will be received through Maximum Allowed Revenue in 2021/22 and is estimated to be £2.5m in 09/10 prices.

Customer & Stakeholder Satisfaction Output

This is supported by two separate elements of financial incentive:

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

NGET are extremely proud of its continual improvements in customer service have again been reflected in an improvement in customer satisfaction (CSAT) ratings. The scores have increased to 8.21 from last year's 7.92 (up from the average for RIIO-T1 of 7.57). This improvement reflects the focus and hard work across the whole business to improve the way NGET provide the experience that customers value. The focus is to continue this journey, always aiming to exceed the expectations of NGET's customers. The stakeholder satisfaction score (SSAT) has also increased from 7.92 to 8.64 and is now reflective of the opinion of a much broader set of stakeholders than ever before.

NGET continued to focus on putting customers and stakeholders at the heart of everything they do from operations and activities as part of RIIO-T1. NGET have further embedded our behavioural principles of Care, Agility, Transparency, earning Trust, and delivering Value into the customer journey delivering improved customer and stakeholder satisfaction. As part of the customer transformation programme NGET continue to improve performance in all areas, whilst expanding their reach across more customer and stakeholder contacts than ever before.

The Stakeholder Engagement Reward (SER) that relates to 2019/20 is scheduled to be directed by Ofgem later in calendar year 2020. The forecast SER is based on average of historic performance.

The 2019/20 earned incentive for all aspects of Customer and Stakeholder Satisfaction incentive will be received through Maximum Allowed Revenue in 2021/22 and is estimated to be £12.2m in 09/10 prices.

SF6 Emissions

SF6 leakage from NGET's equipment has increased from 12,270kg to 12,441kg predominantly due to the impact of COVID-19 in the first few months of 2020. There has been uncertainty on potential travel and access restrictions due to COVID-19 and as a result SF6 usage increased significantly as sites took precautions. This included topping up equipment earlier than NGET would otherwise normally do. This resulted in a spike of usage towards the end of the period. A consequential effect of this is to increase pressure which then increases the rate of leakage. COVID-19 has also impacted on intervention plans with travel restrictions affecting site surveys, availability of contractors and parts. NGET continue to identify our highest leaking assets to plan and implement a prioritised intervention for both repair and replacement activities.

The 2019/20 earned incentive will be received through Maximum Allowed Revenue in 2021/22 and is estimated to be £0.04m in 09/10 prices.

Environmental Discretionary Rewards

Ofgem will direct the Environmental Discretionary for 2019/20 later in calendar year 2020, the value included in the RFPR for 2019/20 has been forecast as £0m as there has been no incentive reward since 2014/15.

Innovation

(2019/20 Price base)

Network Innovation Allowance

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. NIA annual summaries are published on the National Grid Electricity Transmission website[2].

In 2019/20 NGET spent £7.6m of its' £8.2m allowable NIA expenditure. 52 eligible NIA projects were progressed that aligned to the innovation strategy. NGET had 13 further projects, completed the previous year, that incurred cost this financial year as part of their closure.

MTTE and Visor NIC projects are led by other licensees and NGET does not receive direct NIC funding. By agreement NGET invoice the other licensees for the NGET input into these projects.

Network Innovation Competition

The 2019/20 NIC funding was directed by Ofgem on 11 January 2019, NGET was awarded no funding.

In 2019/20 NGET spent £6.8m on the Offgrid Substation Environment for the Acceleration of Innovation Technologies Project (known as Deeside). Forecast spend is set to increase to c£15.2m in 2020/21 as project activity ramps up. The project remains on track to deliver the construction works and innovation project trials by the new delivery date of October 2021, however, it will not affect the delivery of consumer benefits. More information on Deeside can be found on NGET's website[3].

[2] https://www.nationalgridet.com/imagining-tomorrow/innovation

[3] https://www.nationalgridet.com/deeside-project

Financing and net debt

(2009/10 Price base)

Overview

Overall assumed regulatory finance cost at actual gearing for T1 is forecast at £491.8m (including adjustments to be applied for performance assessment), this compares to allowances for the same period of £976.8m thus resulting in £485.0m performance on an actual gearing basis.

On a notional basis, assumed regulatory finance cost for T1 is forecast at £520.2 (including adjustments to be applied for performance assessment) resulting in £456.6m performance at notional gearing. The post-tax view of this difference is £366.5m.

Financing allowances

The forecast financing allowance for T1 has decreased marginally from £982.1m to £976.8m. This is due to a slightly lower T1 RAV forecast than in the 2019 submission.

Financing

(Nominal Price base)
Financing cost per regulatory definition have decreased year-on-year by £5.7m to £218.5m. Total T1 Financing costs are forecast to be £1,849.5m.

Net debt

(Nominal Price base)
Regulatory net debt as at 31st March 2020 has increased by £630.4m to £7,648.2m compared to 31st March 2019. Regulatory gearing has remained stable at 53.9%. The increase in net debt reflects the payment of a dividend during the year as detailed in table R11.

External loans and bonds have increased from last year, from £5,647m to £7,293.5m, largely as a result of 13 issuances in the year. NGET's forecast for embedded debt is based upon the forward rate curve for the underlying rate. This approach is in line with last year.

Loans from other group companies have decreased by £1,098.3m to £649.7m year on year. NGET are forecasting the greater proportion of inter-company debt to be redeemed by 2020/21, which is reflected in the NGET and NGGT submissions. This assumption reflects the need for NGGT, which is the principal provider via National Grid plc, requiring repayment to satisfy the repayment of its external maturing debt.

New issuances in the year were largely fixed rate debt, replacing matured RPI linked debt. This is part of a longer-term strategy to rebalance NGET's portfolio away from RPI linked debt. The forecast for new issuances aligns with NGET's policy of maintaining debt levels close to the notional regulatory gearing level of 60%.

Derivatives

NGET's year to year derivative position has moved from £179.0m in 2019 to £135.6m in 2020, primarily due to external factors which have impacted the year end values. In addition, NGET have rationalised the derivative portfolio in year, as part of ongoing portfolio planning, which has also contributed to changes in year to year values.

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

The same assumptions and methodology have been used in 2020 as in 2019, there have been no changes in assumptions and methodology in 2020.

IFRS 9 Financial Instruments

National Grid adopted IFRS 9 *Financial Instruments* for the first time for reporting year 2018/19. No material changes resulted for NGET.

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 tab 8a (reference B2.10)

Allocation to System Operator

The Electricity System Operator was legally separated from NGET from 1st April 2019. Post-separation, the debt for NGET no longer includes amounts relating to NGESO. As such, the allocation proportion is set to zero for 2019/20 onwards for both debt and financing cost. Previously, debt and financing cost was apportioned based on relative RAVs.

RAV

(2019/20 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 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 a detailed in *Assumptions and enduring value adjustments* section above.

The closing RAV in 2021 has reduced from £15,108m in the 2019 submission, to £14,532m in the current year submission. The primary reason for the change is the reduction in the totex forecast compared to 2019 within the Cost & Outputs RRP and the inclusion of additional enduring value judgments within the RFPR, which defer performance to T2.

Tax

(2009/10 Price base)

The forecast tax allowance for 2019/20 is £82m and forecast tax out performance is £18.3m at actual gearing and £18.7m 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 -0.1% for the period through to 2020 and -0.06% over the RIIO T1 period (-0.07 and -0.05% respectively at actual gearing). This negative performance is primarily as a result of forecasting variances, including capital allowance rate changes, partially offset by the 'dead-band' benefit received on lower corporation tax rates.

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)

NGET'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 £869m paid in July 2019, the last dividend paid for the combined Transmission and System Operator. £129m of this is attributed to the sale of Electricity 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 only notable change is the adjustment of £0.7m (2009/10 price base) for the Pension Payment History Allowance (PPH), which is forecast for the remaining periods of T1. 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 RORE presented in NGET's 2018/19 Cost & Outputs RRP submission to the 2018/19 RFPR submission. The change to Totex performance is due to the re-phasing of allowances within the RFPR RoRE. This shifts allowances from the early to later years of T1 to better align with actual spend profile.

	2019/20 RoRE per RFPR	**2018/19 RoRE per RFPR**
Allowed return	7.00%	7.00%
Totex	2.03%	1.94%
IQI	0.29%	0.29%
Incentives & innovation	0.21%	0.23%
Operational performance	**9.52%**	**9.45%**
Financing	1.21%	1.57%
Tax	-0.06%	-0.51%
Total RoRE	**10.67%**	**10.52%**

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

Due to the legal separation of the ESO and NGET there are no longer any pass through costs for the 2 Scottish TO's and 17 OFTOs in NGET. The 2018/19 PT value has been restated from £1,063.3m to £1,057.8m as a result of a restatement relating to amounts notified to Licensee by all interconnector owners (TICF) detailed below.

Following a review of the Licence, we have changed our input methodology in relation to the IFA revenue to record this in the year it relates to, rather than when its collected, as previously done.

We have therefore restated the -£6.8m we had in 2019 in the 2018/19 submission and input this into 2017, replacing this with the 2019 revenue figure of -£12.3. Following the same approach, we have restated 2018 figures to include the value which relates to 2018 (-£8.4m). This will also mean that the MAR values for 2017 and 2018 were overstated by the respective amounts. The effects of this flow through K, Correction Factor. Prior year K value has been restated from -£55.1m to -£62.2m as a result of a restatement relating to amounts notified to Licensee by all interconnector owners (TICF)

R3 Rec to Totex

Row 50, *Total costs per latest RRP Submission was* previously based on the costs per the submission in the respective year, rather than the latest RRP submission. Hence the numbers have been updated for 2014-2017 to reflect changes made in later RRP submissions.

Within the reconciling items to Totex section, two lines relating to pensions (IAS19 PV accrual and Pensions payments relating to post cut off data service) have been removed for prior years. The RRP Totex includes values associated to these items and therefore they are not reconciling items, this was an oversight in previous submissions.

R5 Output Incentives

The Stakeholder Satisfaction Output incentive values earnt from the reporting year 2016/17 and 2017/18 have changed due to interest rate variations, this has less than a 0.1% impact on RORE. The 2019/19 Stakeholder Engagement Reward values was not directed until November 2019, as noted above, hence was previously based on forecast.

There has been a small change in the 2018/19 SF6 Emissions incentive due to historic leakage updates and RPIF updates.

The historic performance on Environmental Discretional Reward has been updated from 2016/17 onwards to reflect the fact no reward has been received and no future reward is forecast.

R6 Innovation

In NGET's 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 2017/18 Tax liability per latest CT600 has been restated this year from £114.6m to £116.4m due to a resubmission of the CT600 which reallocated some of the capital allowances between the tax pools.

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