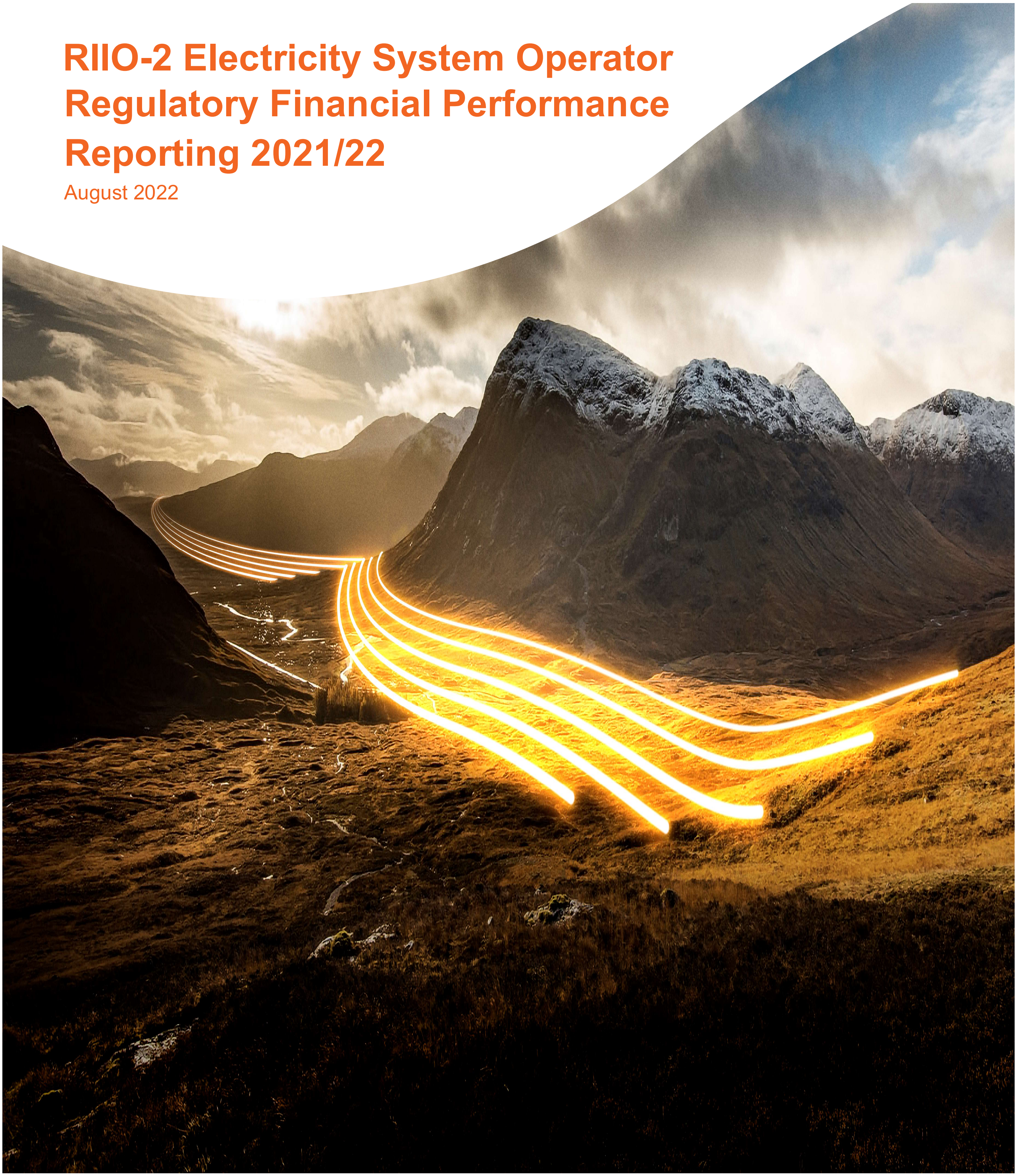
National Grid Electricity System Operator (NGESO)

RIIO-2 Electricity System Operator Regulatory Financial Performance Reporting 2021/22

August 2022



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Executive Summary

As the Electricity System Operator (ESO) for Great Britain, we are at the heart of one of the fastest decarbonising and most reliable energy systems in the world. We move electricity around the country second by second to ensure that the right amount of electricity is where it's needed, when it's needed.

Strongly aligned with the UK Government's mandate, our refreshed mission is to drive the transformation to a fully decarbonised electricity system by 2035, which is reliable, affordable and fair for all. Our renewed set of action-oriented ambitions build on our previous commitments and more explicitly recognise the importance of both people and technology in achieving our goal.

As required by Standard Condition B15 of the NGESO Electricity Transmission licence, and in line with the Regulatory Instructions and Guidance (RIGs), this Regulatory Financial Performance Reporting (RFPR) pack sets out some of the elements of our regulatory performance for the period 2021/22.

We note the purpose of the RFPR is to provide a framework to allow Ofgem to collect accurate and consistent information from licensed network operators (licensees). However much of the performance reporting template is not required to be completed by ESO in its unique role as system operator, since performance measures for the ESO are not comparable to those of network operators. In RIIO-2, the ESO's main source of performance reporting continues to be the Electricity System Operator Reporting and Incentives (ESORI) arrangements. These arrangements require that ESO reports against the costs, activities and deliverables as set out in each business plan period. Specifically, we report on plan delivery, metric performance, stakeholder evidence, plan benefits and value for money. Details of our latest performance can be found on our website.[1]

Throughout this document figures are in nominal prices unless stated otherwise.

[1] https://www.nationalgrideso.com/our-strategy/riio/how-were-performing-under-riio-2

Key Operational Performance and Financial Performance Measures

As noted in the Executive Summary the ESO RIIO-2 RFPR does not report on operational and financial performance. Please refer to the RIIO-2 2021-23 Mid-Scheme Incentives Report [2] for latest details on financial performance and operational metrics.

[2] https://www.nationalgrideso.com/document/250096/download

Overview of Regulatory Performance

R1 - RORE

The Return on Regulatory Equity (RoRE) figure is a key measure by which Ofgem compare operational and financing performance across asset-based Network Operators. The methodology is not a useful comparator for assessing the performance of System Operators as they are service based, not asset based, organisations.

This is not required to be completed for ESO as stated in Table A1.1 in the RIGS.

R2 - Reconciliation to Revenue and Profit

Revenues per the ESO statutory accounts include external balancing revenues as well as TNUoS pass through revenues. These have been removed to reconcile the revenue to allowed revenue per the PCFM.

The profit reconciliation removes costs associated with external balancing and TNUoS costs from the reported costs per the statutory accounts. The ‘Atypical costs’ adjustment reflects the differing treatment between statutory and regulatory cost reporting such as provision movements, IFRS16 and IAS19 adjustments.

The reconciliation as set out shows that under this methodology regulatory and statutory profits are broadly similar. However, this methodology does not consider regulatory timing differences for example differences between statutory depreciation and regulatory depreciation (slow money), or incentives earned versus those collected through revenues.

In row 78 the check cell is returning an error. We do not believe that the error checking formula is correct. The sum of rows 71 to 75 is equal to the regulatory opex calculated in row 77, which is what we believe the formula in row 78 is testing.

In Row 103 the formula calculating the difference between the tax per statutory accounts and the tax per regulated business is currently a sum. The correct formula should deduct from one another therefore the formula for in Column E for 2022 has been amended to = E101-E102 and rolled over to future years.

R3 - Totex – Reconciliation

As per RIGs guidance we have not completed rows 13-99 of this template.

The ESO does not report ‘net costs after non-price control allocations’ in its RRP submission. We have therefore adjusted operating costs per the statutory accounts to remove costs not reported in our PCFM i.e., costs associated with external balancing and TNUoS pass through costs. We have also made an adjustment for depreciation in cell D136 as directed by Ofgem. Due to the differing formats of networks and ESO RRP tables we cannot cross reference cell E148 to our RRP submission.

ESO’s overall totex expenditure as per the ESO RRP for 2021/22 is £263.5m, compared to total expenditure per the statutory accounts of £3,574.0m. The main reconciling differences are:

Balancing costs (£3,153.4m) – external balancing costs are charged directly to suppliers and generators and do not form part of ESO totex.

TNUoS costs (£55.2m) – costs associated with licence fees, cross border trading and TNUoS bad debt are recovered through TNUoS charges and are not classified as ESO totex.

Depreciation (£82.6m) – statutory accounting depreciation is not classified as totex.

Costs not recovered through totex in the PCFM (£24.5m) – costs such as pension deficit, BSUoS bad debt, business rates and innovation costs are recovered through separate terms in the PCFM and not included in totex.

Differences between statutory and regulatory definitions of expenditure (-£4.8m) – certain items of expenditure are treated differently for regulatory purposes for example the RIGs instruct that we include costs on a cash basis exclusive of provisions and accruals and prepayments that are not incurred as part of the ordinary level of business.

Please note the following amendments have been made to the R3 – Totex – Reconciliation table as agreed with Stephanie Fernandes per e-mail dated 16 August 2022:

- Formula correction in cell D178 from "0" to "=SUM(D153:D177)"
- Formula correction in cell D180 from "=D146-D176" to "=D146-D178"

There is an erroneous check on line 182 of this worksheet. We believe this is because ESO are not required to fill out rows 13-99 of this template.

R4 - Incentives and Other Revenue

This is not required to be completed for ESO as stated in Table A1.1 in the RIGS.

R5/6 - Financing and Net Debt Position

Overview

As agreed with Ofgem and outlined in the RIGs, for the purposes of completing the RFPR, regulatory net debt for ESO relates to the Internal BSUoS part of the ESO business only, therefore the Financing and Debt tables have been completed on this basis. There are a number of lines within the tables which remove items relating to TNUoS.

The debt and interest forecast extends to 1 April 2028 which is the maturity date of the ESO long term loan with National Grid. Due to the transition to FSO and the uncertainty around the future funding structure we have not included a forecast for ESO's other debt instruments, which are short term and for management of working capital and which do not impact on regulatory net debt.

Financing

Assumed regulatory finance cost at actual gearing for 2021/22 is -£3.9m, and -£5.4m at notional gearing. This represents an assumed outperformance to the cost of debt allowance by £3.6m and £4.9m (2018/19 prices) respectively. The outperformance is due to high levels of inflation adjusted for in the performance calculation, whereas ESO's debt is linked to SONIA rather than inflation.

Net Debt

RIIO-2 Regulatory Net Debt is £119.9m. Actual gearing in 2021/22 is 40% compared to notional gearing of 55%.

R7 – RAV

The Opening RAV, Transfer RAV for net additions (after disposals) and Depreciation lines are based upon the Aug 22 Dry Run 1 PCFM submission updated with totex inputs per the July 22 ESO RRP submission.

The formula in row 41 'NPV-neutral RAV return base' is linked to Row 15 'Opening RAV (before transfers)' to calculate the NPV-neutral RAV. We believe that the link should be amended to Row 17 'Opening RAV (after transfers)'. This will then be in line with the PCFM calculation and the total return on RAV will tie to the Dry Run 1 PCFM output. Following conversations with Ofgem we have not amended the formula as this amendment will be included in next year's RFPR consultation.

R8- Taxation

The actual tax liability for the licensee will be calculated for the submission of the CT600 which is due by 31 March 2023. Therefore, we have forecast the tax liability in line with PCFM allowance.

R8a - Tax Reconciliation

This table is not required to be completed for 2021/22. Due to the timing of the CT600 submissions to HMRC, this sheet is to be reported with a one-year lag.

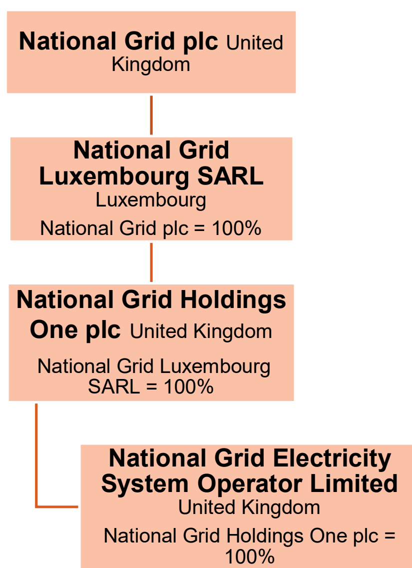
R9 - Corporate Governance

Corporate Ownership and Governance Framework

Corporate ownership structure

National Grid Electricity System Operator Limited's immediate parent company is National Grid Holdings One plc. The ultimate parent company, and controlling party, is National Grid plc. Both companies are incorporated in Great Britain and are registered in England and Wales. National Grid plc consolidates the financial statements of National Grid Electricity System Operator Limited.

The ownership structure, with each parent company holding 100% of the subsidiaries shares is shown below:



National Grid Electricity System Operator Limited Board Members

Name	Office	Date of appointment
Fintan Slye	Executive Director and Chair	1 March 2019
Regina Moran	SID[3]	1 August 2020
John Linwood	SID[3]	16 June 2020
Baroness Gillian Merron	SID[3]	1 April 2019
Hannah Nixon	SID[3]	1 April 2019
Kayte O'Neill	Executive Director	1 April 2019
Paul Plummer	SID[3]	1 April 2019
Gregg Smith	Executive Director	4 May 2020

[3] Sufficiently Independent Director

Committees

The ESO Board has delegated certain governance responsibilities to Board committees that have the knowledge and experience to make recommendations to the Board, each of which have documented terms of reference. Each committee is chaired by a SID and the SID members provide independent challenge and support for effective decision making.

The Board and its committees regularly review terms of reference to ensure that they remain fit for purpose, are adapted to promote good governance and meet the requirements of the Company as they evolve. At each Board meeting, directors receive reports on the key discussion items, activities and recommendations from the Chairs of the committees that have met in the period.

Committee	Activity
Audit & Risk Committee	The Audit & Risk Committee (ARC) monitors the effectiveness of internal controls; risk management; integrity of financial statements; and the performance of the internal Assurance and Corporate Audit department and independent auditor.
Nominations Committee	The Nominations Committee makes sure the Board remains balanced and effective and that its structure, composition and skills align to the ESO's strategic objectives, and has due regard for diversity. The Committee's primary objective is to identify and evaluate candidates for future SID appointments and in doing so, it takes advice from external recruitment consultants. The committee also has oversight of the succession plans for the Executive Leadership within the ESO, Executive remuneration and benefits (including discretionary elements); and input on the remuneration and benefits framework applicable to the Executive Director to the Shareholder.
Business Separation Compliance Committee	The Business Separation Compliance Committee oversees the duties and tasks of the ESO Business Separation & EMR Compliance Officer with the focus upon compliance with the business separation licence and EMR licence conditions.
Health, Safety & Wellbeing Committee	The ESO is dedicated to ensuring the highest standards of health, safety and wellbeing (HS&W) for all staff, going beyond compliance with legal requirements and adopting a good practice model that benefits everyone. To support the Board with this ambition, it established the HS&W Committee, with responsibility for nurturing and promoting a positive attitude to health, safety and wellbeing as an integral part of activities and to maintain an overall assessment of the key health, safety and wellbeing specific risks.

Below is a summary of the committee structures and members:

	Audit & Risk	Compliance	Nomination	Health, Safety & Wellbeing
John Linwood*	●		●	●
Baroness Gillian Merron*		●	●**	
Regina Moran*	●			●**
Hannah Nixon*	●**		●	
Kayte O'Neill	●			
Paul Plummer*		●**		●
Fintan Slye			●	
Gregg Smith		●		

*SID **Chair

Matters reserved for the parent company

As a wholly owned subsidiary, the ESO Board duly considers the views and interests of its ultimate Shareholder, National Grid plc (NG plc), where this is appropriate in the context of its licence obligations around legal separation.

The NG plc Board, the decision-making committee of NG plc, the ultimate shareholder of the ESO, is responsible for ensuring the long-term viability and prudent financial management of the NG Group. Arrangements are in place to both enable appropriate Group oversight but also enable the ESO to operate sufficiently independently within the NG Group.

An NG Group level committee, the ESO Committee (ESOC) supports operational and managerial separation of the ESO, and independence of the ESO Board. It is chaired by the CEO of NG Group. The purpose of ESOC is to consider and provide oversight in respect of matters relating to the ESO which are to be considered by the NG plc Board. The duties also include guiding ESO in its relations with shareholders / stakeholders, keeping under review internal controls, risk management and compliance performance. The ESOC also considers strategic implications that are pertinent to ESO and monitors safety, financial and operational performance and approve certain expenditure and other financial commitments in respect of ESO matters which exceed the authority of the ESO Board. ESOC ensures all ESO ringfenced information required to support good corporate governance is viewed separately from other subsidiaries in the NG portfolio.

The ESOC is chaired by the CEO of NG Group and attended by the Chair of the ESO Board, the Group General Counsel and Company Secretary and the Group Chief Financial Officer. The ESOC has delegated authority from the NG Group Board with a defined financial delegated authority and its own terms of reference to support interaction with the ESO by reviewing and approving matters within its delegated authority. The ESOC is not involved in the day-to-day operation of ESO.

The Articles of Association and Matters Reserved to the NG Group Board describe the remit of the public limited company (plc) and are available on the NG website[4].

As a shareholder-owned company, the Board of NG Group ultimately approves the financial targets and expectations for the ESO for the year ahead. The ESO sets its own objectives in line with its own strategy, business plan and priorities.

The areas of ESO activity that have visibility or require approval at Group Board level through ESOC include things such as:

- approval of the ESO’s annual budget;
- review and approval of the ESO’s long-term rolling financial forecast;
- visibility of the ESO’s financial performance against its annual business plan;
- visibility of the ESO’s principal risks;
- approval of any material extension of the ESO’s activities into new business areas or any decision to cease to operate any part of the ESO’s business;
- authorisation of changes affecting the capital structure of the ESO;
- approval of the long-term strategic objectives of the ESO and any major changes to the size and composition of the ESO Board and its Committees; and
- unforeseen issues that have significant or material impact on the Group (e.g., financial, reputational or principal risks).

ESO Standard Articles also cover shareholders rights which include

- the right to appoint or remove a board director.
- the right to declare a dividend within the ESO Board recommendation of the dividend amount.

[4] https://www.nationalgrid.com/document/142986/download#:~:text=Executive%2C%20however%20the%20following%20matters%20are%20reserved%20for,changes%20to%20the%20Group%E2%80%99s%20management%20and%20control%2Fcorporate%20structure

Executive Remuneration Policies

Role and composition of the remuneration committee

The NG plc Remuneration Committee is responsible for recommending to the NG Board the Remuneration Policy for NG plc Executive Directors, the other members of the Group Executive Committee (Presidents of respective Business Units), the Executive Director of the ESO (subject to independence), and the NG Chair, and for implementing this Policy. The aim is to align the Remuneration Policy to the Company strategy and key business objectives, and ensure it reflects our shareholders', customers' and regulators' interests. The NG plc Remuneration Committee receives input on Policy implementation within the wider workforce before reaching decisions on matters such as salary increases and annual incentive payouts and closely reviews the appropriateness of pay positioning by reference to external measures (benchmarking remuneration packages) and internal review of Company performance and pay gaps (NG Group CEO pay ratios, gender and ethnicity pay gaps), the relativity year-on-year of salary, benefits and annual performance incentives compared with the same for the rest of the workforce.

The budget for annual salary increases for all other Leaders (Executives, Senior Managers and Managers) is set at NG level and allocated to individuals with reference to factors outlined above.

ESO Board of Director Remuneration Framework

Band	**Target APP** % of salary	**LTIP Award**	**Pension DC contribution**	**Car Allowance**	**PMI**	**Holiday**	**Flexible benefits**
Executive Director (Band A)	32.5%	Up to 90% of base salary	20%	£12,000	Family	28 days annual leave (plus public holidays)	A range of benefits including a sharesave scheme, employee assistance programme, and flex benefits scheme
Executive Director (Band B/B+)	17.5-22.5%	60 - 75% of base salary	15%	£ 8,500	Family		

Annual Remuneration Increases

The remuneration of the Executive Director and Chair of ESO is reviewed and approved annually by the NG Group Chief Executive. Levels of remuneration of the other ESO Executive directors are reviewed and approved annually by either the ESO Committee or the responsible Shared Service area where they are not directly employed by the ESO.

Performance Related Remuneration

Performance based elements of remuneration form a significant portion of the total remuneration package for the Executive directors of the ESO. Typically, performance-based (Reward at risk) elements account for 50-60% of the total remuneration opportunity; these are linked to both business performance measures and individual performance and typically comprise an annual element (the Annual Performance Plan, APP) and a longer-term element (the Long-Term Performance Plan, LTIP).

Short term incentives

The Annual Performance Plan (APP) comprises reward for achievement against ESO scorecard measures and achievement against individual objectives. Performance measures and targets are normally agreed at the start of each financial year and are aligned with ESO strategic business priorities. Targets are set with reference to the budget, which is reviewed and approved annually by the ESOC.

Individual performance will be determined by an assessment of the achievement of objectives set at the start of the financial year and their demonstration of leadership behaviours and business values.

Operational performance of ESO during the year will be assessed against metrics and targets set at the start of the financial year. The ESO Committee will also, where appropriate, reflect on business outcomes not directly included in the APP, such as items related to demonstrating service levels to our customers and communities before finalising the plan payouts.

Awards are subject to malus and clawback provisions.

Long term incentives

ESO operates a cash based long-term incentive plan (LTIP) under which awards may be granted to directors and senior managers each year, with the intention to provide an appropriate incentive to ESO employees and to encourage outstanding long-term performance of the ESO business.

Vesting occurs at the third anniversary of the award with the vesting value flexing with the value of the ESO business during the vesting period. The ESO Committee reserves the right to apply discretion on overall vesting outcome taking into consideration the underlying business, financial and operational performance.

LTIP awards are subject to malus and clawback provisions.

Employee Benefits

Benefits for Executive directors and senior management include company car (Electric Vehicle) or a cash alternative, private medical insurance, personal accident insurance, life insurance, opportunity to purchase additional benefits under flexible benefit schemes available to all employees and opportunity to participate in HMRC tax-advantaged all-employee share plans, currently:

- Sharesave: UK employees may make monthly contributions from net salary for a period of three or five years. The savings can be used to purchase shares at a discounted price, set at the launch of each plan period.
- Share Incentive Plan (SIP): UK employees may use their gross salary to purchase shares. These shares are placed in trust.

Pension

Externally hired employees will participate in a Defined Contribution (DC) arrangement. The maximum contribution for Executive directors is shown in the table above. Executive Directors may alternatively choose to receive cash in lieu.

In line with market practice, pensionable pay for employees is basic salary.

Recognition scheme

All employees are eligible to receive awards under the NG recognition programme. Awards may be made to recognise significant efforts of an individual and could potentially be related to service levels to our customers and communities. These awards tend to be small in value and tend to be given to employees further down the organisation.

CEO pay ratio:

We have disclosed our CEO (The Executive Director) pay ratios comparing the CEO single total figure of remuneration to the equivalent pay for the 25th quartile, median, and 75th quartile UK employees (calculated on a full-time equivalent basis). The results highlight a key feature of our remuneration strategy to weight Executive and senior leadership compensation more heavily towards longer-term performance share-based reward. Across the wider workforce, employee compensation is largely focused on in-year annual delivery.

For reference, the NG plc Group-wide pay ratio and NG UK ratio are disclosed in the NG plc Group Annual report.[5]

Flexibility is provided to adopt one of three methods for calculating the ratios. We have chosen Option A, which is a calculation based on the pay of UK employees on a full-time equivalent basis, as this option is considered to be more statistically robust. The ratios are based on total pay and benefits inclusive of short-term and long-term incentives applicable for the respective financial year 1 April – 31 March. The reference employees at the 25th, 50th and 75th percentile have been determined by reference to pay and taxable benefits as at the last day of the respective financial year, 31 March, with estimates for the respective APP payouts and performance outcomes of the LTPP and dividend equivalents.

Most employees are eligible for a performance-based annual payment. Our principles for pay setting and progression in our wider workforce are the same as for our executives – mid-market approach to total reward sufficiently competitive to attract and retain high-calibre individuals without over-paying

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[5] https://www.nationalgrid.com/investors/resources/reports-plc

and providing the opportunity for individual development and career progression. The pay ratios reflect how remuneration arrangements differ, as accountability increases for more senior roles within the organisation, and in particular the ratios reflect the weighting towards long-term value creation and alignment with shareholder interests for the CEO.

We are satisfied that the median pay ratio reported this year is consistent with our wider pay, reward and progression policies for employees. The median reference employee has the opportunity for annual pay increases, annual performance payments and career progression and development opportunities.

Dividend Policies

The Board has a residual dividend policy which takes into account the company's operating and investment requirements and ensures compliance with regulatory and licence conditions.

Specifically, the Board determines the level of dividend declared by reference to:

- an assessment of the Company's ability to finance its functions in the short term and maintain the Company's investment grade credit ratings;
- The Company's cumulative financial performance and past outperformance; and
- the regulatory gearing level of the Company.

The Directors also have regard to:

- Ensuring that the Company meets its statutory and regulatory obligations
- Employees' interests.

R10 – Pensions & Oth Activities

Allocation Methodology

Apportionments between Established and Incremental Deficit are driven by the outcome of the 2020 Pension Deficit Allocation Methodology (PDAM) exercise. The figures shown in rows 14 and 15 are both derived from the 2020 PDAM exercise and are consistent with apportionments shown in last year's 2020/21 RFPR disclosures (sheet "R12 - Pensions - ESO").

Regulated fraction apportionments between NG-ETO (75.7%) and NG-ESO (23%) are historic and unchanged since their confirmation at TPCR4 Rollover Final Proposals document. The figures shown for NG-ESO are both derived from this regulated fraction apportionment and are consistent with apportionments shown in last year's 2020/21 RFPR disclosures (sheet "R12 - Pensions - ESO").

Summary View

Ofgem have previously acknowledged that pension costs, particularly deficit costs disclosed in table R10 are largely outside of the direct control of network operators. Nevertheless, where some element of pension cost mitigation is possible, National Grid has consistently sought to reasonably reduce pension costs associated with its defined benefit pension schemes, as detailed in our 2020 submission to Ofgem's Reasonableness Review which formed part of the 2020 PDAM exercise.

That said, the ESO pension deficit payment (in row 12) is once again broadly in line with previous years and remains consistent both with expectations and with figures submitted as part of the RIIO-2 budget submissions for pension deficit payments.

The pension scheme valuation is performed tri-annually, and the valuation data presented in the 2021/22 RFPR reflects the finalised results of the most recently signed triennial actuarial valuation at 31 March 2019. The EDE and PPH figures shown in rows 21 to 23 reflect the most recent final pension allowances published by Ofgem on 9 November 2020 following Ofgem's decision outcome from the 2020 PDAM exercise.

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 (where deemed appropriate)
5. Director Sign Off

Appendices

Reconciliation

Not applicable for ESO.

Enduring Value Adjustments

Not applicable for ESO.

Basis of any estimates and allocations

Not applicable for ESO.

Other Relevant Information

Not applicable for ESO.

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