Regulatory Financial Performance Report (RFPR) - 2021/22

July 2022

Contents

1. Overview

This report sets out the details of our financial performance in 2021/22 and supports our RFPR tables submitted to Ofgem. Further details of performance, both financial and non-financial which include how we act in a sustainable and environmentally responsible way, can be found within NGN's RIIO-2 Strategic Commentary Report.

The financial highlights as at March 2022 include:

- We delivered 854 Fuel Poor Connections against a target of 1,000, but consider this to be a good performance as the qualification criteria have changed restricting the number of customers who can apply.

- We delivered more Tier 1 mains replacement work than targeted and will continue to do so in order to recover the shortfall seen during the Covid-19 pandemic.

- The Regulatory Asset Value (RAV) increases year on year in line with expectations as we continue to invest in our assets.

- We outperformed the allowances by 15% this year, but expect workload increases and cost pressures against a reducing allowance to reduce this outperformance. We expect to deliver a 6.5% outperformance over RIIO-2.

- We expect to increase our customer service performance each year, delivering an £8.1m incentive over RIIO-2. We expect to pay no penalties under the Complaints and Unplanned Interruptions. We are in penalty in the first year under the Environmental Emissions incentive, but expect to recover this over RIIO-2.

Note on enduring value adjustments

Enduring value is defined as an adjustment made to a licensee's financial or operational performance to reflect true performance against regulatory targets. This could include any timing differences (past or future) on delivery when compared to the allowance, any future uncertainty mechanism claims, and any future close out mechanism adjustments. NGN do not consider it appropriate to make any enduring value adjustments as at 31 March 2022.

Data assurance

The submission process is compliant with NGN's Regulatory Reporting Policy, which requires a full secure audit trail for the submission, segregated roles and responsibilities including independent completion and detailed checking roles. Step by step processes have been documented. All tables are allocated to members of the NGN Finance Management Team, and have been reviewed through departmental internal sign off, in accordance with our policies, by the Finance Director.

Much of the financial data financial data is based on other Regulatory Submissions including those detailed under Condition A40 in our Licence and it has been reconciled to the latest draft/audited statutory accounts. As such the base data is subject to the controls inherent in those processes.

Inflation assumptions

NGN have updated the year end inflation assumptions held of the data sheet row 17 to reflect:

- Actual data for 21/22 in cell F17
- An updated forecast to reflect March OBR forecast data each year thereafter.

2. (R1) Return on Regulatory Equity (RORE)

Ofgem use the Return on Regulatory Equity (RORE) to measure the potential financial returns or penalties on the portion of the value of the company that is financed by equity. RORE is calculated by using the cost of equity (Allowed Equity Return) as the starting point as this amount is funded directly in revenue. The cash value of any outperformance from the incentive mechanisms is then divided by the 40% notional equity portion of the Regulatory Asset Value to calculate the additional return on equity earned.

RORE: %	**21/22 actual**	**22/23 forecast**	**23/24 forecast**	**24/25 forecast**	**25/26 forecast**	**RIIO-2 forecast**
Operational performance	6.82	6.57	5.47	5.06	5.01	5.71

Our RORE starts at 6.82% and reduces over the price control to 5.01%, an average of 5.71%.

After the Allowed Equity Return, the main driver is the Totex incentive mechanism. We expect our out-performance against the Totex allowances to reduce over time, partly due to workload movements, but also due to the tightening of the allowances, which include a very stretching efficiency assumption. We expect to earn further rewards under the Customer Satisfaction Incentive, whilst the Shrinkage Management Incentive will break even over the price control.

Further details of performance can be found within NGN's RIIO-2 Strategic Commentary Report.

3. (R2) Revenue

At the beginning of the price control Ofgem set our Base Revenue, assuming we deliver in line with the allowed costs and workload. Our Allowed Revenue is then calculated based on our actual cost and workload performance and is used to set customer bills. However, because of movements in customer numbers and levels of consumption our Collected Revenue for that year is unlikely to match the Allowed Revenue. Any under or over collection is simply adjusted for in the following years' Allowed Revenue.

In addition to our Allowed Revenue, the gas networks collect revenue to pay for the National Transmission System (NTS) Exit Capacity charges, and the Supplier of Last Resort payments. These are pass through costs – the gas networks have no control over the charges and simply collect the revenue to be passed on. However, they are a significant part of the end customer's bill.

Our average Allowed Revenue for RIIO-2 falls to £383m, a 10.7% reduction from the RIIO- 1 average of £429m, reflecting the challenging nature of the RIIO-2 settlement. NTS Exit Capacity charges increase from an average of £8m in RIIO-1 to £38m in RIIO-2. We also expect to collect c£102m in Supplier of Last Resort Payments in years 2 and 3 of the price control.

Further details of performance can be found within NGN's RIIO-2 Strategic Commentary Report.

4. (R3) Totex

Summary

All data within this section is detailed in 18/19 prices unless stated otherwise. This year we outperformed the Totex allowance by £38.1m, being 15% of the allowance.

Totex: 18/19 prices £m	**21/22 actual**	**22/23 forecast**	**23/24 forecast**	**24/25 forecast**	**25/26 forecast**	**Total forecast**
Opex (controllable)	74.5	86.9	88.6	87.9	87.6	425.5
Capex	40.4	43.6	53.8	56.8	53.2	247.7
Repex	100.7	97.5	96.4	96.3	95.8	486.6
Totex	**215.6**	**228.0**	**238.8**	**241.0**	**236.6**	**1,160.0**
Allowance	253.7	258.0	248.3	241.8	238.5	1,240.2
Variance	**(38.1)**	**(30.0)**	**(9.5)**	**(0.8)**	**(1.9)**	**(80.2)**

As shown above, we expect costs to increase and be more in line with our business plan over the rest of RIIO-2. Further details of this year's performance are provided below and a more detailed analysis is provided within NGN's RIIO-2 Strategic Commentary Report.

Controllable Opex

Our Controllable Opex costs were £74.5m this year, being £21.4m below the allowance of £95.9m. Compared to spend in 20/21, costs were £6.9m lower this year as detailed below.

We spent £2.0m more this year on **Environmental Remediation including holder demolition costs** purely down to project timing.

We spent £0.6m less on **Asset Management** this year, driven by staff turnover and variances in the use of professional and consultancy services.

We spent £0.3m less on **System Control** this year. We now flex the resource here to support other asset management activities to increase efficiency and maximise output.

We spend £8.0m less this year on **Operations Management**, **Customer Management**, **Emergency** and **Repair** costs, although this has been influenced by Covid-19.

We spent £28.6m on Emergency and Repair in 20/21, but this included £3.1m of stranded direct labour resource and £0.8m of increased contractor resource associated with the Covid-19 pandemic. During the pandemic all non-priority customer invasive planned works were stopped to minimise interaction with members of the public and protect both customers and employees. We also saw reduced customer driven connections and service alteration work throughout the year. This resulted in a significant amount of resource in the network being at work but with no specific work to complete, stranding costs in Opex. We also employed additional contractor engineers to provide extra resilience within our emergency workforce to manage any Covid-19 related absences.

Adjusting for this we would have spent c£24.7m in 20/21. This year we only spent c£23.3m, achieved through careful management of overtime and increased focus on productivity as a result of more resource being on our new modern terms and conditions.

We spent £2.6m less on Operations Management this year, the main driver being £1.6m reduced Pensions Deficit payments following the increased payment in 2020/21, as a result of the latest triennial valuation discussed with Ofgem as part of the RIIO-2 business plan submission. The balance is driven by efficiencies, staff turnover and the relative levels of workload across Totex when compared to our business plan, in particular between Opex and Repex.

We spent £0.1m less on Customer Management this year, largely due to reduced calls to the emergency number than expected following the Covid-19 pandemic.

We spent £1.6m more on **Maintenance** this year. In our business plan we outlined our strategy to increase maintenance in several areas, in particular on District Governors to extend their operational life and reduce Capex, carry out on-line inspections using new technology of our 4" high pressure pipelines, and to install more Pressure Control systems which require increased maintenance. Accelerating this workload post the Covid-19 pandemic has proved more difficult with long lead times for some equipment and scarcity of resource. We expect to accelerate this work over the next two years and fully catch up by the end of RIIO-2, spending just under our business plan target over the price control.

We spent £0.7m less on **Other Direct Activities** this year, but last years' costs included £1.2m of costs related to the Covid-19 pandemic, primarily for Personal Protective Equipment (PPE). We expect to spend in line with our plan for the remainder of RIIO-2. Costs can vary year on year, largely driven by the number of district incidents we encounter and our success at recovering costs from 3rd parties if they caused the incident. Our plan was based on the long-term average.

We spent £0.3m less on **IT and Telecoms** this year. We continue to see benefits from our insourcing strategy as we exit older contracts and move roles in house, which has been offset by increases in resource focusing on Cyber Security.

Our **Property** costs have increased by £0.3m this year due to increased rents and utility bills.

Our **Human Resources** costs have increased by £0.1m this year and we expect them to increase again to be in line with our business plan. We are seeing increased costs for recruitment as staff turnover has increased, and are investing more in our wellbeing, hybrid working and talent development strategies, as well as expanding on our existing diversity and inclusion plans.

We spent £1.2m less on **Audit, Finance and Regulation** this year, mainly from the cessation of our RIIO-2 Business Plan team and associated contractors, with the balance from efficiency as we reduced headcount in some areas, and through to natural variations in Professional and Consultancy fees which can move significantly each year. We expect costs to increase year on year from now as we begin to ramp up towards the development of our RIIO-3 business plan.

We spent £0.2m less this year on **Insurance** and claims, with both years below the long-term average due to lower claims. However, claims have historically varied materially from year to year and are very difficult to predict. Our forecast remains at the long-term average.

Our **CEO and Group** costs increased by £0.5m this year, driven by our Hardship fund and the Vulnerability and Carbon Monoxide Allowance (VCMA). We were behind our plan this year but expect to catch up next year, with costs then remaining broadly flat for the remainder of RIIO-2.

Capex

Our Capex costs were £40.4m this year, £11.7m lower than the allowance as detailed below. We expect costs and workload to increase and be more in line with our business plan over the rest of RIIO-2.

LTS, Storage and entry costs were £9.3m, c£2.0m lower than our Business Plan Forecast. The main driver for this has been delays in starting work on some of the major projects associated with the Network Rail driven Transpennine Electrification project. This is the largest area of expenditure on our LTS assets in RIIO-2 and is expected to involve work at 4 separate locations. NGN proposed this c£20m project should be a PCD as we are not driving the work, location or timing, and so the final costs are uncertain. Network Rail continue to work on designs for the projects and as a result suspended but did not cancel their notification for some areas of the project. We expect that formal notification to continue the projects will be made before September 2022, with delivery required by early 2025 and December 2024 respectively. We have also experienced some delays with long lead items and shortage of expert contractor resource, driven by the Covid-19 pandemic and general economic conditions. Despite this we expect costs to increase for LTS, Storage and entry in line with our Business Plan, and to peak in 2024/25.

Net Connections costs were £7.5m this year, c£0.5m lower than our Business Plan forecast. The main driver for the decrease was reduced workload in all areas. Domestic and Non-Domestic workload was c27% lower than our allowed workload. All workloads reduced during the Covid-19 pandemic and have not returned to the levels seen earlier in RIIO-2 which drove our business plan forecasts and the allowed workload.

Mains reinforcement costs were £4.7m this year, c£0.5m under the forecast in our Business Plan. We delivered 10.5km of mains at a unit cost of c£460 per metre, a reduction from £520 per mete in 2020/21. Both of these unit rates are historically high, but they are driven by a large project in Pocklington which has seen significant preparatory work but no recorded workload as the pipe is yet to be commissioned. We expect unit rates to return to more normal levels in the future. In our business plan we did highlight the risk volumes could increase significantly due to improving economic conditions and increasing demand for electricity peaking plant. Much of this workload is third party driven. Clearly the economic situation has changed, and together with the cost-of-living crisis means we now expect to see workload and costs reduce over RIIO-2 to c£19m, c£5m below our business plan forecast.

Replacement governor costs were £0.3m this year, c£1.5m below our business plan forecast, which is also reflected in the workload delivered. We expect to recover from this slow start to RIIO-2 after successfully increasing the resource to deliver the programme and establishing a new commercial framework to deliver value for money. We expect workload and costs to increase year on year to deliver the forecast workload, whilst spending c10% less than our business plan forecast.

Other Capex costs were £18.5m this year, c£7.0m below our business plan forecast. The main drivers for this underspend were:

- c£2.7m lower expenditure on **Vehicles** than planned. This is down to timing and reflects the world-wide semi-conductor shortages which have increased lead times for all types of vehicles. We expect to recover this position over RIIO-2 and that unit costs will increase due to the scarcity of vehicles and world-wide supply issues.
- c£1.5m lower expenditure on **Property and Workspace**. The Covid-19 pandemic has led to a review of our overall property strategy to take into account hybrid working and changes in the office environment, which has delayed the planned expenditure in 2021/22. We currently forecast to spend broadly in line with our business plan but this may change or be focused in other areas than originally expected.
- c£2.2m lower expenditure on **Electrical and Mechanical instrumentation**. This mainly relates to Pressure Management equipment and is a timing issue. We are currently assessing new innovative equipment to support this programme of work which has delayed the planned investment until later in RIIO-2.

Repex

This year we have delivered a total of 565.2km of mains abandonment.

Our Repex costs were £100.7m this year, £5.0m lower than the allowance. The main driver for this was lower than expected costs for Tier 1 Stubs, which are subject to a re-opener mechanism. Ofgem provided allowances for the first two years of RIIO-1 for Tier 1 Stubs as the HSE policy was under review at the time, and so the volume and timing of work was uncertain.

It is now clear under HSE policy that many Tier 1 stubs still need replacing, and so our cost forecast takes this into account. This is the main driver for the allowance outperformance reducing in later years, as we have included costs with no associated allowance. We expect to re-open Tier 1 Stubs to review progress to date and our plans for the rest of RIIO-2 to ensure we can deliver the required work by the end of the Repex programme.

We expect unit rates to remain broadly flat in RIIO-2. The DSP delivery model we introduced in RIIO-1 is now fully embedded and, as a consequence, provides more limited opportunities for efficiencies moving forward. We are still targeting to deliver efficiencies, but we expect these to be offset by cost pressures as the work becomes more complex towards the end of the Repex programme.

5. (R4) Incentives

The adoption of an output and incentive-based framework is a key element of the RIIO regulatory contract. By defining the outputs companies need to deliver and any incentives or penalties they will receive for over or under-performance, as well as setting cost allowances, companies are incentivised to innovate and deliver the services that customers require at least cost. An outputs-based framework also provides greater transparency for customers and the networks as to what services and standards the networks need to deliver.

Outputs for RIIO-2 are grouped into three consumer-facing output categories, as set out below:

Deliver a high quality and reliable service to all network users and consumers including those in vulnerable situations

Deliver a safe and resilient network that is efficient and responsive to change

Enable the transition towards a smart, flexible, low carbon energy system for all consumers and network users

Performance summary

We expect to increase our customer service performance each year, delivering an £8.1m incentive over the RIIO-2 period. We expect to pay no penalties under the Complaints and Unplanned Interruptions. We are in penalty in the first year under the Environmental Emissions incentive, but expect to recover this over the RIIO-2 period.

Output Incentives: 18/19 prices £m	**21/22 actual**	**22/23 forecast**	**23/24 forecast**	**24/25 forecast**	**25/26 forecast**	**Total forecast**
Customer service	1.4	1.6	1.7	1.7	1.8	**8.1**
Complaints	-	-	-	-	-	**-**
Unplanned interrupt	-	-	-	-	-	**-**
Shrinkage mgt	(0.3)	(0.0)	0.1	0.1	0.1	**0.0**
Total	1.0	1.6	1.8	1.8	1.9	**8.1**

Further details of performance can be found within NGN's RIIO-2 Strategic Commentary Report.

6. (R5 - R6) Financing and Debt

Cost of debt

In 2021/22 NGN's net interest cost on a nominal basis (per the regulatory definition) was £31.2m before the impact of accretion on index-linked swaps and £51.4m after accretion.

Very high inflation in the year, coupled with c70% of NGN debt being subject to nominal interest rates, means that on a real basis (using Ofgem's methodology) NGN's net interest cost was -£39.1m before accretion on inflation-linked swaps and -£18.9m net of accretion. That translates to £44.1m of cost of debt outperformance in the year (in 18/19 prices at notional gearing), contributing +5.9% to RoRE for the year. In our view this is not a true reflection of outperformance as the methodology is based on the premise that the inflation element embedded in our debt costs is equal to the short-term inflation of the reporting year, which is not the case in reality. The outperformance indicated by the RFPR tables is a simplification based on a conceptual, rather than actual, position and the indicated outperformance value and contribution to RORE are not reflective of genuine equity returns. Taking an alternative approach, converting the nominal cost of NGN's non-index-linked debt to a real rate using the long-term inflation rate used to calculate the real allowance, we would see allowance outperformance of c£15m and c£25m in 21/22 and 22/23 respectively, rather than the corresponding figures of £45m and £68m calculated in RFPR.

In the year NGN entered into CPI swaps with a notional principal of £450m. These swap existing fixed rate debt to a real rate + CPI basis for 10 years. Under the terms of the swaps NGN receives a fixed rate equivalent to the rate payable on the underlying debt, and "pays" a real rate (in some cases a negative) on the accreted principal (or looked at another way an inflated rate on the initial principal. NGN will also pay accumulated inflation accretion on the notional amounts when the swaps mature in 2031.

From an accounting perspective, accumulated accretion on the swaps is not treated as a separate item but is effectively part of the fair value movement on the swaps

As an infrequent issuer of debt NGN is not able to manage its actual debt costs against the regulatory allowance purely through the timing of debt issuance. Derivatives (interest rate swaps) are therefore used to manage the extent to which NGN's actual debt costs are sensitive to market rates in any particular year.

In 2021/22 all NGN interest rate swaps and floating rate debt instruments that were previously subject to LIBOR re-fixings were amended such that floating rates are now linked to the Sterling Overnight Index Average (SONIA), subject to a Credit Adjustment Spread (CAS) of 0.1193% in the case of instruments with quarterly re-fixings and 0.2766% in the case of instruments with semi-annual re-fixings. (Note that for the syndicated credit facility NGN pays a margin over SONIA with no CAS).

Net Debt

Regulatory net debt increased from £1.51bn in March 2021 to £1.62bn in March 2022. The additional debt was used to fund investment in the network and supporting IT infrastructure as well as to manage changes in working capital, such as the settlement of VAT payments deferred in 2020/21 under COVID-19 arrangements.

NGN raised £176m of new debt in 2021/22:

- A £1m green transition retail bond issued by Northern Gas Networks Finance plc (NGNF) with the proceeds on-lent to NGN. The debenture was issued through Abundance Investment and marketed to NGN's customers and retail investors interested in sustainable investments. The debenture matures in June 2031 and pays fixed rate interest of 1.60%.
- £175m of 2.02% September 2036 US Private placement notes. At the same time a further £65m of 2.10% 2037 notes were priced, settlement of which was completed in June 2022.

NGN also renewed its £160m syndicated credit facility, which has a maturity date in October 2024, subject to two 12-month maturity extension options.

The only debt repaid in the year, other than outstanding facility drawings, was a £1.8m amortisation payment on a European Investment Bank loan.

Completion of tables R5a & R6a

In table R6a, in the section relating to pre- and post-derivative exposure to interest rate and inflation changes, the percentages have been calculated on net debt per regulatory definition. Notwithstanding the note in the table this is because Total Net Debt includes intercompany trading balances, swap fair values and other items to which it is not possible to ascribe a fixed / floating or inflation-linked categorization. Moreover, NGN has no debt which is not related to the regulated entity.

7. (R7) RAV

The table below shows our RAV position in RIIO-2. This has been calculated using the 1 June Ofgem PCFM updated to include all inputs from the revenue interface tab from the Regulatory Reporting Pack. The RAV shown below includes Totex outperformance from 21/22 and a forecast position thereafter.

NGN's closing RAV position at 31st March 2022 is £2.4bn in 18/19 prices as shown below:

RAV: 18/19 prices £m	**21/22 actual**	**22/23 forecast**	**23/24 forecast**	**24/25 forecast**	**25/26 forecast**
Opening asset value	2,232.1	2,265.8	2,297.8	2,325.2	2,347.8
Net additions	149.6	151.3	150.0	148.4	145.9
Depreciation	(115.9)	(119.3)	(122.6)	(125.7)	(128.6)
Closing asset value	**2,265.8**	**2,297.8**	**2,325.2**	**2,347.8**	**2,365.1**

8. (R8) Tax

As communicated, the GDN's will start to provide the reconciliation of tax, following completion of additional work to the template by Ofgem with the assistance of the GDN's.

9. (R9) Dividends

The RIIO-2 dividend profile in nominal prices is shown below.

Dividend: Nominal prices (£m)	**21/22 actual**	**22/23**	**23/24**	**24/25**	**25/26**
Declared & paid	91.7	tbc	tbc	tbc	tbc

10. (R10) Pensions

The pension tables within the RFPR reflect the deficit, contributions and asset / liabilities reported to Ofgem.