31st July 2019

National Grid Gas Transmission (TO) RFPR submission narrative – 2018/19

Introduction

This narrative supports the submission of the National Grid Gas Transmission (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, we make reference to the published RRP narrative as required to avoid duplication.

RoRE

Overview

The Return on Regulatory Equity (RoRE) figure is a key measure by which Ofgem compare operational and financing performance across Network Operators. The methodology of calculating the figure has altered from prior years with the introduction of the Regulatory Financial Performance Reporting pack, part of the suite of regulatory reporting required under Standard Condition A40. The new methodology is more comprehensive than previously, encompassing a fuller range of 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, thus 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.

The new methodology for the RoRE for NGGT (TO) does not include the performance for the System Operator, as was the case previously. Due to these changes in methodology, the RoRE reported in the 2017/18 RRP submission is materially different to that reported in this submission. As such, the comparison here is to the RoRE submitted in accordance with the Request for Information issued by Ofgem on 2nd October 2018 and published as part of the 2017/18 Ofgem Annual Report. A supporting annex has been provided to explain the differences to the prior year reported RoRE.

NGGT (TO) RoRE on a notional basis

(2009/10 Price base)

The overall NGGT (TO) RoRE across RIIO-T1 is 7.17%, an increase of 0.17%. This is due to an increase in post-tax financing performance, offset by a decrease in totex 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 primary reason for the decrease in operational RoRE is that the current year operational RoRE reflects the outcome of the September 2018 reopener decisions, whereas the prior year RoRE assumed allowances equal to the spend forecasts within our reopener submissions. The reopener decisions provided lower levels of allowances than we had requested, offset in part by a consequential reduction in totex. The change in performance is explained fully in the Executive Summary of the Cost and Output (C&O) RRP narrative – Section 1, p2.

	2018/19	2017/18
Operational RoRE	6.07	6.43
Financing and tax	1.09	0.58
Total RoRE	7.17	7.00

Revenue

Collected revenue and the Maximum Allowed Revenue (MAR) for 2018/19 is explained in the Revenue RRP narrative (Appendix I, pp.141-146). In accordance with the RFPR Regulatory Instructions and Guidance (RIGs), we have not completed the forecast section for allowed revenue.

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

The change in accounting standards to IFRS 15 *Revenue from Contracts with Customers* has reduced statutory revenue for NGGT (TO), creating 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. A detailed explanation of the impact of the change to IFRS 15 can be found in the 2018/19 annual report and accounts for NGG plc.

Totex performance

Overview

For an overview of our totex performance, please see the Performance Summary in the C&O RRP narrative (pp.9-11).

The R4 – Totex tab begins with the latest totex actuals and forecasts from our 2019 C&O RRP, and the allowances given in the most recent published PCFM from Nov 18. There are then three enduring value adjustments given.

Allowance assumptions

R4 Totex enduring value adjustment (a) re-analyses the IED allowances from uncertainty to baseline allowances. This is because the initial allowances were themselves in baseline and so this creates the appropriate net allowances profile. This creates no overall change to the total of allowances.

R4 Totex enduring value adjustment (c) reflects allowances forecast in the RRP that are expected from the upcoming RIIO-T1 close-out process. This is driven by increases in allowances assumed for IED work at St Fergus and Hatton compressor sites and for pipeline diversion costs, partially offset by a net reduction in ISS allowances.

R4 Totex enduring value adjustment (b) is rephasing allowances to align with our spend profile. The methodologies for rephasing allowances are as follows:

1. The following key assumptions are embedded within the allowances included in the RRP:

   a. Reopener allowances are set as per the re-opener decisions directed in September 2018, with the exception of allowances for the IED and ISS reopeners. We anticipate making additional claims for funding as part of the close out process. For this spend, forecast allowances are aligned to our anticipated spend profile. This is explained further in the C&O RRP narrative for table 2.3, forecast allowances (pp.150-152).
   b. Additional allowances have been included related to the funding application for diversionary works. Allowances have been set to align with our forecast spend, as explained in the C&O RRP narrative for table 2.3, forecast allowances (pp.150-152).
2. T1 close out assumptions
   a. We have not included a judgement related to the likely outcome of the Network Outputs Measures (NOMs) given that we are mid-way through moving to a monetised risk methodology which is due to conclude in Summer 2019.
3. Rephasing adjustments
   a. We re-phase allowances compared to those in the PCFM. This better matches allowances to the level of incurred or forecasted expenditure, providing a more accurate view of in-year performance. We have presented the impact of the re-phasing allowances as two lines on the R4 totex tab, one for each of baseline and uncertainty allowances. 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

Forecast output incentives are assumed to be an average of the actual earned incentives in T1 to date. This methodology is in line with SO.

Full detail of our historic output incentive performance for SO is included within the C&O RRP narrative:

- Customer and stakeholder satisfaction – Section VII, p41.

Innovation

(2018/19 Price base)

Full details of our innovation projects are included within the C&O RRP Narrative – Section XV Innovation, starting page 116.

Network Innovation Allowance (NIA)

Eligible NIA Expenditure is the net costs per 2018/19 C&O 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 Gas website[1].

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

Network Innovation Competition (NIC)

The 2018/19 value was directed by Ofgem on 22 January 2018 and amounted to £15.4m. £15.3m was awarded for 2 projects, 2 projects were awarded a successful delivery reward of £0.43m, and 1 existing project is returning funding of (£0.47m) to customers via the Funding Return Mechanism. More information on NGGT's NIC projects can be found on the National Grid Gas website[2].

Financing and net debt position

(2009/10 Price base)

Overview

Our overall financing cost, on a notional basis, for RIIO T1 is £381m compared to allowances of £463m. The post-tax view of this difference is £54m, an increase of £20m from 2018. The primary reason for the improvement reflects an increase in the forecast gearing level bringing it closer to the notional level compared to those forecasted in the 2018 submission. Our prior year submission to Ofgem indicated this was our intention.

Financing allowance

The financing allowance has decreased by £6m from £469m to £463m. This is primarily due to the Ofgem provided forecast cost of debt allowance for 2019/20 and 2020/21 being lower in the 2019 submission than the 2018 submission.

Financing

(2018/2019 Price base)
Financing costs per regulatory definition have decreased year-on-year by £15m to £178m in 2018/19.

Net debt and derivatives

(2018/2019 Price base)

Regulatory net debt as at 31st March 2019 has increased by £265m to £2,887m compared to 31st March 2018. This increase is due to decreases in short term liabilities within cash and short term deposits of £1,049m, offset by increased liabilities for inter-company loans of £567m. This is a short term position which we are forecasting will conclude in 2020 when the greater proportion of our inter-company debt will be redeemed. This is reflected in the National Grid Electricity Transmission (NGET) and NGGT RFPR 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.

External borrowings have decreased by £256m, due to natural maturities in year, offset in part by the re-measurement of a bond to fair value in line with IFRS 9. We have issued no additional debt in 2018/19.

[2] https://www.nationalgridgas.com/insight-and-innovation/transmission-innovation/network-innovation-competition-nic

The decrease in the liability position of derivatives is due to natural maturities within external borrowings noted above and market movements.

Changes in assumptions and methodology from 2018

Forecasting methodology

The 2018 RFPR submission was the first time Network Operators (NWOs) were required to complete the RFPR submission. Both NWOs and Ofgem have learnt from that submission and the RIGs have been updated accordingly. National Grid has performed a detailed assessment of its submission, focussing on the forecasting assumptions used. As a result, we have reassessed the forecasting methodology for embedded debt and derivatives. We will move from assuming a flat forecast to using a forward rate curve for debt and interest values for all debt types excepting Retail Price Index (RPI) linked, where the Ofgem provided RPI rate will be used to inflate the debt value and attendant interest cost. Our approach in 2019 provides a greater level of accuracy and better reflects our future debt costs, whilst not creating material differences to the prior year forecast.

National Grid view of financing performance

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

The cost of debt buybacks is included within the financing performance calculation. However, this does not include all buybacks as determined by Ofgem and takes into account the full cost of the buyback in the year it occurred. An alternative view is to present the cost of the buybacks amortised over the remaining life of the instruments bought back.

RAV

(2018/19 Price base)

The RAV table utilises the PCFM published in November 2018 to calculate the adjusted RAV balances.

The RAV figures for net additions (after disposals) and depreciation are those given in the PCFM published in Nov 18. The effect of updated totex figures from the C&O RRP 19 and the enduring value allowance adjustments across T1 are shown in the subsequent lines labelled 'net additions (after disposals) - enduring value adjustment' and 'depreciation - enduring value adjustment'.

The closing RAV in 2021 has reduced by £226m from £6,625m in RFPR 18 to £6,404m in RFPR 19. This reduction reflects the results of the 2018 reopener outcomes and the associated performance compared to the assumptions included within the 2018 RFPR submission.

Tax

Consistent with prior years, the primary driver of the tax performance is the level of financing performance.

The residual tax performance at notional gearing is 0.3% for the period through to 2019 and 0.4% over the RIIO T1 period (0.2% and 0.2% respectively 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 our underlying accounting systems and is reflected in the Statutory Accounts. There are no specific allocations made for the RFPR tables.

The forecast tax allowance is derived from the PCFM post enduring value adjustments.

Dividends paid and current policy

The timing of paying dividends has been altered across the National Grid UK businesses, so that the decision is now made after 31st March 2019. As such, no dividend was paid from NGG PLC to National Grid PLC within the financial year 2019.

The overall dividend policy for National Grid PLC is for the dividend to be aligned with increases in RPI, thus a long run average of 3% per annum. The dividend policy of the subsidiary companies of NGET PLC and NGG PLC is to ensure a gearing ratio close to the regulatory position.

Pensions

(2009/10 price base)

Pension deficit payments were broadly in line with the prior years. The only notable change is the adjustment of £1.7m 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 2018/19 RFPR is therefore the same valuation as that presented for 2017/18.

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.