31st July 2019

National Grid Electricity Transmission RFPR submission narrative – 2018/19

Introduction

This narrative supports the submission of the Regulatory Financial Performance Reporting (RFPR) pack for National Grid Electricity Transmission NGET (TO) for the regulatory reporting year 2018/19.

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). 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 B15. The new methodology is more comprehensive, 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 is calculated by licensee, thus the RoRE for NGET (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.

NGET (TO) RoRE on a notional basis

The overall NGET (TO) RoRE has increased marginally by 0.10% to 10.52%. The increase is primarily due to an increase in totex performance, offset by a slight decrease in tax and financing performance.

	2018/19	**2017/18**
	%	**%**
Allowed return	7.00	7.00
Totex performance	1.94	1.83
IQI	0.29	0.29
Incentives & innovation	0.23	0.20
Operational RoRE	9.45	9.31
Financing and tax	1.06	1.11
Total RoRE	10.52	10.42

Assumptions and enduring value adjustments

(2009/10 Price base)

The overarching principle of enduring value adjustments is to recognise performance that relates to the T1 period.

1. The following assumptions are made within the **Cost and Outputs (C&O) RRP submission** (R4 Totex enduring value adjustment g):
    a. Allowances which have been decided by Ofgem are included as per the decision. This applies to the enhanced site security reopener, visual impact provision project for Dorset (VIP) and landscape enhancement initiatives (LEI). Where a decision is yet to be made on VIP and LEI, we have assumed allowances equal to the spend forecast.
    b. 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, Moorside and Eastern HVDC.
    c. Allowances for the Western HVDC SWW project have been included as per final proposals.
    d. Actual and future load related UM projects delivering an output in RIIO-T1 receive allowances in-line with the current UCA funding mechanism.
    e. 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 2016/17 RRP submission. Presenting the allowances in this way in the RRP provides a more accurate view of the actual allowances for outputs being delivered.
    f. Actual and future load related UM projects delivering an output in RIIO-T2 years 3 and beyond do not have confirmed allowances incldued, but funding is anticipated as part of the T1 close out process.
    g. Termination claims for wider works, demand and generation volume drivers (TPWW/TPG/TPD) will be settled based on the values submitted in the C&O RRP.
2. Totex adjustments for legal settlements not related to the T1 period (R4 Totex enduring value adjustment c):
    a. Legal settlements are treated as negative totex in the year in which monies are received. These receipts do not affect allowances. The largest settlement received in the RIIO-T1 period to date was for £95m in 2015. The benefit of these receipts has not been included in T1 performance 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.
3. Re-phasing (R4 Totex enduring value adjustments a and e):
    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 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. We have re-phased allowances for WHVDC in line with expenditure to reflect the Mid-Period Review parallel works decision, dated 4 July 2017, relating to Western HVDC affecting NGET (TO). In this decision Ofgem decided 'to adjust the regulatory framework so that NGET and SP Transmission do not benefit from delivering the Western HVDC link late while increasing costs to consumers. We will do this by delaying allowances'.

4. Known true-ups that will occur as part of close out
   (R4 Totex enduring value adjustment b):
   a. In-line with the assumptions in Final Proposals, exit connection revenues and costs are subject to a true-up mechanism. The RRP submission of allowances does not adjust for the position whereby our net expenditure is lower than the base allowances given for this type of work. We have included our estimate of the true-up value within our enduring value estimates which aligns with the view provided in the C&O RRP narrative.
5. Adjusting for performance that relates to RIIO-T2
   (R4 Totex enduring value adjustments d and f):
   a. 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 and the allowances are confirmed. The adjustment of £592m aligns with that recorded in the C&O RRP narrative.
   b. Within non-lead assets we have planned our spend to maximise cost-efficiency. This has meant deferring elements of spend on non-lead assets to T2. The judgment we 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, we have applied £30m as the value, this being the mid-point of a range between £20m-£40m.

Revenue

(2018/19 Price base)

Allowed Revenues are directly sourced from the Revenue RRP submitted to Ofgem and upon which our auditors issue an 'agreed upon procedures' report which Ofgem receives. In accordance with the RFPR RIGs, we have not completed the forecast section for allowed revenue.

Collected revenue and the maximum allowed revenue (MAR) for 2018/19 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 £2,749.1m (including Pre vesting) compares to the final MAR of £2,746.5m, resulting in an over-recovery of £2.6m (0.09%).

Table comparing tariff setting and final MAR and collected income

Item	£m	Commentary
TNUoS Charge setting forecast	2670.3	MAR figure set for charge setting on 31st January 2018 for the year 2018/19
Pre Vesting Charges	44	Pre Vesting charges
TNUoS revenue collected	2,749.1	Actual revenue collected in 2018/19
MAR	2,746.5	MAR as per the 2018/19 Revenue RRP submission
Over/(Under) collection	2.6	Over collection amount that will be adjusted via the K term in the 2020/21 MAR.
Difference to forecast	-32.2	The actual MAR was lower than the forecast in January 2018.

2018/19 charges were set to recover Maximum Allowed Revenue of £2,714.3m TNUoS tariffs were set to recover £2,670.3m with the expectation that £44m would be recovered from pre-vesting connection charges.

£2,706.2m was recovered from use of system and terminations, and £43m from pre-vesting income.

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 NGET (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 NGET plc.

Totex performance

(2018/19 Price base)

Our overall total expenditure forecast for the RIIO T1 period is £10.24bn against forecast allowances of £12.77bn, including the adjustment of £266m for forecast excluded services true-up. This total is a £2.53bn reduction of costs below allowances (2018/19 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, we amend our 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. We also made a voluntary deferral of allowances for outputs deferred into future price controls. In addition, the totex incentive mechanism has incentivised us to innovate and deliver more efficiently. This will reduce customer charges by a further £1.3bn which will lower the consumer bill.

Our initial allowances were set at the start of RIIO-T1 to deliver against the Gone Green background.	Allowances are automatically reduced as customer driven requirements change. **100% returned to consumers**	Voluntary deferral of £643m of allowances for work that will move to future price controls **100% returned to consumers**	Forecast allowances equal forecast RIIO-T1 spend on Hinkley, ISS & VIP. These were uncertain at the start of the RIIO-T1. Funding is agreed when we have certainty of need, output, and costs.	Our projected adjusted allowance for the RIIO-T1 period. The allowance will fund the delivery of the outputs required to connect customers and keep our network reliable.	The difference between spend and allowance have resulted in 21% net savings compared to allowances. **Savings shared with consumers (53/47%)**	The projected spend is our estimate of costs to deliver the required outputs. Considering our performance this shows an 'expected' return of 9.45%.
£14.83bn **Initial Baseline Allowance** **LR - £6.38bn** **NLR - £6.12bn** **non-op Capex - £194m** **Opex - £2.13bn**	**£1.94bn** **Uncertainty Mechanism**	**£643m Voluntary Deferral**	**£794m** **Additional Allowance**	**£12.77bn** **Adjusted restated allowance** **LR - £4.36bn** **NLR - £6.01bn** **non-op Capex - £263m** **Opex - £2.15bn**	**£2.53bn savings**	**£10.24bn** **Spend** **LR - £3.43bn** **NLR - £4.15bn** **non-op Capex £358m** **Opex £2.31bn**

Output Incentive Performance

Historic information is directly sourced from the current year Revenue RRP submitted to Ofgem and which our auditors issue an 'agreed upon procedures' report. Our incentive performance for 2018/19 is explained below. Our forecast incentives are based on average of historic performance during T1 to date.

Incentive performance Overview

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

Network Reliability

The total energy not supplied in 2018/19 was 12.0MWh. This result is well below the average of 34.5MWh over the RIIO-T1 period, and is a significant improvement on the 39.7MWh loss of 2017/18. This result is 97% lower than the neutral point and represents an overall level of network reliability of 99.999995%, which our stakeholders tell us continues to be so important to them.

Customer Satisfaction

We are extremely proud that our continual improvements in customer service have again been reflected in an improvement in customer satisfaction ratings. The scores have **increased to 7.92** from last year's 7.74 (up from the average for RIIO-T1 of 7.50). This improvement reflects the focus and hard work across our whole business to improve the way we provide the experience our customers value. Our focus is to continue this journey, always aiming to exceed the expectations of our customers. Our stakeholder satisfaction score has also increased from 7.88 to 7.92 and is now reflective of the opinion of a much broader set of stakeholders than ever before.

We continued our focus on putting our customers and stakeholders at the heart of everything we do from our operations and activities as part of RIIO-T1 to engagement and co creation in building our RIIO-T2 plans. Through the customer feedback we received, we have developed our behavioural principles of **Care, Transparency, Agility, delivering Value and earning Trust**. As part of our customer transformation programme we improved our performance in all these areas, whilst expanding our reach across more customer and stakeholder contacts than ever before.

Environmental Discretionary and Stakeholder Engagement Rewards

Ofgem will direct the Environmental Discretionary and Stakeholder Engagement Rewards for 2018/19. As such, the value included in the RFPR for 2018/19 is a historic average of prior year performance.

SF6

We are disappointed that we have had our worst year in RIIO-T1 in SF6 leakage from our equipment; emissions increased from 9,615kg to 11,935kg because of a significant increase in leakage from 15 assets. These assets were responsible for 28% of the leakage rate and we have repaired or have a planned intervention for all of them. We are confident that the initiatives and process improvements that we have in place will return us to the great performance in the first five years of RIIO-T1.

Innovation

(2018/19 Price base)

Network Innovation Allowance

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 Electricity Transmission website[1].

In 2018/19 the Electricity Transmission Owner spent £7.4m of NGET's £11.7m allowable NIA expenditure. (Note that the £11.7m is shared with NGESO). 54 eligible NIA projects were progressed that aligned to our innovation strategy. We had 11 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 2018/19 NIC funding was directed by Ofgem on 26 January 2018 and amounted to £32.7m. 42.4m was awarded for 5 projects and 2 existing projects are returning funding (9.8m) to customers via the Funding Return Mechanism.

In 2018/19 we spent 1.6m in 2018/19 on the Offgrid Substation Environment for the Acceleration of Innovation Technologies Project (known as Deeside). Forecast spend is set to increase to c£20m in 2019/20 as project activity ramps up. The project remains on track to deliver the construction works and innovation project trials by October 2020. More information on Deeside can be found on our website[2].

Financing and net debt

(2018/19 Price base)

Overview

Our overall financing cost on a notional basis for RIIO T1 is £621m against allowances of £1,290m. The post-tax view of this difference is £553m, a reduction of £38m from 2018.

Financing allowances

The forecast financing allowance for T1 has decreased marginally from £1,297m to £1,290m. This is due to a reduction in the forecast cost of debt and a lower RAV forecast than in the 2018 submission

Financing

Our regulatory finance cost per regulatory definition including refinancing costs has increased marginally by £61.1m to £2,109.8m.

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

Net debt

Regulatory net debt has decreased in the year to £7.02bn from £7.26bn resulting in a lower regulatory gearing at 54.4% down from 55.9%. This is primarily due to reductions in inter-company debt of £0.18bn and changes in derivative values.

External loans and bonds have remained broadly stable from last year, with a slight decrease from £5.66bn to £5.65bn. Our forecast for embedded debt is based upon the forward rate curve for the underlying rate. This approach is a refinement compared to our 2018 submission, which applied the relevant forecast rate to the year-end value. The difference in approaches is not material, but we believe is a more accurate forecast of future debt values.

Loans from other group companies have decreased by £0.18bn to £1.75bn year on year. We are forecasting the greater proportion of our 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 fixed rate debt, replacing matured RPI linked debt. This is part of a longer term strategy to rebalance our portfolio away from RPI linked debt. Our forecast for new issuances aligns with our policy of maintaining debt levels close to the notional regulatory gearing level of 60%.

Derivatives

Our year to year derivative position has moved from £0.11bn in 2018 to £0.18bn in 2019, primarily due to external factors which have impacted the year end values. In addition, we have rationalised our 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 2018

Forecasting methodology

The 2018 RFPR submission was the first time NWOs were required to complete the RFPR submission. Both NWOs and Ofgem have learnt from the 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 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.

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 (TO).

Allocation to System Operator

The Electricity System Operator was legal separated from NGET (TO) from 1st April 2019. Post-separation, the debt for NGET (TO) will no longer include 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.

National Grid view of financing performance

The methodology within 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, which does not fund networks for derivatives, instead using an historic tracker to set the allowance.

The cost of 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 for net additions (after disposals) is based on the November 2018 PCFM. The enduring value adjustment row, reflects the following enduring value adjustments (as detailed in *Assumptions and enduring value adjustments* section above):

- Allowance assumptions included in the C&O RRP
- Rephasing of WHVDC allowances to align with spend
- Excluded Services true up
- Removal of cartel settlements
- Adjustments for RIIO – T2 Output performance for Load and Non Load
- Rephasing allowances

The closing RAV in 2021 has reduced from £15,650m in the 2018 submission, to 15,108m in the current year submission. The primary reason for the change is the reduction in the totex forecast compared to 2018 within the C&O RRP and the inclusion of additional enduring value judgments within the RFPR, which defer performance to T2.

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 -0.8% for the period through to 2019 and -0.5% over the RIIO T1 period (-0.7% and -0.5% 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 allocation of the NGET 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 NGET PLC to NG 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 NGGT PLC is to ensure a gearing ratio close to the regulatory position.

Pensions

Pension deficit payments were broadly in line with the prior years. The only notable change is the adjustment of £0.7m 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.

Appendix

Comparison to prior year RoREs

The table below compares the RoRE presented in our 2017/18 C&O RRP submission to the 2017/18 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 our actual spend profile.

	2017/18 RoRE per C&O RRP	**2017/18 RoRE per RFPR**	**2018/19 RoRE per RFPR**
Allowed return	7.00%	7.00%	7.00%
Totex	1.68%	1.83%	2.01%
IQI	0.24%	0.29%	0.29%
Incentives & innovation	0.26%	0.20%	0.23%
Operational performance	**9.18%**	**9.31%**	**9.53%**
SO performance	0.37%	N/A	N/A
Financing	N/A	2.10%	2.14%
Tax	N/A	-0.45%	-0.62%
Total RoRE	**9.55%**	**10.96%**	**11.04%**