SGN RFPR Commentary September 2023

September 2023

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1 Purpose and background

1.1 Background

As set out in the RIIO-2 Regulatory Financial Performance Reporting (“RFPR”) – guidance and RIGs published 1st June 2022, each licence must provide a RFPR commentary and supporting enduring value methodology where applicable. This commentary is to provide an understanding of the licensee’s financial performance.

This commentary is required to be submitted along with the RFPR reporting pack no later than the 30th September following the end of every reporting year unless directed otherwise by the regulator.

This commentary is completed on behalf of both the Scotland Network and the Southern Network and is to be published on our website however, all commercially sensitive information will be redacted.

Where relevant, the figures provided in this commentary and the associated templates have been reconciled to the Regulatory Reporting Packs (“RRPs”) and, therefore, the statutory accounts.

The tables below are presented in either a 2018/19 price level or a nominal price level dependent on the requirements of the RFPR template inputs. The pricing level attributable to each table is clearly stated for each section.

2 Executive Summary

For our customers, our suppliers, and the energy sector as a whole the financial year 2022/23 has been a particularly turbulent period that has followed rapidly from the disruption of the COVID pandemic. We have worked hard through-out to support our most vulnerable customers, building our partnership network and maximising the benefit delivered from the support that we can provide. In the midst of this disruption the gas networks have continued to provide a crucial role in delivering the energy that keeps our customers safe and warm, as well as undertaking an inspiring, UK wide, journey to achieving Net Zero.

Constraints in the labour market in Southern England have proven particularly challenging as we worked tirelessly through a harsh winter to ensure we deliver on our commitments. As a result of these challenges and despite our best efforts this year we were unable to achieve our standard of service for responding to uncontrolled gas escapes within 1 hour in our Southern Network and for responding to controlled gas escapes within 2 hours in both Scotland and Southern networks. This is the first time we have missed these standards and we are focused on rectifying this for the coming year. Labour and resource challenges have also directly impacted the phasing of our workload and associated expenditure during the 22/23 financial year. We have recognised these challenges and responded with the largest recruitment programme that we have ever undertaken to bolster our frontline staff, to attract new talent into the industry and to train and equip these new recruits with the skills they will need to take our network forward into the future.

In the second year of our RIIO-GD2 price control period we have experienced a Totex underspend of 11%, at an SGN level, this has primarily been due to the challenges in increasing the volume of delivery in the Southern region. This underspend of allowances has meant that the pace of unwinding the position compared to our 21/22 forecast has not been as rapid as we'd expected. We are dedicated to ensuring the delivery of the RIIO-GD2 Price control outputs, which is reflected in our proposed forecast for the remaining years. We continue to focus on customer value by delivering our outputs and providing a cost-efficient network. For the calculation of RoRE we have partially normalised these timing impacts through the use of enduring value adjustments.

We are also continuing our focus on building the evidence base for hydrogen's role in the pathway to net-zero, our pioneering H100 project to demonstrate 100% green hydrogen heating in homes for the first time progresses. This year we have progressed the project, transitioning to the construction stage for the electrolysers and storage tanks, appointing contractors to deliver the distribution network, and gaining confidence from our customers. We are pleased to say that we have exceeded our target and currently have 367 customers who are opting to take part in this first-of-its-kind trial. These customers have signed up with interest in participating in the project to connect to a hydrogen network.

Our second flagship project is LTS Futures, this has cleared Phase 1 of the project plan and is progressing through Phase 2. This project will demonstrate the potential for repurposing the existing Local Transmission System (LTS) to carry hydrogen by carrying on a live trail on a decommissioned stretch of the network between Grangemouth and Granton (on the outskirts of Edinburgh).

Our overall year 2 performance has resulted in an operational RoRE (based on notional gearing) of 4.4% in Southern and 6.4% in Scotland. In Southern, there is a small reduction in return of -0.2 % from our allowed equity return, driven primarily by Totex underperformance. Additional returns of 1.8% on top of Scotland's allowed equity return is driven primarily by a favourable Totex performance. The RoRE's are calculated post enduring value adjustments so remove most of the timing variances. Overall output incentive performance is broadly neutral in both networks with 'LTS Futures' shareholder contributions in both networks, and penalties and fines within Guaranteed Standard of Performance (GSOP) payments in Southern for the regulated business . In addition, overspends necessary to deliver the outputs of the H100 project are being funded outside of regulatory totex of approximately £40m (nominal prices). Totex over/under performance in Scotland and Southern, respectively, has driven an average GD2 forecast Notional Operational RORE of c 6% in Scotland and 4% in Southern, against an allowed equity return of 5%.

2.1 RIIO-GD2 Key Financial performance measures

SGN's Totex performance in the second year of RIIO-GD2, in 2018/19 prices, is as follows:

Second year Totex performance

	Scotland			Southern		
£m's 2018/19 prices	Actuals (£m)	Allowance* (£m)	Variance (%)	Actuals (£m)	GD2 Allowance* (£m)	Variance (%)
Opex	66	76	13%	132	127	-4%
Repex	58	64	10%	148	176	16%
Capex	42	63	33%	67	74	10%
Total	166	203	18%	347	377	8%

**Indicative revised allowanced to reflect impact of volume drivers*

Below we have broken down the second-year variance into 4 categories:

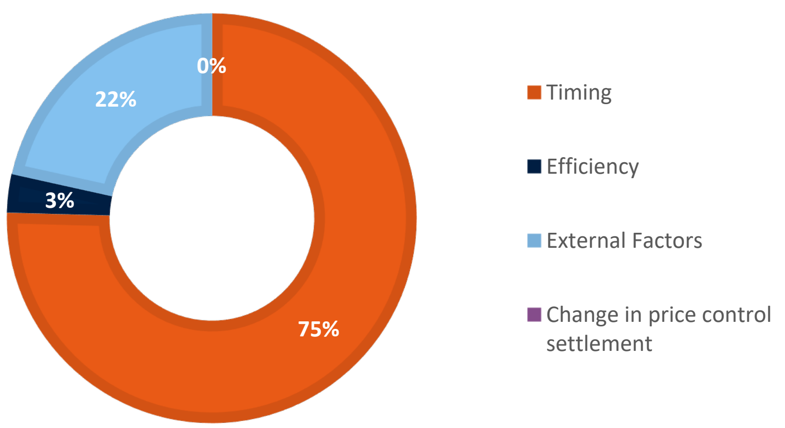
- Timing: Where workload and associated expenditure has not been completed yet but will be undertaken in later years.
- Efficiency: an improvement in how things are being done, resulting from, for example, innovation and more efficient working practices.
- External factors: factors outside of the control of GDNs and unforeseeable at the time of setting the price control. This includes areas such as weather and economic conditions.
- Provision in the price control settlement: assumptions made within the RIIO-GD2 settlement that have varied against the actual position.

The year 2 underspend has been assessed against categories (Timing, Efficiency, External factors, and Provision in the price control settlement).

Our second-year position has largely been driven by timing, with 75% of the underspend, where the anticipated phasing of expenditure set out in our 2019 business plan has not come to fruition. This has been primarily driven by the reduction in repex volumes in southern and the timing impacts of large capital projects (due to delays at the start of GD2 associated with COVID-19 and the economic disruption post COVID). External factors have attributed to a further 22% of the underspend, this is largely due to challenges in recruitment, with the remaining 3% being attributed to efficiency savings. There is a similar share of drivers to those reported in last year's strategic commentary.

For RoRE calculations, in particular for actuals year to date we have utilised Enduring Value adjustments, further listed in the appendices to partly normalise for timing differences.

Figure 1.1 - Second year Totex drivers



2.2 RIIO-GD2 Key Operational performance measures

Below is a summary of our annual output performance:

RAG Status:
Green: Delivered Licence Obligation, reputational commitments or positive outcome on financial incentive
Amber: Marginal under-delivery on reputational commitments or marginal penalty on financial incentive (amber is not applied to Licence Obligations).
Red: Not delivering a licence obligation, significant under-delivery on reputational commitments or significant penalty on financial incentive.

Outputs Summary		SC	SO
Meeting the needs of consumers and network users			
LO	Consumer vulnerability minimum standards		
LO	Guaranteed Standards of Performance (GSOPs)		
LO	Emergency response time (Uncontrolled)		
LO	Emergency response time (Controlled)		
LO	Digitalisation Strategy and Action Plan		
LO	Annual Environmental Report		
LO	Holder demolition		
ODI-F	Customer satisfaction survey		
ODI-F	Complaints metric		
ODI-F	Unplanned interruptions	*	
ODI-F	Network Asset Risk Metric		
ODI-F	Deliver an environmentally sustainable network		
ODI-F	Shrinkage and environmental emissions		
ODI-F	Collaborative streetworks		
ODI-R	Consumer vulnerability reputational incentive		
ODI-R	Fuel Poor Network Extension Scheme	N/A	N/A

Outputs Summary		SC	SO
Deliver an environmentally sustainable network			
ODI-R	Shrinkage and environmental emissions		
ODI-R	Business Carbon Footprint (BCF) reporting		
PCD	Commercial Fleet EV PCD		
PCD	Gas escape reduction		
PCD	Biomethane improved access rollout		
PCD	Intermediate pressure reconfigurations		
PCD	Remote pressure management		
Maintain a safe and resilient network			
PCD	Repex - Tier 1 mains replacement		
PCD	Repex - Tier 1 services		
PCD	Capital projects		
PCD	NARMs		
PCD	Cyber resilience Operational Technology (OT)		
PCD	Cyber resilience IT		

* If the ODI for unplanned interruptions was replicated to reflect Cadent's licence with a split between Multi-Occupancy Buildings (MOBs) and non-MOBs, our Scotland network would have been green.

Emergency Response time

Our emergency response time is shown in our outputs table as red for Scotland on the controlled gas escapes and red for southern on both controlled and uncontrolled as we were unable to deliver the licence obligation as we reached the end of year 2. This is not something we have experienced before, and we are implementing actions to try and prevent this from reoccurring in the future.

Unplanned interruptions

For Unplanned interruptions an isolated event on a multi occupancy building which resulted in a long duration unplanned interruption has driven our average for the year in our Scotland network over the excessive deterioration level, meaning we are now exposed to the penalty.

In July 2023 we submitted a report requesting a waiver on the penalty due to the circumstance that has led us to this position, Ofgem responded to this request on 25th August and rejected our request for a waiver.

Commercial Fleet EV PCD

On commercial fleet EV PCD, we are currently on a red status due to the continued slowed delivery of electric vehicles, and other factors such as the existing lifecycle of vehicles, and availability of charging points.

Environmental outputs

With our other Environmental outputs, although for the year 2022/23 we are on target for our scope 1 and scope 2 (excl shrinkage emissions), we are currently in an amber status due to the risk we currently have with the commercial fleet, a key element of scope 1. We are currently tracking above our emissions target on commercial fleet and will monitor this closely through the remaining years.

Repex Tier 1 Mains and Services PCDs

Our Tier 1 mains and service PCD is now red for our southern network as we were unable to achieve our linear target for year 2 of RIIO-GD2. There are many factors that have driven this underperformance in year two, further detail of which can be found in section 3.3.

3 Overview of Regulatory Performance

3.1 (R1) RoRE

As shown in the table below, the 22_23 operational RORE (based on notional gearing) is 6.4% in Scotland and 4.4% in Southern. Additional returns of 1.8% on top of Scotland's allowed equity return is driven primarily by a favourable Totex performance. In Southern there is small reduction in return of -0.2 % from our allowed equity return, driven primarily by Totex underperformance. This is post our enduring value adjustments which help to normalise for timing differences. Overall output incentive performance is broadly neutral in both networks, and there are 'LTS Futures' shareholder contribution in both networks, and penalties and fines within Guaranteed Standard of Performance (GSOP) payments in Southern for the regulated business. In addition, overspends necessary to deliver the outputs of the H100 project are being funded outside of regulatory totex of approximately £40m (nominal prices). This is not included in the table below.

Totex over/under performance in Scotland and Southern, respectively, has driven an average GD2 forecast Notional Operational RORE of c 6% in Scotland and 4% in Southern, against an allowed equity return of 5%. Further details of Totex performance can be found in sections 2.1 & 3.3 and output incentive performance in section 3.4.

2022/23 Debt performance in Scotland and Southern is driven by the impact of high inflation, partially offset by the impact of an unfunded differential between RPI and CPIH, and CPI and CPIH, for RPI and CPI linked bonds. Closing actual gearing dropped to c.64% for Scotland and 65% for Southern in 2022/23, driven predominantly by inflation. Although we don't have a specific gearing target, we forecast our gearing will rise towards 70% over RIIO-GD2, and this is reviewed regularly by the board. We note that the primary constraint driving financial policy decisions is now our rating agency interest cover metrics over the current price control.

Over GD2 the Debt Performance averages 1.2% for Scotland and 1.7% for Southern. For both networks, tax performance is forecast to be broadly neutral in 2022/23 and GD2 as a whole. Overall, the Total Notional RORE including financing and tax is c. 12% for Scotland and 10% for Southern in 2022/23 and forecast to average 7.2% for Scotland and 5.6% Southern for GD2.

Notional RORE	2022/23			GD2 Forecast		
	Scotland	Southern	SGN	Scotland	Southern	SGN
Allowed Equity Return	4.6%	4.6%	4.6%	5.0%	5.0%	5.0%
Totex outperformance	2.0%	-0.2%	0.5%	0.9%	-0.9%	-0.3%
Customer Satisfaction Survey ODI	0.2%	0.0%	0.1%	0.1%	0.0%	0.0%
Complaints Metric ODI	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Unplanned Interruption ODI	-0.2%	0.0%	-0.1%	0.0%	0.0%	0.0%
Shrinkage Management ODI	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Collaborative Streetworks ODI	0.0%	0.1%	0.1%	0.0%	0.0%	0.0%
Network Innovation	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
H100 shareholder contribution[1]	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
LTS shareholder contribution	-0.1%	-0.1%	-0.1%	0.0%	0.0%	0.0%
Penalties and fines	0.0%	-0.1%	-0.1%	0.0%	0.0%	0.0%
NOTIONAL RORE – Operational Performance	**6.4%**	**4.4%**	**5.0%**	**5.9%**	**4.1%**	**4.6%**

Debt performance (at notional gearing)	5.7%	6.3%	6.1%	1.2%	1.7%	1.5%
Tax performance (at notional gearing)	0.0%	-0.6%	-0.4%	0.1%	-0.1%	0.0%
NOTIONAL RORE – including financing and tax	**12.2%**	**10.0%**	**10.7%**	**7.2%**	**5.6%**	**6.1%**

Notes

[1] SGN's shareholders are forecast to make additional unregulated contributions of £41.5m (nominal prices) to the H100 project, which is not included above. This is the equivalent to a -0.2% impact on average SGN GD2 RORE.

3.2 (R2) Reconciliation to Revenue and Profit

Revenue

RIIO-GD2 revenues are set on a forecast basis, the tables below show the 2021/22 and 2022/23 final calculated revenue for Scotland and southern, differences will be adjusted for in future tariff calculations. All figures in the below table are quoted in 2018/19 prices so exclude the impact of inflation (CPIH).

Scotland

Scotland Revenue £m 18/19 prices	2021/22	2022/23	Delta
Calculated [Base] Revenue	213.9	213.8	0.1
Innovation [Other Revenue]	1.5	2.2	0.7
Incentives	1.3	0.1	-1.2
Pass-through expenditure	47.7	44.4	-3.3
Total LDZ Calculated Revenue	**264.5**	**260.5**	**-3.9**
ECN revenue	27.5	23	-4.5
SoLR revenue	0.5	58.2	57.6
Total Calculated Revenue	**292.5**	**341.7**	**49.2**

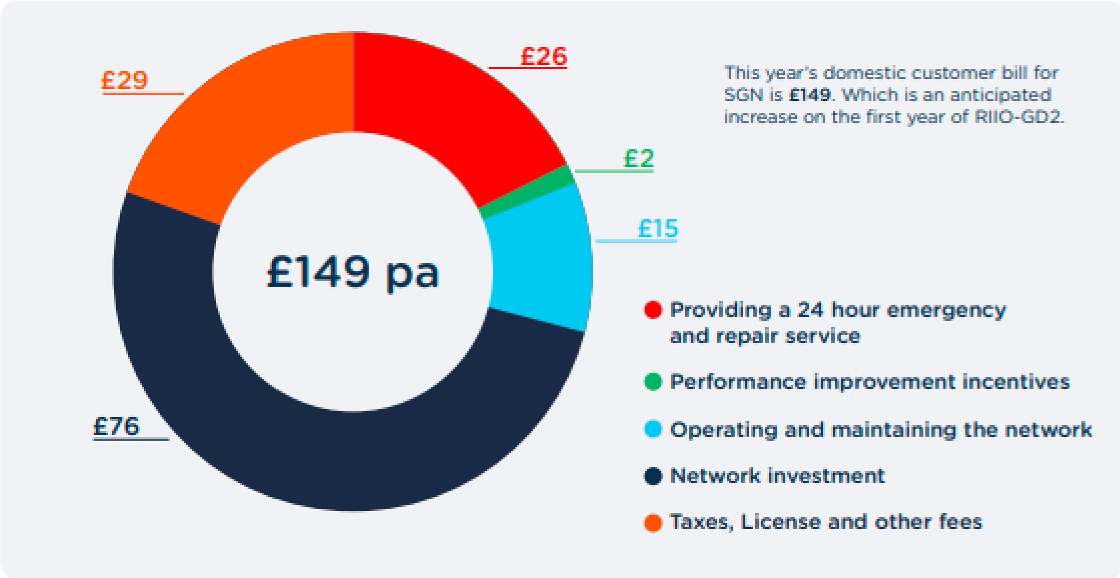
Southern

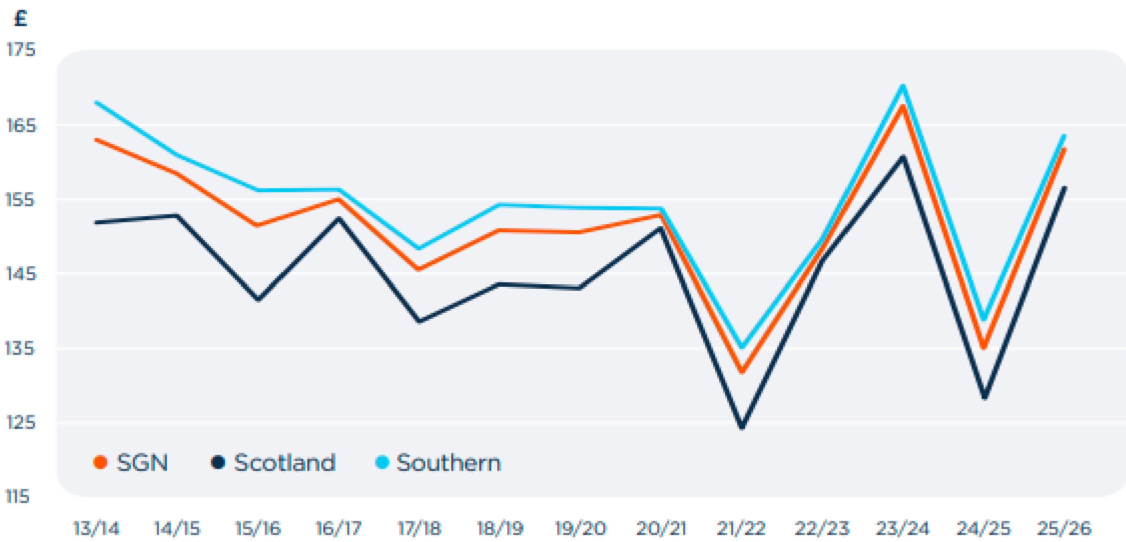
Southern Revenue £m 18/19 prices	2021/22	2022/23	Delta
Calculated [Base] Revenue	472.9	466.7	-6.2
Innovation [Other Revenue]	2.7	4	1.4
Incentives	2.1	2.3	0.2
Pass-through expenditure	109.4	100.2	-9.1
Total LDZ Calculated Revenue	**587.1**	**573.3**	**-13.8**
ECN revenue	64.5	56.3	-8.2
SoLR revenue	1.2	131	129.8
Total Calculated Revenue	**652.7**	**760.6**	**107.8**

The reasons for the variance include;

- By far the largest impact is the increases in Supplier of Last Resort (SoLR) claims received in 2022/23. This was a result of the difficulties the industry experienced in late 2021 through to 2022 when there were many failed suppliers. This resulted in the suppliers, who had taken on the failed supplier portfolios, submitting claims to distribution networks for costs incurred.
- There are low levels of movements in pass-through costs across many inputs when comparing the two years. NTS Exit Capacity charges (ECN revenue), which is based on the costs SGN incur saw a reduction in both networks. This was a result of a reduction in National Grids National Transmission System (NTS) Exit capacity rates which are set in October each year. Due to the rates being set at the beginning of each Gas year (October to September), SGN's costs for 2022/23 are based on a combination of the NTS rates as of October 2021 and October 2022.
- The small reduction in Calculated 'base' revenue. This negative variance arises as a result of the increase in Totex spend being more than offset by reductions in tax allowances (driven by a combination of an increase in super tax deductions and higher financing costs)
- Innovation, incorporating both Network Innovation Allowance (NIA) and Vulnerability and Carbon Monoxide Allowance (VCMA), has set allowances for the RIIO-GD2 price control which networks can profile as they choose. The increase in 2022/23, compared to 2021/22 is a result of an increased number of projects undertaken in year two of the price control.
- Incentive reward saw a small increase in both customer satisfaction and shrinkage management. In Scotland, this has been offset by mean unplanned interruptions which ended the year in penalty.

Customer Bill Impact





Note: Customer bill impacts are presented in nominal prices

3.3 (R3) 2022/23 Totex reconciliation

The table below shows SGN's totex performance, in 2018/19 prices, for this financial year.

£m's 2018/19 prices	2022/23 Actuals (£m)	2022/22 Allowance* (£m)	Variance (%)
Opex	198	202	**2%**
Repex	206	240	**14%**
Capex	109	137	**21%**
Total	**513**	**579**	**11%**

**Indicative revised allowanced to reflect impact of volume drivers*

Our in year Totex position continues to be dominated by timing. Whilst we are forecasting to overspend our Totex allowances over GD2, the current year total Totex underspend was 11% under allowances. As we forecasted in the 21/22 RFPR report this is a reduction in the total underspend compared to the first year of 19%, however the pace of unwinding this position has not been as rapid as we forecast last year. This is primarily due to challenges in increasing the volume of delivery in the Southern region.

Opex

Across both networks our Opex spend has seen an increase in year 2 compared to the first year of RIIO-GD2, however, while in Scotland we remained within our allowances, the increase in our Southern region was significantly more. The increase within Southern is higher than assumed in our year 1 submission and we anticipate this will continue through the remaining years of RIIO-GD2, as such, we have adjusted our forecast with the assumption we will overspend allowances by approximately 13% (£83m). The main drivers behind these changes in southern are within our emergency and repair costs, where more challenging workloads are expected.

In Scotland, our year 2 performance was slightly better in Opex compared to our year 1 outlook and as such our forecast for the remainder of RIIO-GD2 has slightly improved to an underspend of approximately 3%.

Repex

During the second year of RIIO-GD2, we can see two very distinct stories. SGN Scotland has performed well against its targets, and we anticipate this strong delivery will continue for the remaining years of GD2 and currently forecast that we should outperform allowances by approximately 8% (£26m) over the 5-year period.

In our Southern Licence the challenges that we identified in the 21/22 strategic commentary in being able to attract contractors to complete the work have increased and we have been unable to achieve a substantial pick up in the contractor lengths being delivered. We delivered 510.3km in length for 22/23 compared to the 21/22 year which was 586.5km. At the outset of GD2, we had an annual linear target of 600km, the shortfall in the first two years has put significant pressure on the remaining years.

Over the second year of GD2, we have tried all available options to maintain delivery, however, we have been unsuccessful. During this period contractors have gone into administration and as expected with more challenging work, productivity decreases as lengths become more challenging thereby requiring additional resources to complete. We are now showing the PCD as red due to the distance that we are behind the linear targets.

In order to rectify the situation in Southern and deliver the PCD we are now looking at what more we can do to attract new resources and new contractors into the market. However, the recovery will be slow given the time it will take to build this capacity and in the coming year we expect a partial recovery before building to substantial over delivery in order to catch up with the 5-year target.

This highlights the very different challenges faced between the North and the South of the country. This was an issue that we raised extensively during the GD2 settlement where we expressed our concern is that the benchmarking process did not provide appropriate adjustments for the costs of doing business efficiently in the south of the country and did not reflect observed market prices. These concerns are currently being realised and we anticipate it becoming more challenging as the complexity of work in the southern region increases.

Capex

During the second year of RIIO-GD2 both SGN Scotland and SGN Southern have underspent their allowances. The scale of the under spend is primarily due to timing differences between allowances and expenditure and is expected to reverse out over the coming years as we move into contracting and project delivery for the larger projects.

Over the course of RIIO-GD2, we anticipate that we will deliver our outputs and outperform our allowances by approximately 10% in Scotland and 7% in Southern.

3.4 (R4) Incentive and Other Revenue

Incentives

The table below shows our 2022/23 performance for incentives has generated income of £0.05m for Scotland and £2.32m for Southern.

Both of our networks continue to perform strongly, achieving excellent performance for our customer service outputs. Our Scotland network remains the UK's number one gas network for customer service for the seventh year running.

£m 2018/19 prices	Scotland	Southern	SGN
Output Delivery Incentives (ODI-F) - potential reward or penalty			
Shrinkage Management	0.21	0.21	0.42
Customer Satisfaction	1.31	0.58	1.89
Collaborative Streetworks	n/a	1.53	1.53
Output Delivery Incentives (ODI-F) – penalty only			
Complaint's metric	0	0	0
Unplanned interruptions	-1.47	0	0
Total Incentives	0.05	2.32	2.37

Shrinkage Management ODI

The ODI for Shrinkage Management is generating a small incentive allowance due to an outperformance of approx. 1.2 GWh against the Lower Deadband (PLDV) in South LDZ. In Scotland, Average System Pressures (ASP) fell within the Deadband (between PLDV and Pressure Upper Deadband Volume (PUDV)), neither generating a reward or a penalty

Also, against the Gas Conditioning Baseline Volumes (CBV), South East saw an outperformance of approx. 0.2 GWh, and Scotland an outperformance of approx. 1.4 GWh. There are currently no low-pressure systems with active gas conditioning in the South.

Customer Satisfaction Survey ODI

For the second year of RIIO-GD2 our Scotland network achieved the number 1 position for customer satisfaction, this is a great achievement as they hold this position for the 7th year in a row. Progressing into the third year of this price control period Scotland maintain a healthy score. We are therefore focusing on lifting the customer satisfaction score in our Southern network. Overall, our Southern network was ranked 6th but has continued to improve their score from previous years however there is still work to be done. Specific areas we are working on to improve our service and our customer satisfaction scores are:

- **Governance -** Working with agility to deliver the Customer Experience plans and Vulnerable plans, as well as developing OKRs and creating dashboards to monitor progress, and establishing Working groups and key partnerships for supporting Vulnerable customers across RIIO-GD2.
- **Technology** - We have implemented 2-way SMS, WhatsApp & social media Direct Messaging. Also, our website has been updated to indicative pricing, lead times, navigation & Live chat pop ups. PayPal & split payments for Connection's customers is now available.
- **People** - We hold many customer forums and focus sessions to understand the changes needed, we recognise our people that make the difference through our 10/10 corner and give monthly awards as well as sharing 'make the difference' stories across the business. We have also implemented leads for Southern Customer Experience (CX) and GSOP to ensure compliance.
- **Training** - We have delivered 'Trust in Us' training for team leaders, FCO's and account managers which will continue through RIIO-GD2, as well as designing and delivering customer service e-learning modules for our customer facing employees. In order to maintain a high standard of customer service we have ongoing refresher training courses, which include topics such as dealing with vulnerable customers and identifying vulnerability.

Our front-line teams have helped support us with knowing our customers' needs and offering a helping hand when needed. They continue to uphold their commitment to never walking away from a customer in need.
We have continued to help our fuel poor customers through the 'Emergency crisis fund' which we implemented during the COVID-19 pandemic. We continued this into RIIO-GD2 and developed the fund into vouchers for same day food and fuel to help our vulnerable customers.

As the energy crisis began, SGN made a conscious decision as part of our collaborative partnerships to join national schemes and actively made partnerships with trusted partners including Fuel Bank Foundation, and Citizens Advice England and Wales, both of which have made a huge impact in helping support our fuel poor customers. We have also taken our existing partnership with Scope and expanded that to collaborate with the other gas networks in order to enhance the help we provide to customers across all areas of the UK.

Collaborative Streetworks ODI

The collaborative streetworks incentive is a bespoke incentive for the Southern and London GDN's network, it 'incentivises' collaboration with other utilities within the Greater London area to reduce inconvenience to member of the public. The maximum reward is generated at 10 projects per year and is subject to the totex incentive mechanism. In 2022/23 we maximised this incentive by completing 10 projects, claiming a reward of £1.53m.

Complaints Metric ODI

For both networks, no penalty was incurred in 2021/22. Both our networks have continued to perform well with complaints handling, achieving significantly lower than the penalty threshold of 5.00 (Scotland 1.71 and south 4.74).

Unplanned Interruption ODI

Our Unplanned interruption results for Southern were below the minimum performance level, however, in our Scotland network, in the final months of 2021/22, we experienced a long duration unplanned interruption on a multi occupancy building affecting 32 customers. Due to the complexity of replacing the riser in order to reconnect customers safely, this interruption was recorded in statistics in April 2022, once the interruption had been fully rectified, and it, therefore, affects the network average score for the reporting year of 2022/23. This single event contributed 67,497 hours to the annual average, driving our average for MOBs at the end of the year to 484.4 hours, and consequently driving our combined average to 31.1 hours, exceeding the unplanned interruption excessive deterioration level.

As a result, we have exceeded the unplanned interruption excessive deterioration level (UIED) of 23.5 hours for the regulatory year 2022/23 in our Scotland network.

Other Revenue

The table below shows our 2022/23 performance for other revenue, this is primarily cost recovery for customer vulnerability and innovation projects undertaken in GD2 and increased total allowances by £4.1m for Scotland and £9.1m for Southern.

£m 2018/19 prices	Scotland			Southern		
	GD2 Allowance	Expenditure to date	Percentage Used	GD2 Allowance	Expenditure to date	Percentage used
Vulnerability and Carbon Monoxide Allowance VCMA[1]	5.0	2.0	40%	11.2	2.9	26%
Additional VCMA as per updated licence June 23	9.3	0.0	0%	20.9	0.0	0%
Network Innovation Allowance (NIA)	11.0	1.6	15%	24.6	2.8	12%
Net Zero and Reopener Use it or Lose it	3.3	0.3	9%	7.5	0.6	8%
Carry over RIIO-GD1 NIA		0.2			0.6	
Strategic Innovation Fund (SIF)					2.2	

All details relating to the above table can be found in our 2023 Stakeholder report.

3.5 (R5-6) Financing and Net Debt position

2022/23 Net Debt £m's nominal	Scotland (£m)	Southern (£m)
Opening Net Debt	**1,365.00**	**3,015.40**
Issuances	284.0	116.0
Repayments	(277.4)	(30.0)
Accretion	47.0	125.0
(Net inflow) / Net outflow of cash equivalents and short-term deposits	(27.9)	(117.6)
Closing Net Debt	**1,390.70**	**3,108.8**

The above figures are presented in nominal prices

Financing

During the financial year Scotland had a £277m RPI-linked public bond that matured in October 2022. The maturity was part-refinanced by a £100m CPI-linked loan put in place in March 2022, which was drawn in September 2022. The remainder was refinanced by £184m of fixed rate private placement notes issued in October 2022, with £154m of this drawn in October 2022 and £30m drawn in March 2023. Scotland has no scheduled debt maturities in the coming year.

Other than repaying a £30m drawing on its Revolving Credit Facility ("RCF"), Southern had no debt maturities in the last financial year. In the coming financial year, Southern has a £300m fixed rate public bond maturing in October 2023. To part-

[1] Includes both the company specific and collaborative allowance attributable to each network

refinance this, $132m (£116m equivalent) of fixed rate private placement notes were issued in October 2022, which were fully drawn in March 2023. Additional short-term committed liquidity, in the form of a £560m bridging facility, was put in place at Southern in June 2023, and additional long-term financing has been sought ahead of the October 2023 maturity.

At the year end, our RCFs in place for both Southern and Scotland were undrawn (2022: £30m drawn at Southern only). As highlighted above, a £560m bridge facility has also been put in place at Southern in June 2023 to provide additional liquidity to cover its upcoming bond maturity and give it the flexibility to prepay certain floating rate loans.

RPI and CPI impacted our index-linked debt and derivatives over the last financial year by accruing:

- At Scotland, £47m of RPI-linked accretion (2022: £24m) and £24m of CPI-linked accretion (2022: nil)
- At Southern, £67m of RPI-linked accretion (2022: £23m) and £57m of CPI-linked accretion (2022: £29m)

Risk management

To reduce the interest rate concentration risk of its private placement issuances, in October 2022, Scotland entered into three fixed-to-floating interest rate swaps ("IRS") totalling £90m that convert a portion of the £184m fixed rate notes (as highlighted above), entered into within the same month, into floating rates based on SONIA:

- £30m of the £34m notes due 2032 converted from fixed to SONIA plus 2.115%, effective October 2022
- £30m of the £30m notes due 2035 converted from fixed to SONIA plus 2.373%, effective March 2023
- £30m of the £50m notes due 2035 converted from fixed to SONIA plus 2.2695%, effective October 2022

In June 2022 the mandatory break on Scotland's £80m IRS maturing in March 2043 was extended by 10 years to March 2033. As part of this exercise, the swap was novated to another of SGN's relationship banks, and the fixed rate payable leg was increased by around 0.5%. The floating rate receivable was unchanged and remains the same as the floating rate payable on the hedged £80m floating rate bond due 2043.

In February 2023, the Company entered into a single floating-to-fixed £30m IRS to 're-fix' the IRS hedging the fixed rate notes due in 2032. The new swap's floating receive leg exactly offsets the original swap's floating pay leg of SONIA plus 2.115%, resulting in a net fixed exposure.

Subsequently, in May 2023 and August 2023, Scotland entered into two more floating-to-fixed £30m IRSs to re-fix the remaining two IRSs, with floating receive legs that offset the original swaps' floating pay legs of SONIA plus 20373% and SONIA plus 2.2695%.

In line with its hedging policy and requirements under its financing documents, the entire principal amounts and interest payments under the $132m USD private placement notes issued in October 2022 were hedged to GBP using cross-currency swaps with effective dates matching the drawdown profile of the notes. Under these cross-currency swaps, Southern receives a USD upfront payment and fixed USD payments equal to the principal amounts and coupons under the notes respectively, and pays fixed GBP amounts:

- $41m converted to £36m with fixed 6.2440% GBP interest payable, due 2033, effective March 2023
- $25m converted to £22m with fixed 6.2485% GBP interest payable, due 2033, effective March 2023
- $66m converted to £59m with fixed 6.2800% GBP interest payable, due 2035, effective March 2023

In June 2022, Southern agreed to settle outstanding fees due in relation to certain guarantees provided by Assured Guarantee Corp. (as agent for Syncora Guarantee Inc.) and Assured Guarantee UK Limited that were previously in place over certain outstanding public bond instruments. The cash settlement amount of £9m is included within the "interest paid" line of Southern's cash flow statement.

3.6 (R7) RAV

The table sets out the RAV for second and final years of RIIO-GD2 (31st March 2023 and 2026, respectively):

	2022/23			2025/26		
£m's 2018/19 prices	Scotland	Southern	SGN	Scotland	Southern	SGN
Opening RAV	1,761.0	3,899.4	**5,660.4**	1,841.0	4,017.4	**5,858.4**
Net Additions	112.9	224.5	**337.5**	118.4	304.1	**422.5**
Depreciation	(94.2)	(207.1)	**(301.3)**	(102.1)	(222.0)	**(324.1)**
Closing RAV	**1,779.7**	**3,916.8**	**5,696.6**	**1,857.3**	**4,099.4**	**5,956.7**
£m's nominal						
Adjusted closing RAV	**2,177.0**	**4,791.1**	**6,968.0**	**2,335.9**	**5,155.9**	**7,491.8**

In 2018/19 prices, our Regulated Asset Value (RAV) increased by 1.1% for Scotland and 0.4% for Southern in 2022/23. Reopeners and volume drivers are capitalised at 70% for Scotland and Southern, with the remaining majority of capex and opex capitalised at 41% for Scotland and 33% for Southern. All repex is capitalised at 100%.

3.7 (R8 & R8a) Taxation and Tax Reconciliation

We take a prudent approach with relation to tax, recognising liabilities expected to arise and only recognising assets once confirmation has been received from HMRC. Our primary objective has always been to recognise and adhere to all tax legislation policies and remain compliant.

Our tax strategy

We shall organise ourselves to ensure that we:

- Comply with all tax legislation requirements.
- Operate within the law.
- Maintain strong relationships with the tax authorities built on trust and co-operation.

Compliance

We are proud to pay our fair share of tax, and our primary objective from a tax perspective is to be compliant with all tax legislation requirements. This includes making timely and accurate returns which reflect our fiscal obligation to government whilst, at the same time, recognising all legislative concessions and reliefs.

Operate within the law

We strive to minimise our total tax liability within the framework of legislative reliefs but do not take an aggressive stance in our interpretation of tax legislation. Our policy is to operate within the law at all times, therefore we do not use artificial tax avoidance schemes or tax havens to reduce our tax liabilities.

Trust and co-operation

Central to our Tax Policy is the maintenance and development of a strong working relationship with HMRC and other Treasury departments based on trust and co-operation.

Tax contribution

Our tax contributions in the year amounted to £411.8m (2022: £371.9m), these consist of the following contributions:

- Corporation tax of £41.5m (2022: £38.3m) paid on our taxable profits
- VAT of £174.0m (2022: £146.5m)
- Business rates of £121.0m (2022: £121.9m) paid to local authorities

- Employment taxes of £75.3m (2022: £65.2m) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions

2021/22 Tax Reconciliation

An explanation of the differences between Scotland and Southern's CT600 actual corporation tax liability and the calculated tax allowance in the Latest PCFM, which are detailed in tab R8a, is found in the tables and commentary below. We have aggregated all the differences in tab R8a, which drive the profits and thus corporation tax variances, into 4 categories: EBITDA (net of turnover and operating expenses), Total Interest, Capital Allowances and CT600 Adjustments.

The materiality thresholds for the differences in these categories, and thus also the profits chargeable to corporation tax, are £4.5m for Scotland and £9.4m for Southern. The materiality threshold for the difference between the CT600 actual corporation tax liability and the calculated tax allowance in the Latest PCFM is £1.1m for Scotland and £2.2m for Southern. Please note that all figures in this tax reconciliation commentary are in £ms (nominal).

Scotland Summary

As shown in the table below the difference of -£2.2m between the corporation tax determined by the CT600 and the calculated tax allowance in the latest PCFM is due to a variance of £-11.7m in the profits chargeable to corporation tax. These material variances are caused by differences in the 4 categories detailed above, with the only individual material difference being in the CT600 adjustments category which relates to pension and intangible amortisation CT600 tax adjustments that aren't factored into PCFM calculations.

	CT600	PCFM	DIFFERENCE PCFM vs CT600	MATERIALITY CHECK
i. EBITDA	169.5	174.0	-4.5	Immaterial
ii. Total Interest	-73.7	-75.9	2.2	Immaterial
iii. Capital Allowances	-59.5	-55.9	-3.7	Immaterial
iv. CT600 Adjustments	-5.7	0.0	-5.7	Material
Profits Chargeable to Corporation Tax	30.5	42.2	-11.7	Material
Corporation Tax due on PCTCT @ 19%	5.8	8.0	-2.2	Material

Southern Summary

As shown in the table below the difference of -£7.4m between the corporation tax determined by the CT600 and the calculated tax allowance in the latest PCFM is due to a £-39.0m variance in the profits chargeable to corporation tax. These material variances are caused by differences in the 4 categories detailed above, with the only individual material difference being in the EBITDA category which is mainly due to a regulated revenue timing difference between the January 2021 PCFM that sets the forecasted allowed revenue to collect in 2021/22 and the revenue in the latest September 2023 PCFM, based on actualised inputs, used to generate the allowed tax. Under Forecasts of gas prices (impacting shrinkage costs) and inflation, when setting the tariffs, are the main timing differences.

	CT600	PCFM	DIFFERENCE PCFM vs CT600	MATERIALITY CHECK
i. EBITDA	364.9	393.7	-28.7	Material
ii. Total Interest	-128.7	-131.4	2.7	Immaterial
iii. Capital Allowances	-98.7	-95.1	-3.6	Immaterial
iv. CT600 Adjustments	-9.3	0.0	-9.3	Immaterial

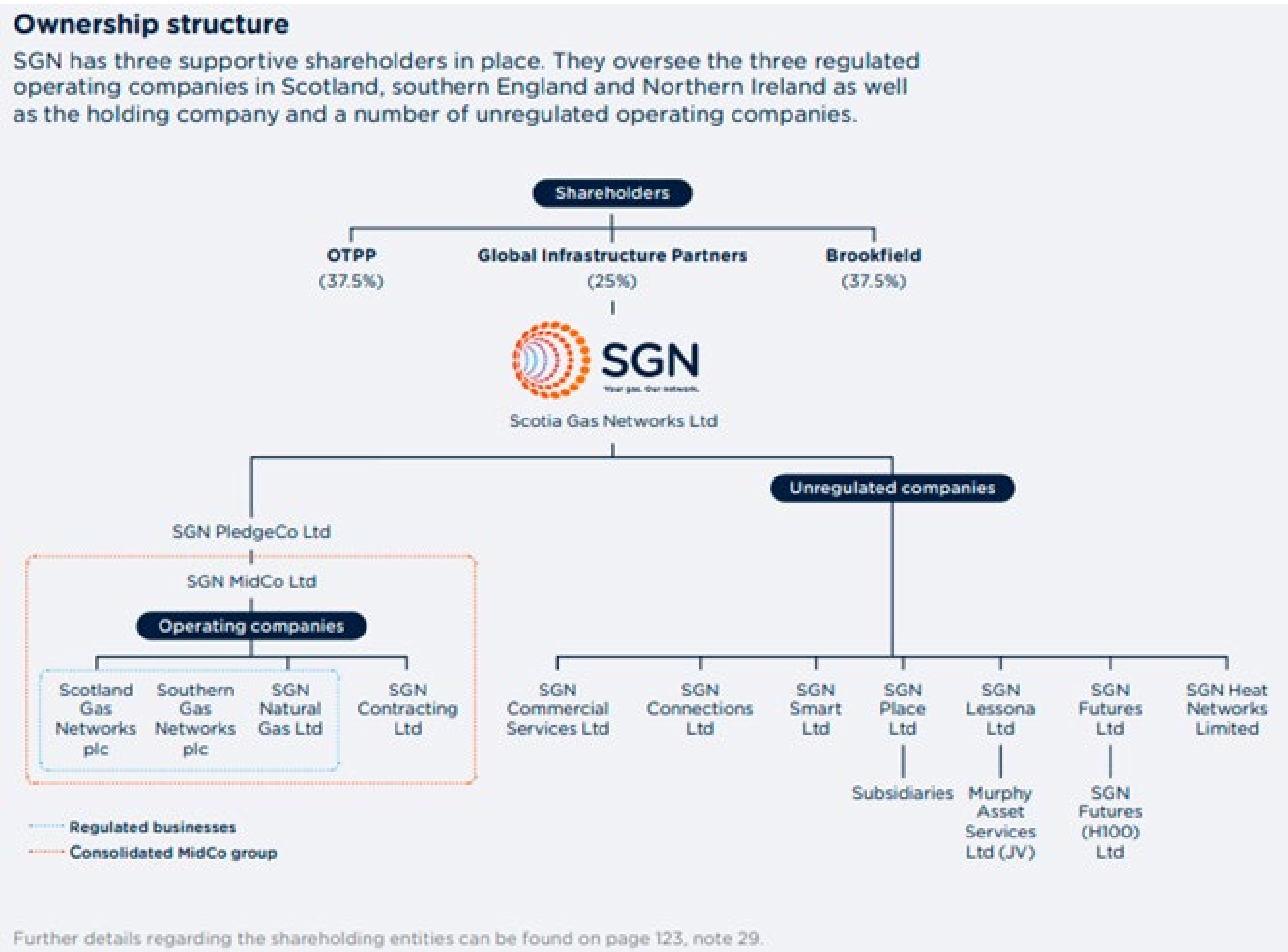
Profits Chargeable to Corporation Tax	128.3	167.2	-38.9	Material
Corporation Tax due on PCTCT @ 19%	24.4	31.8	-7.4	Material

3.8 (R9) Corporate Governance

Ownership and Board Structure

At the beginning of RIIO-GD2 the biggest ownership changes since the Group was formed some 17 years ago were completed. Two of the original three shareholders, SSE and OMERs sold their shareholdings, as did the more recent investor ADIA. This was undertaken in two separate deals and brought two new investors into our Group. The new investors are Brookfield Super-Core Infrastructure Partners (Brookfield), a Canadian global asset manager, and Global Infrastructure Partners (GIP), a US based global independent infrastructure fund manager. Brookfield has taken 37.5% share and GIP has taken a 25% share. As part of the transactions, Ontario Teachers' Pension Plan (OTTP), our third original investor, increased its ownership from 25% to 37.5%.

This structure is set out below:



Board of Directors

The Board of Directors is comprised entirely of Non-Executive Directors and is the principal decision-making forum for the company. Directors are nominated to the Board in accordance with the terms of the Shareholders' and Governance Agreement.

The Board is collectively responsible for the long-term success of the Group and for setting a clear purpose, vision and sustainable strategy which creates value for existing and future customers, stakeholders and shareholders. It provides the leadership necessary for the Group to meet its business objectives while ensuring a sound system of internal control and risk management is in place. The powers and the duties of the Directors are determined by legislation and by the Company's Articles of Association. The Board has also adopted a formal schedule of matter detailing key aspects of the Company's affairs reserved to it for decision.

The Board of Directors comprises eight Non-Executive Directors. This consists of a Non-Executive Chair and seven Non-Executive Directors.

The Board of Directors is the same for the Company and each subsidiary company within the Group, except for:

- Scotland Gas Networks plc and Southern Gas Networks plc, which consist of two additional independent Non-Executive Directors; and
- Subsidiary companies of SGN Place Limited, SGN Futures Limited, SGN Lessona Limited and SGN Gas to Grid ProjectCo1, which have their own Board of Directors.

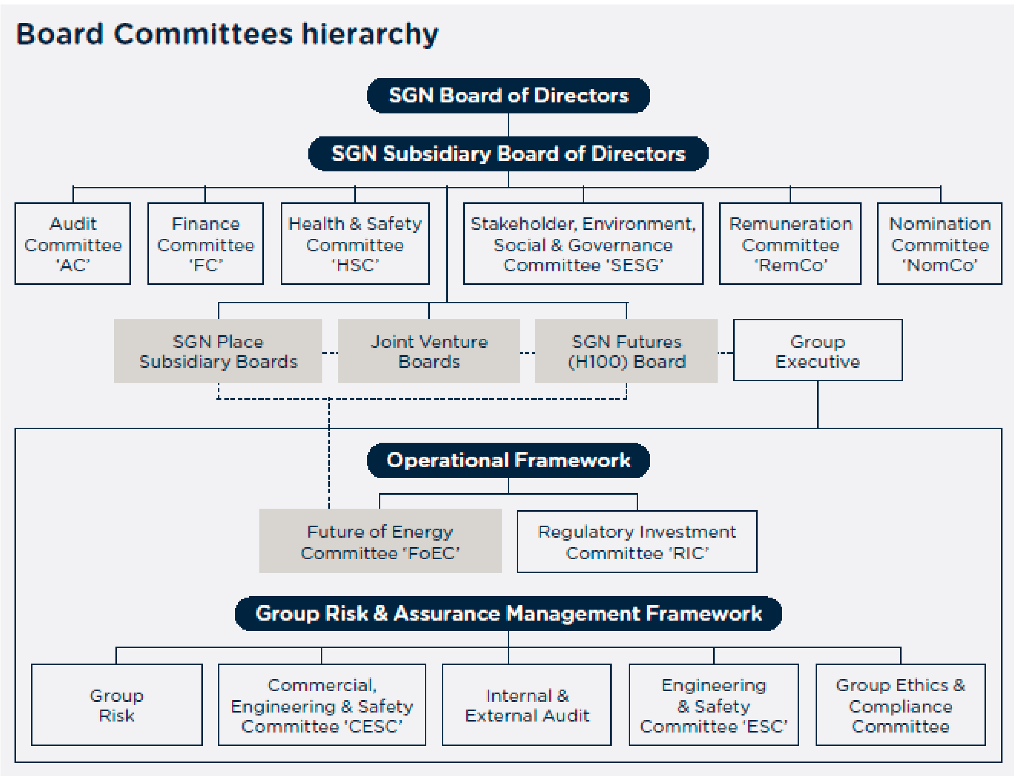
Each of the Non-Executive Directors are chosen for their diversity of skills and experience.

The Non-Executive Directors scrutinise, measure and review the performance of management; constructively challenge and assist in the development of strategy; review the Group financial information; and ensure systems of internal control and risk management are appropriate and effective.

Board Committees

During the year the Board was directly assisted in the discharge of its duties by six Board Committees whose remit, authority and composition are monitored to ensure continued and appropriate Board support.

Each of the Board Committees provides a dedicated focus on a defined area of responsibility. Board Committees act as an advisory body, with the Board retaining oversight and final decision-making, except where otherwise delegated by the Board in which case the Committee will act within their agreed authority. Board Committee membership is determined by the Board. Prior to determining membership, the Board will consider the subject matter of the Committee's purpose and duties to ensure that the membership addresses its specific needs. Membership will assess technical skills, knowledge and experience whilst recognising the benefits associated with diversity. Each Board Committee is chaired by a shareholder or independent Non-Executive Director.



There is no parent or group company that has reserved rights that would supersede the decision making of any of these companies. As set out in our annual report, the attendance of individual non-executive directors during the 2022/23 period was as follows:

Meeting attendance, April 2022 to March 2023

	Board meetings	Audit Committee meetings	Finance Committee meetings	Health & Safety Committee meetings	Remuneration Committee meetings	Stakeholder, Environment, Social & Governance Committee meetings	Nomination Committee meetings**
Directors							
Charlotte Brunning	6/6	–	6/6	–	4/4	3/3	2/2
Michael Botha	6/6	3/3	6/6	–	–	–	2/2
Martin Catchpole	6/6	3/3	6/6	–	–	–	0/2
Christian Fingerle	6/6	–	–	–	–	–	2/2
Paul Jeffery	6/6	3/3	6/6	–	–	–	1/2
Rebecca Lumlock	6/6	–	–	3/3	4/4	3/3	2/2
Felipe Ortiz*	3/3	–	–	–	–	–	1/1
Jeff Rosenthal*	3/3	–	–	–	–	–	0/1
Nicholas Salmon	6/6	3/3	–	3/3	2/2	3/3	2/2
Laura Sandys	6/6	–	–	3/3	3/4	–	2/2
Paul Trimmer	6/6	–	–	3/3	4/4	3/3	2/2

* Jeff Rosenthal was appointed as a Director and Felipe Ortiz was appointed as an Alternate Director on 24 November 2022.

Executive committee

In FY 2022/23 the decision was made to split the Executive Committee into two forums, the Operational Executive Committee, and the Strategic Executive Committee. This was to ensure that the appropriate level of focus was given to Operational Performance and Strategic Planning respectively. The day-to-day management of the Company is delegated to these Committees which meet monthly and is chaired by the Chief Executive Officer and whose membership includes the Chief Financial Officer and leaders of each business unit. Both Committees are in turn supported by their own operational and assurance framework, with defined roles and responsibilities including relevant delegated authorities.

Corporate Governance Principles

For the year ended 31 March 2023, under the Companies (Miscellaneous Reporting) Regulations 2018, the SGN Group has applied the Wates Corporate Governance Principles for Large Private Companies, published by the Financial Reporting Council (FRC) in December 2018[1].

The Wates Principles provide a framework of six principles through which the SGN Board monitors the corporate governance of the SGN Group and sees where standards can be raised to a higher level across the business. These principles are;

- Purpose and leadership. An effective Board develops and promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.
- Board composition. Effective Board composition requires an effective Chair and a balance of skills, backgrounds, experience and knowledge, with individual Directors having sufficient capacity to make a valuable contribution. The size of a Board should be guided by the scale and complexity of the company.
- Director responsibilities. The Board and individual Directors should have a clear understanding of their accountability and responsibilities. The Board's policies and procedures should support effective decision-making and independent challenge.

[1] A full copy can be viewed on its website under www.frc.org.uk/directors/corporate-governance-and-stewardship/governance-of-large-private-companies.

- Opportunity and risk. A Board should promote the long-term sustainable success of the Company by identifying opportunities to create and preserve value, establishing oversight for the identification and mitigation of risks.
- Remuneration. A Board should promote Executive remuneration structures aligned to the long-term sustainable success of a company, considering pay and conditions elsewhere in the Company.
- Stakeholder relationships and engagement. Directors should foster effective stakeholder relationships aligned with the Company's purpose. The Board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard for their views when making decisions.

The governance framework is set out in more detail in the SGN Annual Report and will provide the right environment for the Board to make decisions for the long-term success of the SGN Group. Throughout the remaining years of RIIO-GD2 we will continue to develop and improve our corporate governance with regular review and challenge from our Board members.

Dividend Policy

- The Board of Directors for Scotland Gas Networks plc and Southern Gas Networks Limited plc separately take dividend decisions on behalf of the respective entities. For each entity, two independent directors sit on the Board and therefore are part of the decision-making process.
- Any dividend paid must have accompanying certificates signed by the Board stating, amongst other things, that the company has sufficient financial and operational resources for the next 12 months as per Special Standard Condition A37: Availability of Resources
- Dividend decisions take into account the levels of committed funding available across the Group as well as the Group's financial covenants and credit metrics and targets set by the Board, as well as fulfilling the Credit Rating Obligations in Special Standard Condition A38: Credit Rating of the Licensee and Related Obligations. The inherent risk in the business and wider economy is also considered.
- The Board also considers dividends in the context of the Wates principles, as described in the above Corporate Governance Principles section.

Dividend Policy 2022/23

- During the financial year Scotia Gas Networks Ltd paid scheduled shareholder loan interest distributions totalling £30.6m (2022: £30.7m). A dividend distribution of £54.5m was paid in November 2022 (2022: £84.0m). No further dividends were declared for 2022/23. At 31 March 2023, Scotia Gas Networks Ltd had £675.5m (2022: £722.6m) of available distributable reserves. Dividends of £23m and £47m were paid from Scotland and Southern respectively in Nov-22.
- Due to the extremely challenging recruitment market in our southern licence area, we were unable to maintain the 97% standard for responding to an uncontrolled gas escape in a one-hour window and responding to a controlled gas escape in a two-hour window. This is the first time we have failed these standards and this was despite drawing on all available contingency measures we had available to us. Since the winter we have been recruiting, training, and putting in place measures to make sure it is a one-off event and that we are in a better place for next winter.
- Given the challenging winter in 2022/23, in Scotland, one of the two emergency standards – responding to a controlled gas escape within a 2-hour window was narrowly missed. This loss of standard was due to an extremely high number of calls due to an isolated four-day cold period in December. With a very high response standard prior to and after that four-day period and the number of uncontrollable gas escape calls received it was mathematically impossible to recover from that four-day extreme period. Although Scotland only failed its controlled standard marginally, no year-end dividend payments were made from Scotland. As there is greater confidence that Scotland's failure was an isolated incident and that it has the necessary resources for the coming winter period, a £12m dividend was paid from Scotland in Jul-23.

CEO Remuneration

The CEO Remuneration is determined by the Remuneration Committee. This Committee is established to promote Executive remuneration structures aligned to the long-term sustainable success of a company, considering pay and conditions elsewhere in the Company. This has clearly defined terms of reference and is responsible for making recommendations to the Board concerning the Group's remuneration strategy, recruitment framework and long-term incentive plans for senior executives. The Committee takes advice from independent external consultants who provide updates on legislative requirements, best market practices and remuneration benchmarking.

The primary objective is to set remuneration at a level that will enhance the Group's resources by securing and retaining quality people who can deliver our Strategic Pillars and long-term value for its existing and future customers, stakeholders and shareholders.

3.9 (R10) Pensions and Other Activities

Pensions

The R10 template of our submission shows the movement of the pension deficit for the defined benefit scheme. No deficit repair payment was made during the last financial year as our pension scheme is currently in surplus. For the latest valuation section of the template, we have used our PDAM valuation report dated 2022 submitted at the end of August to Ofgem.

Fines and Penalties

During the second year of the price control, our Guaranteed Standards of Performance (GSOP) payments, in 2018/19 prices, were £0.17m in our Scotland Network and £1.12m in our Southern Network.

4 Data Assurance

For the new price control, the Data Assurance Guidance (DAG) requires a risk score for the reporting pack as a whole. However, as there are several new templates and reporting requirements, we have retained approval at a template level of which includes a 5-stage sign-off process. We believe this to be an appropriate measure to ensure the level of quality is maintained across all templates.

Our regulatory reporting submissions have been through the appropriate governance with our Chief Financial Officer, Chief Executive Officer, and our Board.

5 Appendices

5.1 Enduring Value adjustments

As set out in the RFPR RIGS, enduring value adjustments can be made by a licencee where:

- Adjustments cannot be recorded in the PCFM
- Any rephasing of allowances that cannot be done through the PCFM
- Timing differences of delivery of outputs
- Known changes to future output delivery
- Known adjustments not yet made to the PCFM[1]

As identified in section 2.1, our year 2 performance has been mostly influenced by the timing of expenditure, we therefore believe it appropriate to identify enduring value adjustments within the year that are offset by reversing entries throughout the remaining period where the expenditure is anticipated to be incurred. Across the RIIO-GD2 period all enduing value adjustments are of a nil impact.

The enduring value adjustments identified within the R3 – Totex – Reconciliation template, in £m's 2018/19 prices, are as follows:

Enduring value item	Scotland	Southern
Governor Replacement	0.2	2.0
Purchase of Vehicles	(3.8)	
Recruitment of Staff	(2.0)	(2.5)
Training and Apprentice costs	(1.0)	(1.0)
Rescheduling of maintenance programme	(2.4)	
Delays in LTS projects		(1.5)
Other Capex		(3.0)
Non-Tier 1 Mains	0.3	(6.0)
Risers	0.6	(1.0)
Reinforcement		(4.0)
Tier 1 and non Tier 1 Mains		(24.0)

The enduring values have been determined by assessing the expenditure against the awarded allowances within the defined area. Where there was a large variation, and the known driver was timing, an enduring value adjustment was deemed appropriate.

5.2 Basis of any estimates and allocations

Where costs are determined at a group level, corporate drivers such as customer numbers, km's of distribution mains, have been used to derive the basis of the allocation between the two regulated networks.

[1] RIIO Regulatory Financial Performance Reporting – Regulatory Instructions and Guidance Page 40