Regulatory Financial Performance Reporting (RFPR) Commentary

RIIO-GD2

September 2023

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Executive Summary

Overview

Our Regulatory Financial Performance Reporting (RFPR) comprises information for each of our 4 networks in line with the Regulatory Instructions and Guidance (RIGs).

Our RFPR submission and our Strategic Performance Overview (SPO) both address the regulatory performance of Cadent. The SPO is available on our website.

The 2 documents should be read in conjunction. Specific details on our operational financial performance can be found from page 6 and output performance can be found from page 17 in the SPO.

There are a number of changes in Return on Regulatory Equity (RORE) reporting relative to RIIO-GD1.

- Firstly the price index has changed from RPI to CPIH. All values are presented in real terms excluding the impact of this inflation index; as such, if the RIIO-1 values were to be re-presented relative to CPIH they would be higher by the difference between RPI and CPIH.
- The allowed returns on equity are significantly lower. In RIIO-GD1 the baseline return to equity was 6.7% (RPI based) with this being 4.97% on average over RIIO-GD2 – indexed over time to the risk-free rate.
- Opportunity for over and under performance is much more constrained in RIIO-GD2 with Ofgem noting that in RIIO-GD1 strong performing networks can deliver double digit returns. In RIIO-GD2 this is significantly reduced as a result of a number of new mechanisms which reduce incentive properties.
- Some of these reduced incentive properties include sharing factors which are now set to 50% sharing between customers and networks (compared to 63% in RIIO-GD1), and a reduced number and potential value from Financial Output Delivery Incentives (“ODI-F”).

As a consequence the range of returns is constrained around base level of equity return. This is not to say our standards of performance have reduced relative to RIIO-GD1. Performance levels are re-baselined for RIIO-2 with continuous improvement on cost and customer performance expected through the price control.

A further change to RIIO-GD2 is that allowances are reset annually based on volumes delivered in relation to outputs governed by mechanisms such as Volume Drivers.

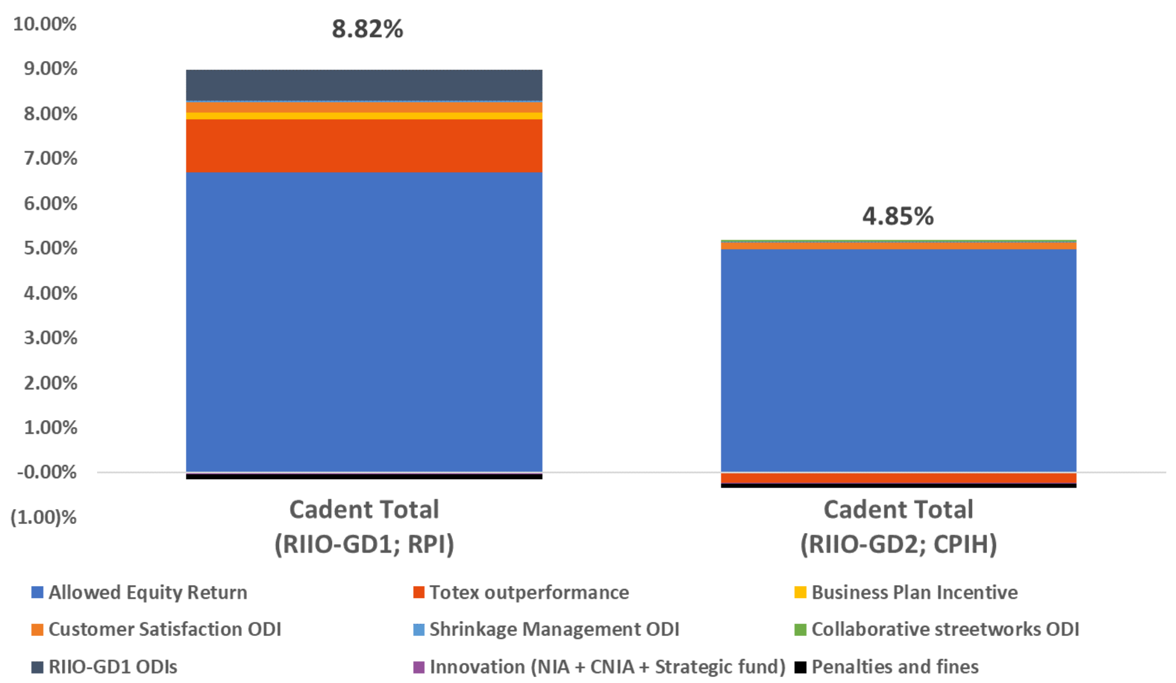
Our Performance

Operational Performance

Across all our networks on a consolidated basis, RORE (excluding financing and tax) forecast for RIIO-GD2 period is 4.85% with the breakdown across our 4 networks set out later in this report.

Compared to RIIO-GD1 Operational RORE has reduced by 3.97% (a circa 50% drop between price controls) as summarised in the chart below, however, as noted due to the price base change the reduction is more significant than shown.

Chart 1: RIIO-GD1 vs RIIO-GD2 Operational RORE (excludes Financing and tax)



As noted above the base allowed returns has reduced from 6.7% in RIIO-1 to 4.97% over RIIO-GD2, excluding the impact on the price base adjustment from RPI to CPIH which effectively further reduces the nominal returns allowed.

Over RIIO 2 we expect RORE on average over the five years to be marginally below the allowed return of 4.97% at a Cadent level. To deliver this forecast requires continued improvement in customer incentive performance and delivery of stretching efficiency plans. With a volatile economic backdrop, this remains a very ambitious plan.

After the Allowed Equity Return, the main driver of RORE is the Totex incentive mechanism. Through the continued delivery of our ambitious programme of organisational transformation we are striving to deliver stretching ongoing efficiencies. These efficiencies are equally a component of our allowances, as such we aim to deliver at a similar level of performance to that achieved in 2022/23 over the remainder of the RIIO-GD2 period.

We are experiencing significant input cost pressures that are not being compensated for through allowances. Mitigating these cost pressures through our transformation programme and rigorous control over expenditure ensure overspend is constrained; and where there is overspend, the risk is split evenly between customers and the company, reducing the impact on revenues and our contribution to the customer bill.

At a Cadent wide level Totex spend is expected to be slightly higher than the allowances set over RIIO-2 with some networks seeing outperformance, however our London and Eastern networks in particular are forecast to spend more than allowed as a result of certain regional factors not being recognised through the RIIO-GD2 price setting process and subsequent Competition and Markets Authority (CMA) Appeal. We remain confident we are driving strong levels of efficiency performance which will compare well with our peers over the RIIO-GD2 period.

So far in RIIO-GD2 whilst delivering strong performance against our outputs we have overspent our Totex allowances by £5m (0.2%) cumulatively at a Cadent overall level. During 2022/23 we overspent our Totex allowances by £56m as our investment programme increased further in scale, whilst allowances reduced, and inflationary and market pressures impacted the cost base. The evolving challenge is demonstrated by the rising costs of materials, energy and wages. With these pressures unlikely to reverse in the near future, delivery against our plan with continued efficiency embedded will be extremely challenging, however we are actively mitigating these pressures as noted above.

Offsetting this performance we have a run rate of GSOP payments which are not subject to customer sharing. We also contribute significant cashflow from equity (£5m, equivalent to 0.5% of Totex in 22/23) into our Cadent Foundation, reducing earned returns to investors, however this is not a part of Totex and as such not shown in the regulatory performance reporting.

Financial Performance

As in previous years, financing performance reported in this year's RFPR, through Ofgem's methodology, shows Cadent has outperformed the cost of debt allowance. This is primarily driven by:

- The timing of our debt refinancing in 2017 resulting in lower comparative cash interest costs. However, to achieve this saving, a significant one-off cost was incurred that needs to be reflected in ongoing performance; and
- The RFPR methodology when combined with the current high inflationary environment creates an arithmetical performance gap driven by the methodology not reflecting notional or actual capital structures.

Timing of debt refinancing:

As previously advised, Cadent currently benefits from comparatively low relative cash cost of embedded debt as our debt was raised and refinanced largely in a single financial year when interest rates were low. As a result, we outperform the trailing Iboxx index used for allowance setting. To achieve this comparative low cost of debt significant one-off cash costs were incurred in FY2017. We have included in our analysis below the impact of incurring these one-off cost this provides a fairer reflection of the true economic cost of our debt. However, currently the regulatory instructions and guidance do not support reporting these costs in the RFPR tables.

RFPR methodology in relation to inflation

The methodology skews debt performance to appear higher compared to calculating performance over a long period of time or reflecting the notional capital structure.

The RFPR methodology does not take into account actual or notional company capital structures, particularly the quantum of inflation linked debt typically used by networks including Cadent to manage inflation risk. The spreadsheet measures performance assuming all of debt within the capital structure is 100% linked to outturn inflation for the year – CPIH specifically. This is not aligned to actual structures within the sector or the notional company used by Ofgem in setting the price control where only 30% of the debt is linked to outturn CPIH. This mismatch, where the models attempt to reflect the economic form of interest rates rather than the cash cost, result in distortions in the performance metrics when considering short time periods, rather than the long time periods the debt is issued over.

This has the effect of presenting under-performance in years where inflation in a single year is below the long run average as was the case in RIIO-GD1 and outperformance of the cost of debt allowance when inflation is higher than long run averages. As example, in the last year of RIIO-1 when RPI inflation was 1.2%, we saw significant underperformance when presented through the RFPR. We issue debt for long periods of time, often in excess of 10 years, and therefore during the tenor of these instruments, there will be periods where inflation is above or below the long run position.

We are very focused on how inflation is impacting our customers particularly in light of the cost of living crisis. We have a comprehensive customer vulnerability strategy which targets support to the most vulnerable and we have detailed the significant social benefits we have delivered in our recent Social Impact report and in our Vulnerability and Carbon Monoxide Allowance Annal report and showcase. As noted above, we are also investing profits directly back into the communities we serve though the Cadent Foundation.

Chart 2: RIIO-GD2 vs RIIO-GD1 RORE from Financing and tax

	RIIO-GD1	RIIO-GD2					
% RORE from Finance and tax performance (Notional Company)	**FY20/21 Actual**	**FY 21/22 Actual**	**FY 22/23 Actual**	**FY 23/24 Forecast**	**FY 24/25 Forecast**	**FY 25/26 Forecast**	**RIIO-GD2 Average**
Excluding adjustment to reflect the true economic cost of debt	0.0%	4.6%	7.0%	4.6%	0.0%	-0.7%	3.4%
Including adjustment to reflect the true economic cost of debt	-2.6%	2.8%	5.5%	3.4%	-0.9%	-1.6%	2.2%
Variance	2.6%	1.8%	1.5%	1.1%	0.9%	0.9%	1.2%
Memo: Inflation (RPI / CPIH)	*1.2%*	*4.5%*	*8.8%*	*4.7%*	*0.7%*	*0.3%*	

Corporate Governance

Executive remuneration

Our executive directors pay is explained in detail in our [Annual Report and Accounts] within the remuneration committee section from page 89-101.

As always, there is a strong focus to connect strong performance to remuneration for the benefit of all of our stakeholders. This includes ensuring that incentives drive efficiency and provide value for money for our customers, as well as delivering excellent customer service and taking a lead across sustainability and social matters, in particular by providing practical support to customers in vulnerable situations. This has ensured continued increases in customer satisfaction and improved complaints handling, along with strong delivery against our fuel poor network investment scheme and positive social return on investment for our customers.

The impact of the cost of living challenge on our customers has made it more important than ever before for us to ensure that we are tackling fuel poverty. We have played a leading role in pushing the debate on the role that a gas network business could and should play. We have reached more than one million households in our regions through the provision of energy efficiency advice, income and energy management support and a range of in-home (beyond the meter) tailored interventions to make energy more affordable for our customer. This has included the establishment of over 50 regional Centres for Warmth and a refocus of the Cadent Foundation funding directly to address affordability and fuel poverty related schemes.

In addition to ensuring strong operational delivery of a high-quality service, there is also a strong focus on safety engagement and outcomes, along with ensuring that remuneration is closely linked to sustainability; through reducing waste, reducing carbon emissions and in the important role that Cadent is playing in shaping the country's future energy system transition to net zero.

The Committee has also taken careful consideration of the broader landscape when assessing remuneration outcomes. This includes the high wholesale gas prices, high inflation and cost of living challenge.

Dividend policy

Cadent's dividend policy is to have an appropriate distribution after having considered the forward committed cash requirements of the business to support our investment programmes, including the Cadent Foundation, and managing an appropriate level of gearing, as well as considering wider macroeconomic factors and the broader performance of the business relative to a range of regulatory and customer performance metrics.

This policy ensures that we take into account wider macro-economic factors, such as the uncertainty created by the COVID-19 pandemic when we had the flexibility not to pay a dividend in the year to March 2021. This policy is welcomed by rating agencies and as such supports low-cost debt funding to the benefit of consumers.

During the year to March 2023, we paid dividends totaling £350 million (2022: £195 million) wholly attributable to the regulated business. We have disclosed this previously in our Annual Report and Accounts ("ARA") located here (extract below).

Dividends

£350m

(2022: £195m)

The amount paid to our parent company as a return on its investment in Cadent. No dividend was paid in 2020/21. The 2021/22 dividend was paid only once the full impact of COVID-19 was established. The allowed rate of return to fund a notional company is regulated by Ofgem. For the 3 years to March 2023, the dividend paid represents a return on regulated equity of 3.9%*.

This timely publication in June ensured stakeholders have access to this information early. Ofgem, our Economic Regulator are informed of dividend decisions prior to payment.

When considering dividends, we don't just look at a single year but the cumulative performance and payments over recent years and a forward assessment into future years. This analysis shows that over the last 3 years, we have paid dividends that are equivalent to 3.9% return on regulated equity. This is below the amount allowed through the price control setting process for an equivalent period.

Broader considerations

Our policy is based on our belief that in order to deliver successful outcomes, there should be a balanced approach to meet the requirements of all our stakeholders. This means:

- customers benefitting from value for money and better services;
- supporting households through the shareholder funded Cadent Foundation;
- enhancing the environment in which we operate;
- employees being rewarded for their hard work; and
- our investors earning a reasonable return on the equity they have invested in the business. This investment is critical for ensuring the efficient and economic operation of our network today and the investment requirements of the future.

We share outperformance with our customers through delivering efficiencies that result in lower bills; with our employees through responsible incentive-based bonuses; and with investors through sustainable dividends. And we've been able to do this while delivering on our environmental targets, maintaining appropriate gearing and delivering strong financial resilience.

The Board also reviews the company's performance around employees, and executive pay. As noted above, Executive pay disclosures are significantly enhanced relative to sector standards supported by a strong remuneration committee that target societal benefits such as performance on customer and sustainability measures.

We also have transparent and low risk policies in relation to how we interact with the tax authorities.

Legal and Regulatory Requirements

We provide further information below regarding the existing protections that exist to ensure the highest standards of governance relative to dividend decisions and payments:

Licence Requirements

In addition to statutory responsibilities of Directors relative to the Companies Act, as a regulated business we have additional requirements governed by our licence. We summarise below to provide transparency to stakeholders.

Before a dividend can be recommended or declared, Cadent must provide Ofgem with a certificate (that has been approved by a resolution of the board of directors) to confirm that, after making enquiries, Cadent is satisfied that: (1) it is in compliance in all material respects with key ring-fencing licence conditions; and (2) the making of a distribution will not (alone or together with other circumstances) cause it to be in material breach of any of those ring fencing licence conditions in the future. A summary of the relevant licence conditions is set out below.

Obligation	**Overview of requirement**
Standard Special Condition A26 (Provision of Information to the Authority)	Requirement to comply with formal information requests issued under this condition and to obtain an undertaking from anyone who is an ultimate controller of Cadent confirming that they will also provide any information required to enable Cadent to respond to an information request.
Standard Special Condition A36 (Restriction on Activity and Financial Ring-Fencing)	Restricts the activities that the licensee can undertake, including investment activities. Requires that a licensee has in force a system of treasury management operations internal controls that complies with best corporate governance practice.
Standard Special Condition A37 (Availability of Resources)	There is an overarching obligation to act in a manner that ensures that Cadent has sufficient resources (e.g. financial, management, operational) to properly and efficiently carry on its core transportation business and comply with all relevant obligations under the licence, the Gas Act 1986 and any other relevant statutory obligations. Cadent must provide a number of board approved certificates to Ofgem each year confirming that it has sufficient resources to operate the transportation business for the next 12 months. Cadent must provide an independent auditor's report to support such certificates. A certificate is also required before the recommendation or declaration of dividends.
Standard Condition	An obligation on Cadent to obtain an undertaking from the ultimate controllers of the

45 (Undertaking from Ultimate Controller)	company that they will refrain from action which could cause Cadent to breach its licence condition or any obligations under the Gas Act 1986.
Standard Special Condition A38 (Credit Rating of the Licensee)	Licensee must use reasonable endeavours to maintain an investment grade issuer credit rating. Includes financial resilience reporting subject to credit rating.
Standard Special Conditions A39 (Indebtedness)	Restricts/places conditions around: indebtedness; transfers of assets/rights/sums to associated companies; cross-default obligations.

The Board seek positive assurance from the Executive Committee that all activities conducted by the organisation are compliant with the above licence requirements. Our internal assurance teams cascade detailed surveys through the organisation providing independent review to ensure that all requirements are met.

Other protections to consumers:

Our Board's continuing philosophy is to uphold the highest standards of corporate governance appropriate to the essential public service Cadent provides and the regulatory framework that Cadent operates within. Pursuant to the Companies (Miscellaneous Reporting) Regulations 2018, the company applied the Wates Corporate Governance Principles for Large Private Companies in the ARA during the year.

Our Group structure and financial covenants provide protection to the level of debt that can be held in Cadent relative to the size of the asset base (RAV) improving financial resilience.

The company ensures compliance with Companies Act 2006 and ensures it has sufficient distributable reserves at the time of paying a dividend.

Shareholder loans:

Cadent does not have any loans payable to its sole shareholder Quadgas MidCo Limited and as such, the Dividend paid is equal to the total distribution from the Company. The dividends were used to service debt and cover ancillary costs in other group entities with the resulting dividend paid to the ultimate shareholders being £212 million (2022: £135 million).

Table Overview

1. Return on Regulated Equity (RoRE)

The RORE tab within the RFPR pack expresses the Return on Regulated Equity based on both notional gearing and actual gearing, as well as showing the monetary value of performance for each year of RIIO-GD2 in constant prices.

The overall operational RORE is 4.85% for Cadent and the table below shows the split by network;

Chart 3: 5 Year Average RORE Performance by Network

Price Control Average	RIIO-GD2				
Category	**Eastern**	**London**	**North West**	**West Midlands**	**Cadent**
Allowed Equity Return	4.97%	4.97%	4.97%	4.97%	4.97%
Totex outperformance	(1.13)%	(0.47)%	0.32%	1.00%	(0.24)%
Business Plan Incentive	0.02%	(0.00)%	(0.00)%	(0.00)%	0.01%
Customer Satisfaction Survey ODI	0.16%	0.09%	0.19%	0.17%	0.15%
Complaints metric ODI	-	-	-	-	-
Unplanned Interruption Mean Duration ODI	-	-	-	-	-
Shrinkage Management ODI	0.00%	0.00%	0.05%	0.05%	0.02%
Collaborative streetworks ODI [Cadent Lon & EoE]	0.03%	0.10%	-	-	0.03%
Other RIIO-1 ODI's	-	-	-	-	-
Network innovation input for RORE	(0.02)%	(0.01)%	(0.02)%	(0.02)%	(0.02)%
Carry-over Network innovation input for RORE	(0.00)%	(0.00)%	(0.00)%	(0.00)%	(0.00)%
Strategic innovation input for RORE	-	-	-	-	-
Penalties and fines	(0.10)%	(0.10)%	(0.05)%	(0.08)%	(0.08)%
OPERATIONAL RORE PERFORMANCE	**3.93%**	**4.58%**	**5.46%**	**6.10%**	**4.85%**

Chart 4: 5 Year Average Operational RORE Performance by Network

We provide details on performance on the individual RFPR tables below.

2. Reconciliation to Revenue and Profit

This table reconciles the collected revenues reported within the RRP to the Annual Report and Accounts. As we have 4 networks a reconciling item is bringing in the revenues from the other 3 networks to reconcile back to a Cadent level total. Specific procedures are completed to provide assurance over collected income (Agreed Upon Procedures) and reported revenues (external audit).

Information being sourced from the RRP and Annual Report and Accounts.

For details of revenues in RIIO-GD2 please refer to our SPO on pages 7-8. This also contains details of customer bills over time and how Cadent has delivered on-going efficiencies for customers driving down bills in real terms over the course of RIIO-GD2.

For details of forecast revenues, further information can be found in the Price Control Financial Model ("PCFM"). This model will be published by Ofgem in January 2024 and shows expected revenues over the remaining years of RIIO-GD2.

3. Totex Reconciliation & Performance

3.1. Totex performance

The tables below show the Totex performance by network projected out for the 5 years of the price control.

Chart 5: Totex Forecast by Network relative to allowances

	Actual		Forecast					
Eastern	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	Total	Allowed	Variance
Opex	134	147	139	139	139	**699**	633	(66)
Capex	70	72	83	80	66	**370**	324	(47)
Repex	129	154	144	136	136	**698**	663	(35)
Totex	**333**	**373**	**366**	**354**	**341**	**1,767**	**1,620**	**(148)**
Allowance	335	326	324	319	315	**1,620**		
Out / (Under) Performance	**2**	**(47)**	**(42)**	**(35)**	**(26)**	**(148)**		
Cumulative Performance	2	(45)	(87)	(121)	(148)			

	Actual		Forecast					
London	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	Total	Allowed	Variance
Opex	97	103	103	101	101	**504**	516	12
Capex	27	37	36	36	30	**166**	163	(4)
Repex	130	141	133	141	132	**677**	624	(53)
Totex	**254**	**281**	**272**	**278**	**262**	**1,347**	**1,303**	**(45)**
Allowance	271	267	265	253	247	**1,303**		
Out / (Under) Performance	**17**	**(14)**	**(7)**	**(25)**	**(15)**	**(45)**		
Cumulative Performance	17	3	(4)	(29)	(45)			

	Actual		Forecast					
North West	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	Total	Allowed	Variance
Opex	90	98	95	90	90	**462**	446	(16)
Capex	40	49	45	29	21	**184**	211	27
Repex	105	98	91	94	87	**475**	494	19
Totex	**235**	**245**	**231**	**213**	**198**	**1,121**	**1,151**	**30**
Allowance	240	238	234	225	214	**1,151**		
Out / (Under) Performance	**5**	**(7)**	**4**	**12**	**16**	**30**		
Cumulative Performance	5	(2)	2	14	30			

West Midlands	Actual		Forecast					
	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	Total	Allowed	Variance
Opex	62	66	69	68	68	**333**	353	21
Capex	21	32	30	23	17	**122**	148	25
Repex	76	74	76	72	70	**367**	391	24
Totex	**159**	**171**	**175**	**163**	**155**	**822**	**892**	**70**
Allowance	187	182	180	174	170	**892**		
Out / (Under) Performance	**28**	**12**	**6**	**11**	**14**	**70**		
Cumulative Performance	28	39	45	56	70			

Cadent	Actual		Forecast					
	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	Total	Allowed	Variance
Opex	383	413	406	398	397	**1,998**	1,949	(49)
Capex	158	190	194	168	134	**843**	845	2
Repex	440	466	444	442	425	**2,217**	2,172	(45)
Totex	**981**	**1,069**	**1,043**	**1,008**	**956**	**5,058**	**4,966**	**(92)**
Allowance	1,033	1,013	1,004	971	945	**4,966**		
Out / (Under) Performance	**51**	**(56)**	**(39)**	**(37)**	**(11)**	**(92)**		
Cumulative Performance	51	(5)	(44)	(81)	(92)			

So far in RIIO-GD2 whilst delivering strong performance against our outputs we have overspent our Totex allowances by £5m (0.2%) cumulatively at a Cadent overall level. During 2022/23 we overspent our Totex allowances by £56m as our capital investment programme increased further in scale, whilst allowances reduced, and inflationary and market pressures impacted the cost base.

This year we delivered Controllable Opex within just 4% of the stretching allowance. This variance was predominantly due to inflationary and market pressures. Importantly, an increase in emergency and repair costs to respond to higher workload following a sudden spike in gas demand in December 2022 led to an exceptional level of customer calls, with an associated cost. In addition, building resilience to deal with unexpected incidents outside of our control, including in Stannington, Sheffield, added to resource costs.

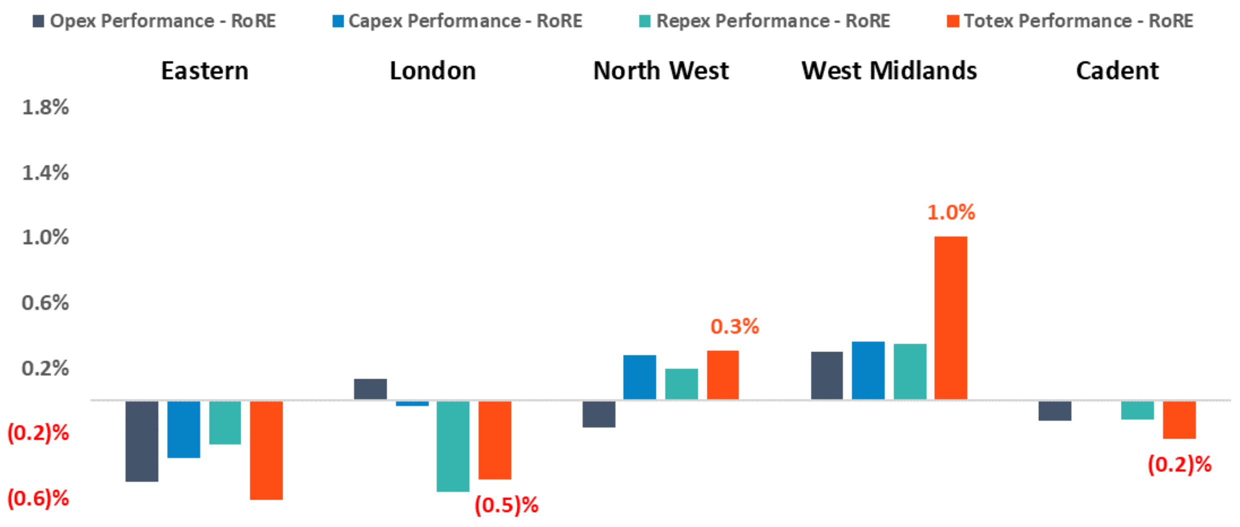
We invested £11m more on Capex compared to allowances for the year. This was due to variance between the phasing of our delivery profile compared to the baseline included in our allowances, along with the above inflationary and market pressures seen across the cost base not covered through allowances. In addition, our capex programme included significant investment in a Governor Improvement Programme this year.

We invested 7% more on Repex this year than our allowances due to:

- Challenging Repex allowances driven by our already stretching business plan, the use of the 85th percentile in cost assessment and the inclusion of a very stretching efficiency assumption.
- Some key London regional factors not being recognised within our allowances, with average unit costs per meter running significantly above those allowed. As well as impacting our London network it also has a significant affect in our Eastern network which includes the Outer Met area of London.
- Significant inflationary and market pressures beyond those compensated for through our allowances, on materials and labour; and
- A significant increase in workload delivery this year, with a 6% increase in mains decommissioned from 2021/22; combined with differences in workload phasing between our delivery plans and those assumed in the final determination.

The chart below shows the expected over / (under) performance relative to Totex allowances presented in RORE terms. This shows that the level of outperformance and underperformance is expected to be relatively tightly constrained around the baseline of allowed returns.

Chart 6: Totex over / (under) performance relative to allowances after adjustment for Enduring Value, RIIO-GD2 5 year average



3.2. Enduring Value

We have not identified any items that could be classified as an Enduring Value adjustment.

RIIO-GD1 Close out

Items in relation to RIIO-1 have been factored into the underlying financials presented. Work continues on this area in collaboration with Ofgem.

4. Incentives & Other Revenue Allowances

Overview

Financial Output Delivery Incentives ("ODI-Fs") are an important component of the RIIO price control framework and incentivise network companies to drive continuous performance improvements relevant to customers.

In RIIO-GD2, there is not a time lag between earning incentives and recognising the allowed income for them. The forecast completed in this RFPR is used to generate future revenues with true ups relative to actual performance over time.

For detailed analysis of our output performance please refer to the SPO. We have ambitious customer plans that results in a forecast improvement in Customer Service scores over RIIO-GD2. This is the primary driver of increasing RORE over the RIIO-GD2 period from incentives.

There is less opportunity to drive outperformance of the regulated return from incentives in RIIO-GD2 relative to RIIO-GD1. This comes from both the incentive strength (i.e., the amount that can be earned) reducing and from fewer incentives available to networks.

Customer Satisfaction Survey ("CSAT")

We have continued to make significant CSAT improvements in 2022/23 with all our networks improving at an aggregate level and on average achieving a score of 9.20 out of 10 (0.15 increase in score vs. last year), representing our highest ever score since the introduction of the incentive at the start of RIIO-GD1. We are particularly proud of our performance in our Connections service where we expect our networks to be positioned as the leading performers in the sector.

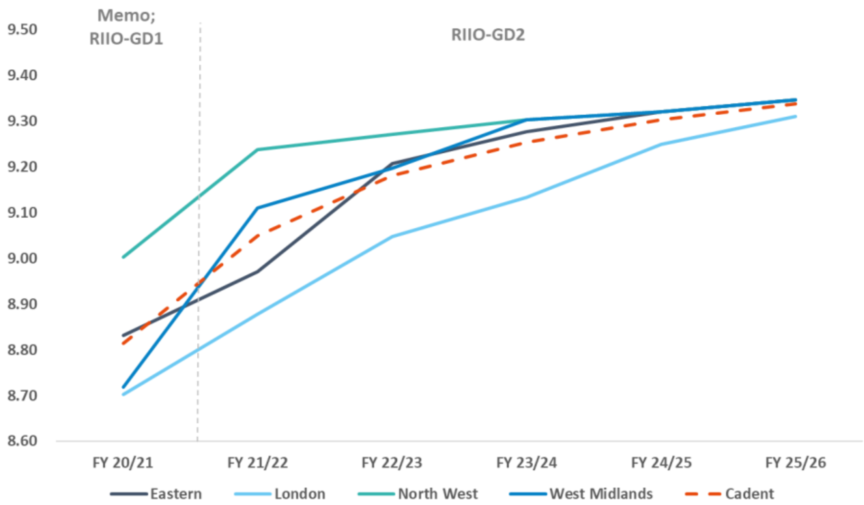
More information on our CSAT performance and the breakdown by component part and network can be found in our SPO document, pages 23-24.

Chart 7: CSAT improvement relative to FY21/22

	2022/23	2021/22	Movement
Eastern	9.21	8.97	+0.24
London	9.05	8.88	+0.17
North West	9.27	9.24	+0.03
West Midlands	9.20	9.08	+0.12

Our ambition has not stopped, and the chart below shows our planned improvement in customer scores over RIIO-GD2 with all networks expected to deliver performance improvements over time.

Chart 8: Forecast CSAT improvement over remainder of RIIO-GD2



Other Output Delivery Incentives

In RIIO-GD2, Cadent has the opportunity to earn reward and/or incur penalties through financial output delivery incentives (ODI-F). There is potential for reward or penalty through Shrinkage Management, reward through delivery of Collaborative Streetwork projects (only in Eastern and London networks), and mitigation of penalty through performance against Unplanned Interruptions and the Complaints Metric.

Shrinkage Management is key to help us in tackling climate change and improving the environment. See pages 31-32 of our SPO for more information on our Shrinkage performance and strategies.

Collaborative Streetworks encourages collaboration between utilities and local authorities to minimise disruption and was introduced in RIIO-GD2 for London-based networks. We have delivered 6 projects in our London network reducing disruption by 291 days. Across all of our collaboration projects delivered, including those that did not qualify for the incentive, we have achieved 1018 days of avoided disruption. Whilst there is a fixed incentive reward for each project delivered, the real value each project is delivering to customers and the wider community is much greater and this needs to be reflected when the incentive is updated or re-calibrated. Further details are provided on pages 26 – 27 of our SPO.

Cadent incurred no penalties on Unplanned Interruptions and Complaints metrics in 22/23 and forecasts the same for the remainder of RIIO-GD2 with further details shown on pages 24-26 of the SPO.

Other Revenue Allowances

Other Revenue allowances (ORAs) relate to, Network Innovation Allowance, Carry-over Network Innovation Allowance from RIIO-GD1, and Strategic Innovation Fund. The company contributes 10% towards allowed projects reducing RoRE performance. Vulnerability and Carbon Monoxide allowances is also included within ORAs however this is 100% funded on a use it or lose it basis (UIOLI).

5. Financing and Net Debt Position

As previously explained in the Financial Performance section of this document, we benefit from a comparatively low cash cost of debt. This is as a result of significant capital structure changes to create a separate Gas Distribution business (the "segmentation"). The low cost of debt results in an outperformance of the allowed funding for debt and an increase in reported RORE; however, this excludes the one-off costs associated with the segmentation. If the repayment of old legacy National Grid debt had not happened, then the current cost of debt for the Gas Distribution business would be higher over the medium term.

Cost of debt allowances are set assuming debt is raised evenly over a trailing average period from 10-14 years to fund investment in the network over time. However, the majority of our current debt portfolio was priced largely in a single year (FY17) due to the segmentation when market rates were low.

The intent of the segmentation was to transfer National Grid's debt across to Cadent. However, due to the complexity and cost of this process, the novation of all debt requirements was not possible. As such, expensive National Grid legacy debt was repaid and new cheaper debt was issued at the low prevailing market rates. However, significant costs were incurred in order to repay the old legacy debt and secure a much lower ongoing cost of debt effectively accelerating future cash payments.

Chart 9: RORE including and excluding adjustment for Cost of Debt segmentation

5-Year Average RORE - Including Financing and Tax					
	Eastern	London	North West	West Midlands	Cadent
Financing and Tax RORE Excluding Adjustment	2.8%	3.0%	3.2%	3.4%	3.1%
Financing and Tax RORE Including Adjustment	1.5%	1.8%	2.0%	2.2%	1.8%

(All RORE numbers quoted above are based on notional gearing)

Ofgem has completed cross checks and note in footnote 11 of their publication "RIIO-GD2 Sector Methodology Decision – Finance" that the cross checks support the total quantum of the adjustment.

Bondholders and banks were paid the difference between the cost of the old expensive debt and the market rate of new debt as compensation. These one-off costs incurred at various points during the segmentation are recorded in the statutory accounts of various entities, including the 2017 statutory accounts of National Grid Electricity Transmission plc ('NGET' or 'the electricity business') and National Grid Gas plc ('NGG' or 'the gas business'), as well as in the 2017 regulatory accounts for Cadent.

Current Ofgem RIGs do not support the adjustment to be included in reported results and as such we are providing RFPR tables with and without the adjustment. We firmly believe adjusting the cost of reported debt to reflect the true economic cost provides stakeholders with a more meaningful view on our performance.

The current high level of inflation influences the cost of debt and our (and all GDNs) performance against the respective allowance. The result of inflation over RIIO-GD2 can be seen in table 1 within Financial Performance section of this paper. As noted in this section the current Ofgem methodology skews debt performance to appear higher compared to calculating performance over a long period of time or reflecting the notional capital structure.

6. RAV

The RAV has been calculated based on the Totex allowances relative to spend as detailed in section 3. RAV is reported in real, 18/19 prices, however it will be a product of underlying Totex spend and increases in Real Price Effect's, which are influenced by inflation.

Total return on RAV is calculated using cost of capital. These values were set for the RIIO-GD2 price control period by Ofgem, following consultation with the GDNs and a CMA appeal of the Final Determinations. Cost of capital is influenced by real world market conditions, including inflation.

Over and under spend relative to allowances is shared 50:50 with customers in RIIO-GD2 and this impacts

RAV as well and transportation charges.

7. Tax and Tax Reconciliation

Comparing the tax per Cadent's tax return or CT600 shows a total of £84m which compares to tax allowances of £95m; a difference of £11m (excluding the impact of group relief). This is made up of regulatory adjustments shown on table R8 of £4m and the remaining difference of £7m being attributable to outperformance.

A summary of the differences is set out in the table below:

Chart 10: Summary of Tax reconciliation

Tax Reconciliation			
	Regulatory adjustments shown in R8	**Other differences associated to performance**	**Total**
Difference between allowed revenue and actual revenue (a)	7	-	7
Different Regulatory treatment of costs (b)	-	6	6
Tax trigger event deadband (c)	-	6	6
Difference between actual and notional interest (d)	(1)	(4)	(5)
Other regulatory differences (e)	(2)	-	(2)
Non-deductible costs in CT600 and other immaterial differences	-	(1)	(1)
Total (£Nominal)	**4**	**7**	**11**
Total (£18/19)	**4**	**6**	**10**

(a) Revenue in the statutory accounts of the company was £36m lower than the aggregate PCFM calculated revenue for the 4 networks giving rise to a lower actual tax liability than in the PCFM tax allowance.

(b) Agreed regulatory treatment of costs being different in the PCFM tax allowances than in the tax return. This is a predominantly a timing issue as to when the deduction is taken in the tax calculation, e.g. repex depreciation period is shorter in the accounts giving rise to a higher allowance. These regulatory treatments have been mandated by Ofgem.

(c) Impact of the deadband of the 4 Networks of £6m in the calculation of the tax trigger adjustment.

(d) Notional interest deducted in the PCFM calculation of the tax allowance was greater than the actual interest incurred, this reduced the overall outperformance.

(e) Other regulatory differences include adjustments relating to the non-regulatory business including metering, de-minimis, consented and excluded services as well as other excluded costs.

There are factors specific to Cadent that introduce complexity into the tax reconciliation making it difficult to complete and as a consequence some aspects of the reconciliation may be difficult to understand.

Firstly, the figures for revenue, costs and interest are taken from the group statutory accounts which are prepared under IFRS. The CT600 is based on the company accounts prepared under FRS 102. This has required that GAAP adjustments are shown in the adjustments section despite the fact that these adjustments are not shown in the CT600 but are required to reflect the adjustments made to the revenue, interest and costs in the FRS 102 accounts.

Secondly the CT600 is prepared for single legal entity Cadent Gas Limited, but our allowance is provided on a network specific basis. These 2 factors together create large differences between the values in each column requiring explanation. We would welcome the opportunity to discuss how this can be better represented in the table to aid understanding.

As can be seen above, after removing the presentational impact of GAAP differences and aggregating all 4 networks, the differences between the tax liability and the tax allowance arise as a result of timing differences on the treatment of revenue and costs and regulatory adjustments including the impact of the tax trigger deadband.

8. Corporate Governance

As noted in the section above we explain in detail our remuneration and Dividend policy and the tables provide the information requested however, we recommend that for further details the Directors' Remuneration Committee Report included in our Annual Report and Accounts (from page 101) is read in conjunction with the RFPR.

9. Pension & Other Activities

Prior to the separation of the business from National Grid and the subsequent sectionalisation of the Defined Benefit pension scheme, allowances were applied to National Grid Gas Transmission and allocated indirectly to each network via an NTS recharge. From 2017, following Sectionalisation of the National Grid UK Pension Scheme allowances, all liabilities are now applied to each network directly and there is no NTS recharge. This has led to an increase in the deficit contribution shown for 2017/18 onwards in table R10.

We have received confirmation that in compiling and reviewing Cadent's 2016/17 and 2017/18 RRP pension tables National Grid ensured that the total regulated deficit contributions (and PPF and Admin contributions) for the year for the scheme were split between Gas Transmission and Distribution in line with Ofgem's formal approach to allocating allowances between Transmission and Distribution.

In accordance with a shareholder agreement with National Grid, Cadent set up the Cadent Gas Pension Scheme (CGPS) in January 2020 and CGPS received a transfer of all assets and liabilities of Section C on 30 September 2020. The Schedule of Contributions agreed for CGPS replicated the Schedule of Contributions agreed with NGUKPS following the 2019 Valuation. All references to Section C now refer CGPS.

The latest valuation was performed as 31 March 2022 and the values presented in table R10 reflect this.

Other activities relate to Guaranteed Standard of Performance and reflect the values reported through our RRP submission. Further information can be found on page 25 of the SPO.

Data Assurance

Where available we have used information from the Regulatory Reporting Pack ("RRP") for the year to March 2023, the Licence as published in August 2023, the PCFM that has been submitted as part of the Annual Iteration Process, statutory accounts published in June 2023. Outputs from the Pensions Reasonable Review in relation to the Pension Deficit Allocation Methodology ("PDAM") relate to the March 2022 valuation. All of these documents have been through thorough assurance review processes including data accuracy and completeness checks as well as independent reviews.

The information submitted in the RFPR has been subject to a high level of internal reviews and followed Ofgem's Data Assurance Guidance (DAG) structure of Planning, Review, and Sign-off.

Appendices

1. Allocations and Estimates

Existing revenue and cost allocation methodologies have been used to populate the RFPR. For any revenues and costs that are not network specific the amounts have been allocated in line with the revenue and cost methodologies set out in our cost allocation methodology statements which are reported to Ofgem annually and are applied to all regulatory reporting. This is subject to agreed upon procedures set by Ofgem.

- **General**

Costs that relate to more than one activity, or that have arisen from shared services such including human resources, central operation and network strategy activities, IS, etc. have been allocated between activities using drivers that reflect, in management's opinion, the relative consumption of the services that give rise to the costs. Where this has not been possible, such costs have been allocated on a basis that reflects the relative size of those activities or using the relative numbers of staff. Management have applied the principals within the Methodology Statement.

In reaching an opinion on suitable cost drivers, management's objective has been to produce a fair and reasonable allocation of costs, after taking into account the materiality of the costs, the availability and accuracy of cost drivers and the cost of maintaining the drivers.

Following finalisation of the RIIO-GD2 settlement we have reviewed approaches to allocating centrally incurred operational costs in light of the approaches utilised to set network allowances for the GD2 period. For the majority of these costs the drivers utilised remain appropriate and we have not made any changes to their methods of allocation.

However, for those elements of Work Management, Other Direct Activities and Business Support costs that have previously been allocated evenly across our Networks, we have changed the method of allocation to one using network shares of RIIO-GD2 average Modern Equivalent Asset Value (MEAV), as a measure of relative scale. Taking this approach has the advantage of providing greater alignment with how allowances were set for the GD2 period, reducing the risk of providing an unfair advantage or disadvantage to customers in different networks due solely to differences in cost allocation. Ofgem have also used this approach to underpin their network specific efficiency targets and benchmarking. In making this change Cadent have ensured that it is consistent with the principles within the methodology statement and the associated unified cost allocation methodology.

- **Revenue**

The second section of the Revenue table involves adding back all items of revenue that are included within the statutory accounts but excluded from the collected regulatory network revenues. These items include:

  - De-minimis revenue
  - Excluded services
  - Consented activities
  - Bad debt
  - Supplier of last Resort
  - R&D Tax Credit
  - Accruals
  - Customer contributions
  - IFRS 15 Contribution released
  - Theft of Gas recoveries

- Other three networks – revenue relating to other three networks needs to be added to get back to the total amount for Gas Distribution

For any revenue that is not network specific the revenue has been allocated in line with the methodologies used within the Regulatory Accounts and the Revenue RRP which are either subject to an audit or agreed upon procedures.

- **Totex**

For the reconciliation to Totex on tab R3, each of the network tables start with total costs per the Cadent Gas Statutory Accounts. An adjustment is then required to remove the other three networks based on their RFPR table R3 submission.

The nature of the reconciling items for total expenditure are largely consistent with those previously reported - the principal adjustments relate to:

- An adjustment to fully reflect the costs relating to Excluded Services which are included in the statutory accounts operational cost figure but do not form part of the Totex figure in the RRP 1.01 table.
- The removal of non-cash items (e.g. depreciation/amortisation, provision releases/additions) reported within the statutory accounts as these are not part of operating costs within the RRP.
- Adjust for any Profit or Loss on disposals not included within Totex
- The exclusion of GSOP payments as these do not form part of Totex.
- The inclusion of cash spend against provisions (e.g. environmental provision utilisation) and any cash costs charged directly to exceptional items in the accounts.
- Adjusting for capital contributions received for new connections – these are included within turnover in the IFRS accounts but netted off Capex in the RRP Totex.
- Adjusting for leases previously deemed operating but now under the new IFRS16 standard are capitalised as a Right of Use Asset.
- Bad debt costs which are included as a revenue recovery item and therefore excluded from RRP Totex.
- Theft of gas income recoveries are treated as turnover in the statutory accounts but included within Totex in the RRP.
- Reconciling items specifically in respect of the atypical events which are included in the Statutory Accounts but have been excluded from the RRP. Please see below
  - The removal of costs associated with the Grenfell tower investigation and public enquiry as these do not form part of the normal course of operating a GDN.
  - The exclusion of costs in relation to the funding for Cadent foundation (our community fund) to support customers in vulnerable areas which is excluded from Totex and reported separately in the RRP.
  - Pension costs in respect of the pension deficit recovery plan payment, which we have split between Established and Incremental. These are reported in RRP total expenditure incurred figure but not in the Statutory Accounts operational costs.
  - Non controllable costs' as reported in table 4.01 of the RRP which include costs such as Network Rates, National Transmission System (NTS) Exit costs, Shrinkage – these form part of statutory costs but are excluded from Totex.

- **Innovation**

  The NIA and CNIA actual information in this table has been extracted from the RRP tables already submitted to Ofgem.

- **Financing**

  Debt instruments that are expected to be refinanced in the medium-term are excluded from existing debt at the point in time of the planned refinancing and replaced with new debt.

  New debt is forecast to support the Totex investment levels included in our RRP forecast.

- **RAV**

  We use the Ofgem PCFM to generate the output in the format required by the RFPR templates. As such items such as Enduring Value adjustments can be modelled through into allowances to note the impact on the RAV.

- **Tax**

  Our calculation methodology for the prior year tax reconciliation is explained above. The forecast tax liability is allocated to Networks from a Cadent level based on RAV allocation. Further information will be provided in subsequent RFPRs where CT600 reconciliations will be available.

- **Corporate Governance**

  Within the RFPR, we have allocated dividends and remuneration across the networks based on their respective RAV balances.

- **Pensions**

  The network splits within this table have been based on the PDAM methodology.

  Within the table the deficit payments have been based on amounts paid to the scheme. These payments have then been split into the established and incremental deficit elements of the scheme.

  The pre cut-off assets and liabilities have been based on the PDAM submission, with these lines being completed based on the overall pension scheme (section a, b and c).

  The post-cut off assets and liabilities have also been based on the PDAM submission, but have been populated for our scheme only (section C).

  The licensee elements of the total incremental deficit has been determined using an allocation driver consistent with the cost allocation methodology.

  The licensee established deficit based on the gas distribution networks element of the total deficit, which has been allocated in line with the PDAM methodology.