Regulatory Financial Performance Report

Commentary

July 2021

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1 Purpose and background

1.1 Background

In August 2018, Ofgem's Open letter set out the alternative approach to RIIO Accounts, the 'Regulatory Financial Performance Reporting ("RFPR")' guidance and RIGS, to network operators. Along with this reporting pack is the 'RFPR Commentary' which we are required to submit on the 31st of July and publish on our website. 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.

2 Executive Summary

SGN has maintained strong performance during GD1 and has made significant investment in ensuring the provision of a safe and reliable network.

Safety is paramount in everything we do, keeping our customers, our people and the public at large safe in and around our activities. This has been particularly important over the last year with the unprecedent changes enforced during the Covid-19 pandemic. The first lock-down came into effect shortly before the start of this reporting period. Over the first quarter our working processes had to change, including the transition to home working for most office-based employees, and the implementation of new procedures to enable the continued safe operation of our network. Through this period of uncertainty, we have continued to exceed our 97% emergency response rate target, attaining our highest response rate during 2020/21, achieving all of our annual primary output targets and exceeding some of our 8-year output targets in safety critical and environmental areas.

The measures we had in place to deliver our Fuel Poor Network Extension Scheme (FPNES) connections targets have been severely affected by the Covid-19 related limitations and our compliance with government guidance. We were not able to deliver any fuel poor connections for the first three months of the financial year due to the lockdown. Many of our fuel poor connections delivery partners had furloughed staff during the year and were under resourced, and customer appetite for letting engineers into their homes was understandably low. We will continue to invest in this area going into GD2. Our Scotland network exceeded its eight-year FPNES target during 2018/19. At a group level we have exceeded the target by 2,282 connections.

We have delivered high standards of safety, reliability and customer service while underspending our allowances by 15.6%. This has been driven by a combination of:

- efficiency savings, some of which are specific to GD1 and represent a significant step change in performance,
- business decisions that have resulted in opportunities from macro factors such as delays in smart metering,
- external factors where the risk sat with SGN and
- delays due to the Covid-19 pandemic[1]

We continue to prioritise delivering what our customers tell us is important to them whilst working with other stakeholders towards a decarbonised future.

We were awarded fourteen external awards in the year including Utility Week Magazine ‘Company of the Year’, as well as holding the number one spot for customer satisfaction in our Scotland network for the fifth year running. We achieved an operational RORE (based on notional gearing) of 11.2% at an SGN level for the RIIO-GD1 period.

[1] *We have made no assessment as to enduring value adjustments as this is subject to ongoing discussions*

2.1 GD1 Financial performance measures

NETWORK	SCOTLAND	SOUTHERN	SGN
Additional returns (£m 20/21 prices)	8 year average	8 year average	8 year average
Totex outperformance	43	66	108
Incentive income	4	18	21
Other (eg innovation contributions)	(0)	(1)	(1)
IQI reward	2	5	7
Less sharing/tax	(16)	(29)	(46)
Average additional income	32	58	90
Additional return on equity			
Average additional returns	32	58	90
Equity (based on notional gearing)	613	1,363	1,976
Additional returns	**5.2%**	**4.2%**	**4.5%**
Base cost of equity	**6.7%**	**6.7%**	**6.7%**
Total RoRE	11.9%	10.9%	11.2%

We continue to focus on customer value by delivering our outputs and providing a cost-efficient network. This approach has provided each network with continuing benefits from incentive income outlined by the RIIO-GD1 framework.

Over the eight years, we have achieved a return on equity of 11.2% (Operational RORE based on notional gearing) across our two networks compared to a base cost of equity of 6.7% (real post tax).

SGN's Totex performance over GD1 is as follows:

	GD1 Actuals (£m)	GD1 Allowance (£m)	Variance (%)
Opex	**1,634**	**2,134**	**23.4%**
Repex	**2,048**	**2,396**	**14.5%**
Capex	**985**	**1,002**	**1.7%**
Total	**4,666**	**5,532**	**15.6%**

The impacts of Covid-19 have been far reaching, affecting all aspects of the work we do and the costs we incur. With reported spikes globally, and guidance introduced by local authorities, such as the GLA, already in force for up to 18 months, operational measures will remain in place for some time. Due to the Covid-19 restrictions we have seen lower workload in certain areas, particularly in repex, which has resulted in lower costs. However, Covid restrictions have also elevated cost pressures during 2020/21 with increases being seen in direct operational costs associated with completing work and the time that it takes to deliver a job. These cost pressures have partly offset the impact of lower workload giving a net reduction for totex expenditure of £63m.

Our GD1 allowance includes a reward for SGN being the frontier network for overhead costs. Allowances also include reductions within the final two years of the price control period to our repex allowance as part of our voluntary contribution.

There are several key drivers of the outperformance, primarily driven by:

Efficiency improvements

We constantly review our processes, costs and approach to maximise value for customers. Having captured the efficiency and delivered one-off step changes during the GD1 price control period, the same changes (and subsequent savings) will not be repeatable in future years. Examples are set out below:

The application and roll out of **innovation techniques,** such as Core n Vac and CISBOT, have assisted in reducing disruption and have led to cost reductions through reinstatement and reduced labour.

Utilisation and flexibility of workforce, allowing cross flexing of staff across multiple activities improved processes, frontier performance / efficient business model and improved contracting strategies.

Organisational structures: Management structures in both networks are designed to maximise productivity and performance in the network. In Southern, the management structure is process aligned, with a Head of Operations and a Head of Replacement due to size and volume of work. In Scotland management structures reflect a geographic focus, facilitating the use and application of local knowledge and accountability.

Improved processes: Improved scheduling and work management has enabled us to drive greater efficiencies in how we respond to and prioritise workloads.

Improved data analytics: We were the first gas network to adopt predictive analytics and to develop our strategy on the iron mains risk reduction programme (repex). We've developed an extensive analytics capability that has allowed us to target pipes that pose the highest safety risk. Using analytics to target highest risk pipes has reduced the number of escapes and associated emergency and repair work.

Our **designs** rebalanced repex and capex investment in the new totex environment created under RIIO-1 encouraging innovative capex solutions to solve repex problems with 'least cost' overall solutions.

Contracting strategy: Moving away from the larger first tier contractors to smaller second and third tier contractors where we have absorbed a proportion of management and general overheads.

A more **flexible approach** to pipe selection (HSE driven) allowed a more holistic approach to the design of new replacement pipes, also enabling us to build fewer, larger project schemes. This allowed increases to pipe insertion rates which resulted in smaller polyethylene pipes being installed. We moved from circa 60% insertion / 40% open cut at the start of GD1 to over 90% insertion now which is the maximum practically achievable. This is not repeatable going forward.

Cost pressures: We have experienced contractor cost pressures in both of our networks. During 2020/21 we saw rates rising by circa 5% including the demobilisation/mobilisation of works, as well as anticipated loss of productivity associated with constraints on working practices. During the previous three years of GD1, we have experienced average rate increases from 2.7% to 5.1% within our Southern network, and 2.7% to 4.3% in our Scotland network.

Business decisions

These show the areas where **assumptions set at the start of the price control** have varied but we were incentivised to manage the risk exposure and good business decision have been made that were beneficial. These include maintaining our volume of meter work, which has benefited SGN due to the delay in the roll out of smart meters and also identifying more cost-effective **enduring solution for the Scottish Independent Undertakings.**

Risks allocation

At the start of RIIO-GD1, companies took the risk that actual expenditure could have exceeded allowances or vice versa, based on a variable that was not directly controlled by the network. Examples include:

Weather: We have experienced relatively mild winters, however, due to the complexity of the changes in weather patterns, sudden cold events, or flooding could stretch our emergency resources, or cause asset integrity issues.

Economy: Affected all our customer driven activities. Although there were slight improvements later on in GD1, there was slow uptake in the earlier years of the price control period.

Covid Impact

With the outbreak of Covid at the start to the year Ofgem recognised that there may be disruption to the ability of networks to deliver their outputs, and that the focus should be on doing the right thing for customers rather than being restricted to the focus on outputs delivery. We are pleased to say that we have been able to maintain our delivery of primary outputs with the exception of the Fuel Poor Network Extensions Scheme (FPNES).

The new guidance in place to manage Covid-19 related restrictions increases the direct operational costs associated with completing work and the time that it takes us to deliver each job. However, the reduced delivery and the temporary shutdown of all non-essential work has also reduced the amount of repex that we have delivered during the year. This has produced a saving associated with work that would otherwise have taken place had the lock down and associated restrictions not occurred. This saving has been partially offset by the increased expenditure in operating costs and other capital costs associated with demobilising and making safe and then remobilising and delivering in a Covid safe manner.

Our overall level of totex expenditure during 2020/21 was estimated to be £63m lower than anticipated, due to the restrictions mentioned above:

2020/21 prices £m	Financial Impact of Covid-19 on SGN
Opex	(13)
Repex	82
Capex	(6)
TOTEX	63

2.2 Operational performance measures

Below is a summary of our annual output performance where we continued to deliver strong performance:

How we fared in our primary outputs:

- 🟢 Successful achievement of an annual output or forecast achievement of the eight year output.
- 🔴 Failure to reach an annual output or forecast achievement for the eight year period.

ANNUAL OUTPUT MEASURE 2020/21		ACTUAL	
Primary Output	**Deliverable**	**Scotland**	**Southern**
Connections	Guaranteed standards performance	🟢	🟢
Environmental	Leakage	🟢	🟢
Reliability (network capacity)	Achieving 1 in 20 obligation	🟢	🟢
Safety (emergency response)	97% controlled escapes	🟢	🟢
	97% uncontrolled escapes	🟢	🟢
Safety (management of repairs)	GS(M)R 12 hour escape repair requirement	🟢	🟢
	Management of repairs (repair risk)	🟢	🟢
Safety (major accident hazard prevention)	GS(M)R safety case acceptance by HSE	🟢	🟢
	COMAH safety report reviewed by HSE	🟢	🟢
Customer service	Planned interruptions survey	🟢	🟢
	Emergency response and repair survey	🟢	🟢
	Connections survey	🟢	🟢
	Complaints metric	🟢	🟢

Under exceptionally challenging circumstances, we delivered all our Annual Output Measures during 2020/21, putting safety and customers at the forefront of what we do. The table below is a summary of our performance against our output commitments for the 8 years of RIIO-GD1 price control.

RIIO-GD1 EIGHT YEAR OUTPUT COMMITMENT		ACTUAL	
Primary Output	**Deliverable**	**Scotland**	**Southern**
Connections	Introduce distributed gas entry standards	🟢	🟢
Social obligation	Fuel poor connections	🟢	🔴
	Carbon monoxide awareness	🟢	🟢
Environmental	Leakage	🟢	🟢
	Provide biomethane connections information	🟢	🟢
Reliability (loss of supply)	Duration of planned interruptions	🟢	🟢
	Duration of unplanned interruptions	🟢	🟢
	Number of planned interruptions	🟢	🟢
	Number of unplanned interruptions	🟢	🟢
Reliability (network reliability)	Maintaining operational performance	🟢	🟢
Safety (mains replacement)	Iron mains risk reduction (based on MRPS)	🟢	🟢
	Sub-deducts networks off risk	🟢	🟢

Apart from the fuel poor connections target for our Southern network, we have delivered all our 8-year output commitments.

In September 2015 we increased our fuel poor connection targets by 1,367 in southern and 6,130 in Scotland following feedback from our stakeholders. This increase accounted for more than half of the total increase in connections targets from all GDNs combined, and directly contrasts with some networks that did not adjust their targets.

We allocated £20m (in additional Price Control allowance terms) to be used with the support of project partners, to develop innovative methods for delivering fuel poor connections through our Help to Heat program. Our current position is that Scotland over delivered on the eight-year target in 2018/19, whilst in Southern, we had a pipeline of works which would have meant that we would have met the output by the end of GD1. However, the current Covid-19 restrictions have significantly impacted our operations and made our delivery of this target extremely challenging, resulting in a 1,438 shortfall against target.

More information on our performance against outputs can be found in our annual GD1 Stakeholder Report, available on our website (*https://www.sgn.co.uk/*).

3 Overview of Regulatory Performance

3.1 RORE

The GD1 operational RORE (based on notional gearing) is 11.9% in Scotland and 10.9% in Southern. Additional returns on top of our allowed equity return (6.7%) is driven primarily by:

- Totex performance (4.4% in Scotland and 3.1% in Southern) (See section 2.1 & 3.3) and;
- Output incentives (0.5% in Scotland and 0.9% in Southern) (See section 3.4).

This is further broken down as follows:

	RIIO-GD1		
Notional RORE	**Scotland**	**Southern**	**SGN**
Allowed Equity Return	6.7%	6.7%	**6.7%**
Totex outperformance	4.4%	3.1%	**3.5%**
IQI Reward	0.4%	0.3%	**0.3%**
Broad Measure of Customer Satisfaction	0.3%	0.3%	**0.3%**
Shrinkage Allowance Revenue Adjustment	0.0%	0.0%	**0.0%**
Environment Emissions Incentive	0.1%	0.2%	**0.2%**
Discretionary Reward Scheme	0.0%	0.0%	**0.0%**
NTS Exit Capacity	0.0%	0.3%	**0.2%**
Network Innovation	0.0%	0.0%	**0.0%**
Penalties and fines	0.0%	0.0%	**0.0%**
RORE - Operational performance	**11.9%**	**10.9%**	**11.2%**
Debt performance - at notional gearing	-0.2%	-0.4%	**-0.3%**
Tax performance - at notional gearing	0.6%	0.4%	**0.5%**
RORE - including financing and tax	**12.3%**	**11.0%**	**11.4%**

The GD1 Operational RORE has increased by 0.3% from last year’s forecast. This is primarily due to higher than forecast totex underspend in the year as set out in Section 3.3.

3.2 Revenue

Scotland year on year allowed revenue movements

Scotland Revenue Category Nominal £m	2019/20	2020/21	Variance	RPI Impact	Non RPI Impact
Opening Base Revenue	349.3	361.1	11.8	5.6	6.2
MODt Adjustment	(30.5)	(29.6)	0.9	(0.5)	1.4
RPI True Up	0.9	(0.3)	(1.2)	0.0	(1.1)
Pass Through	8.0	8.6	0.5	0.1	0.4
DRS	0.1	0.0	(0.1)	0.0	(0.1)
Innovation	1.4	1.3	(0.2)	0.0	(0.2)
Incentives	3.4	3.7	0.3	0.1	0.3
K (under or over recovery)	(4.0)	6.2	10.2	0.1	10.1
Maximum Allowed Revenue (exc. SIUs)	**328.7**	**351.1**	**22.3**	**5.4**	**16.9**
SIUs	15.7	16.0	0.3	0.2	0.0
Maximum Allowed Revenue (inc. SIUs)	**344.4**	**367.0**	**22.6**	**5.7**	**17.0**

Collected revenues, excluding our Statutory Independent Undertakings (SIUs)[1], were £350.7m, reflecting an under recovery of £0.3m against our allowed revenue, primarily driven by variations in commodity due to a mild winter.

In 2020/21 allowed revenue in Scotland was £22.3m higher than the prior year, driven primarily by:

- An increase of £11.8m in base revenue as per our licence – partly due to the application of inflation to our charges
- An increase in 'K' adjustment of £10.2m (which is on a two-year lag), moving from an under-recovery of revenue of £4m from 2017/18 to an over-recovery of £6.2m from 2018/19
- The increase in allowed revenue was slightly offset by a reduction in the RPI true up in each of the years; the movement in RPI forecast used to set the tariffs versus the actual RPI for the tariff year

[1] SGN manages five SIUs in Scotland. Each one is a stand-alone gas network serving remote communities disconnected from the main gas distribution network. Combined, the SIU's serve approximately 10,000 customers.

Southern year on year allowed revenue movements

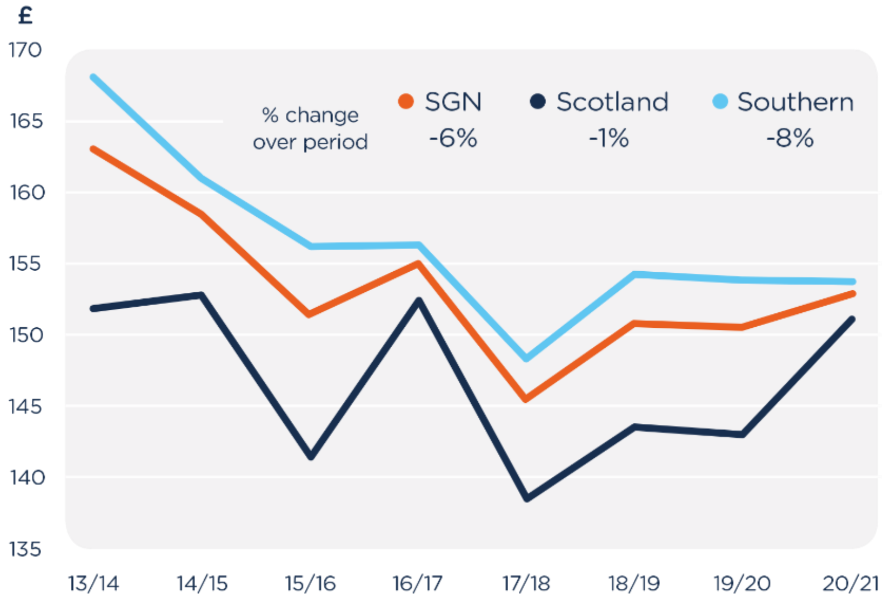
Southern Revenue Category Nominal £m	2019/20	2020/21	Variance	RPI Impact	Non RPI Impact
Opening Base Revenue	822.4	840.5	18.1	12.9	5.2
MODt Adjustment	(61.3)	(76.4)	(15.1)	(1.2)	(13.9)
RPI True Up	2.1	(0.6)	(2.7)	0.0	(2.7)
Pass Through	11.9	(3.9)	(15.8)	(0.1)	(15.7)
DRS	0.3	0.0	(0.3)	0.0	(0.3)
Innovation	3.4	2.9	(0.5)	0.0	(0.6)
Incentives	16.4	22.1	5.7	0.3	5.3
K (under or over recovery)	(3.7)	(2.2)	1.5	0.0	1.6
Maximum Allowed Revenue (exc. SIUs)	**791.4**	**782.3**	**(9.1)**	**12.0**	**(21.2)**
SIUs	0.0	0.0	0.0	0.0	0.0
Maximum Allowed Revenue (inc. SIUs)	**791.4**	**782.3**	**(9.1)**	**12.0**	**(21.2)**

Collected revenues were £783.3m, reflecting an over recovery of £1.0m against our allowed revenue, primarily driven by variations in commodity due to a mild winter.

In 2020/21 our allowed revenue in Southern was £9.1 lower than the prior year, driven primarily by:

- An increase of £18.1m in base revenue as per our licence, partly due to the application of inflation to our charges An increase in incentives in 2018/19 (these are recovered on a 2 year lag), which saw a £4m increase in **NTS,** £0.9m increase in Shrinkage/Leakage and £0.7m increase in Customer Broad Measures
- A decrease of £15.1m in MODt primarily due to a £12.8m reduction in Cost of Debt, and a reduction of £3.5m from tax allowance adjustment
- A decrease in pass through costs of £15.8m largely due to reduction in **NTS** costs of £17.2m partly offset by an increase in shrinkage costs of £1.7m

Under the sharing arrangement, the company retains approximately 64% of the GD1 totex outperformance, and the remainder will go back to customers after allowing for corporation tax. This has helped ensure that over the RIIO-GD1 period, there has been a 6% real reduction in customer bills. The below graph highlights this real price reduction across the period and for both Scotland and Southern networks.



The customer bill impacts are presented in real terms and include the impact of tax changes during GD1.

Bad debt

For GD2 revenues GDNs can include the recovery of unpaid transportation charges via the Bad Debt term. This is subject to direction from Ofgem each year and is designed to allow the recovery of transportation charges which remain outstanding due to a shipper failure.

Covid-19 liquidity modification

During the regulatory year 2020/21 Ofgem approved the Uniform Network Code (UNC) Covid-19 Liquidity Deferral modification. This UNC modification allowed shippers that met a set of criteria to defer transportation charges relating to the months June 20 through to August 2020. These charges were then paid by the qualifying shippers in instalments over the months September 2020 to March 2021. Due to the subsequent failure of one qualifying shipper, SGN have included c. £0.8m of unrecovered charges through the bad debt term in the tariff year 2021/22.

NTS Charging methodology

In October 2020 National Grid implemented a new charging methodology for the recovery of charges. The costs incurred by distribution networks are a pass-through item in line with the transportation licence. Due to the change in methodology SGN incurred an increase in costs, most noticeably in Scotland, for the period October 2020 to March 2021. However, the additional costs associated with this period will not be passed onto customers until the 2022/23 tariff year due to the inclusion of a two year 'lag' on pass-through costs in GD1. It is worth noting that in GD2 the lag on pass-through costs has been removed and they are now based on forecasts of costs for the coming year. As a result, tariffs for 2021/22 include the costs associated with the new methodology.

3.3 2020_21 Totex performance

The table below shows SGN's totex performance for this financial year.

20/21 prices (£m)	2020/21		Variance to Allowance	2019/20 Actual	Year on Year Mvt
	Actual	Allowance			
Opex	205	258	20.5%	196	-9
Repex	231	281	17.7%	295	64
Capex	111	96	-14.9%	136	25
Total	**547**	**635**	**13.9%**	**627**	**80**

We had a favourable totex variance to allowance for the year 2020/21 of 13.9%, driven by performance within both opex and repex.

Opex

During the financial year, operating costs have increased from the previous year's level due to the impact of the Covid pandemic, particularly within our direct activities, i.e. Emergency, Repair, Maintenance. This increase is due to higher PPE costs for these activities and higher levels of unproductive time. The Covid related restrictions placed on other work activities, which Emergency, Repair and Maintenance labour would normally carry out, made that work unavailable. These increases in costs have been partially offset by reductions in overheads, as the majority of our staff continue to work from home.

Repex

Our repex activities have been hugely affected by the Covid-19 restrictions in place before and during 2020/21. Our reduction in spend of £64m compared to last year is a direct result of these restrictions and not being able to fully complete our program of works. We continue to face increasing cost pressures from contractors, within both our networks, in the delivery of our output safety measures These cost pressures along with additional Covid costs (PPE etc) and a greater proportion of more costly Tier 2 and 3 replacements works have partially mitigated the reduced spend due to access difficulties etc due to Covid. We have delivered greater than target risk removal as the price control period has allowed for flexibility in delivering the output target and use of our innovative techniques where possible.

Capex

Capex has continued to normalise in the final year of GD1, after a slower start. The phasing of capex had been planned longer term for efficient investment to maximise the use of savings in procurement, contract awards and flex of direct labour workload. Our customer driven workloads were affected during 2020/21, due to the challenging restrictions we faced. We continue to invest in our IT network/systems and our vehicle investment is in line with our replacement program.

3.4 Incentive performance

The table below show's our 2020/21 performance for incentives has generated income of £2.4m for Scotland and £14m 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 fifth year running. Our incentive performance to date has resulted in average incentive income earned per year of £17.2m, A breakdown of the overall incentive income earned in each year is shown in Appendix 1.

Incentive Nominal Prices £m	Scotland		Southern		SGN	
	2020_21	GD1 Average	2020_21	GD1 Average	2020_21	GD1 Average
Shrinkage	0.0	0.1	0.5	0.7	0.5	0.8
EEI	-0.1	0.7	5.2	3.7	5.1	4.4
NTS Exit Incentive	0.0	0.0	2.7	4.3	2.7	4.3
Customer Satisfaction	1.7	1.6	3.9	3.6	5.6	5.2
Customer Complaints	0.0	0.0	0.0	0.0	0.0	0.0
Stakeholder Engagement	0.7	0.7	1.7	1.7	2.4	2.3
DRS Award	0.0	0.2	0.0	0.4	0.0	0.6
Total	**2.4**	**3.2**	**14.0**	**14.4**	**16.4**	**17.2**

NTS Exit Incentive

The performance for the incentive is lower than the GD1 average in the year due to the capacity booked at various offtakes having to be moved around the network to ensure availability of capacity. This, coupled with reduced price rates compared to the prior year resulted in a reduction between baseline and actual costs, impacting the incentive.

Environmental Emissions Incentive

The leakage incentive is above the average for GD1 in the year at SGN level, as a result of the continued outperformance of baseline targets and the impact of the eight year rolling incentive mechanism has on continued year on year outperformance, particularly in Southern. Scotland saw a reduction in the incentive in 2020/21 due to slight decrease in outperformance (10.9GWh) compared to 2019/20 (12.7GWh), for GD1 Scotland was awarded £5.6m under the EEI.

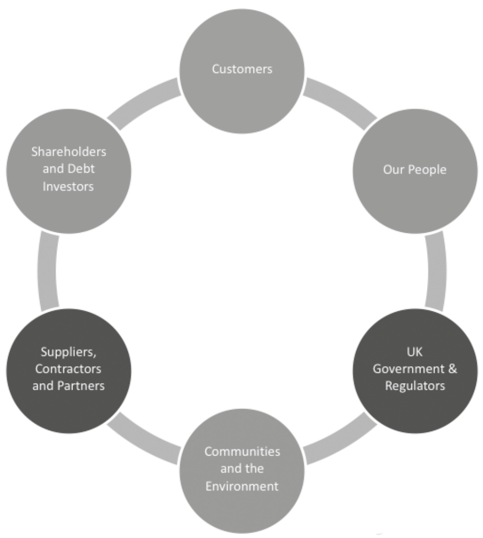
Stakeholder Engagement

Effective engagement with our key stakeholders is critical to the long-term success of the Company. Dialogue with stakeholders helps the board understand the effects of company policies and practices, predict future developments and trends, and re-align strategy.

We identified six key stakeholder groups and recognise the purpose of stakeholder engagement is to ensure perspectives, insights and opinions of stakeholders are understood and taken account of. Our key stakeholders are

- Customers
- Our people
- UK and Scottish Government & Regulators
- Communities and Environment
- Suppliers, contractors and partners
- Shareholders and debt investors.

The impact of the Company's activities on our stakeholders, taking into account their advice and feedback, helps to inform our directors when making relevant decisions. We see engagement as a two-way constructive relationship with all six of our key stakeholder groups regularly engaged. To comply with lockdown and social distancing restrictions we have adapted our approach for the year to maintain these relationships, with fewer face to face meetings and more online contact. During 2020/21 we delivered over 40 individual engagement events and surveys, reaching more than 6,850 stakeholders and customers. Our full stakeholder engagement strategy and activity for 2020/21 is set out in our annual Stakeholder Engagement Incentive Report on our website.



Customers

We have well-established customer engagement channels ranging from dedicated panels and focus groups to ensure the perspectives of vulnerable customers are considered, to forums to engage with large business customers. Customer satisfaction surveys drive KPIs which measure how successful we are and provide feedback on the impact of our decisions. We use consumer research groups to engage and shape the key decisions we make. We use social media and our website to communicate directly with our customers. The Consumer Engagement Group (CEG) and Stakeholder Advisory Panel (SAP) help shape our engagement strategy by providing independent challenge on the use of our customer engagement in our business planning.

Employee engagement

We have ongoing, two-way channels for engaging with our people. This ranges from on site and office visits, Lets Chat sessions, regular communication via internal channels and media platforms, employee forums and structured engagement with trades unions and pension trustees. Employee pulse surveys help measure progress made with our engagement plans and make sure we're moving in the right direction.

UK /Scottish Governments and regulators

Understanding what drives policy decisions by Government and Ofgem helps us to ensure we deliver effective solutions and deliver on our regulatory outputs to ensure everyone is kept safe and warm. We meet regularly with Government and Ofgem to discuss all issues relating to the regulated elements of SGN. We engaged on a range of issues over the year including Covid-19, net-zero and the green recovery.

Communities and environment

Working with communities at local, regional and national levels enables us to build our shared net-zero future by accelerating decarbonised energy solutions and minimising our environmental impact. We held a number of consultation events and online stakeholder workshops (due to Covid restrictions), throughout the year to gather feedback on projects and business plans, and progressed partnerships with NGOs which deliver additional social and environmental benefits for the communities in which we operate.

Suppliers, contractors and partners

The services provided to SGN from different organisations are critical to our safe and efficient operation. It is important that we understand their needs and deliver the right operating environment for all partners to keep the gas flowing and costs down and collectively reduce our environmental impact. We work closely with suppliers to ensure their values on issues, such as, safety, environment and modern slavery are upheld throughout our supply chain. We have joined the Supply Chain Sustainability School and have invited our suppliers to join and embed sustainability in our supply chain. Meetings are held with strategic suppliers through our Supplier Relationship Management (SRM) programme, helping enhance performance and strengthen relationships to deliver mutual value as well as key relationship meetings with our Executive and CEO. To ensure high operational standards onsite health and safety audits are undertaken. We actively engaged with key suppliers to ensure we had sufficient stocks of key materials in preparation for Brexit and to support Covid-19 resilience.

Shareholders and debt investors

Understanding the needs of our shareholders and debt investors helps us to access a cost-effective, stable, diversified financing base for the business and to make SGN an attractive investment, whilst delivering long term value for existing and future customers. All shareholders are entitled to appoint at least one Non-Executive Shareholder Director to the SGN Board with representation overall proportionate to their shareholding. We proactivity engage with shareholders to obtain their views on all shareholder resolved matters. We provide bi-annual performance updates and debt investor reports and an annual report and accounts. Our lenders give their views on key areas of financial risk management strategy. These are regularly discussed by the Finance Committee. The Chief Financial Officer and the Group Treasurer brief the board on the views of lenders and rating agencies. We liaise with credit rating agencies to ensure we understand the impact of Ofgem and our own strategic decisions on their assessment.

3.5 Innovation

Our innovation strategy is formed around collaborative working to develop new technologies, adopting market ready solutions and has delivered savings in GD1. During the year we completed works on the Harwell Science and Innovation campus, a new vaccine manufacturing centre to help the UK deliver the Covid vaccine programme. We were nominated for the Innovation Project of the Year (Gas) for our Real-Time Networks project and we published a Green prospectus in October, outlining how we are using innovation to define and explore the future of gas. Other achievements in the year have included:

Live Service Transfer: Updated working practices introduced at the start of the Covid-19 lockdown meant that GDNs must avoid any access to customer's property, meaning limitations for GDNs to transfer a service connection or network riser without accessing the property and performing a purge and relight.

Live Service Transfer was is a method to transfer services live quickly and safely without entering customers' homes or disrupting supply. This project included a four-stage approach to enable the gathering of information, the generation of ideas and the development of those concepts before a final validation exercise.

Stent bag: Damage caused to our pipeline network by third parties can result in high volume gas escapes and in these situations, it is often necessary to isolate the affected section by closing a valve upstream, turning off the supply to customers until the damage has been fixed.

Alternatively, by inserted then inflating a stent into the damaged main through a drill point immediately upstream of the damage we can create a seal around the inside of the pipe and prevent gas from escaping. Due to the ring shape design of the stent bag gas would continue to flow through the annular space and therefore maintain the supply to customers.

Pressure control and management (PC&M): All Gas Distribution Networks (GDNs) rely on effective pressure management processes to maintain security of supply and high levels of customer service. UK GDNs currently employ a variety of PC&M technologies, however, some have become outdated and are reaching the end of their design life making it necessary to find new solutions.

We collaborated with another GDN to develop a new PC&M system for GDNs to maximise their network operations more efficiently by improving the response to variances in network demand. The concept involves retrofitting electronic actuators onto the K-Pilots of District Governors (DGs), which can be remotely controlled by operatives, using a device such as a laptop or smart phone, to adjust the pressure settings, allowing the management of pressure control tasks like seasonal adjustments without having to physically attend site.

As we transition toward GD2 we will focus our innovation efforts on Consumer Vulnerability themes within NIA, our internal BAU innovation strategy, and continue to progress those projects that will provide our key stakeholders with the most value through external funded mechanisms such as Transport for London and Kent Lane Rental Schemes.

3.6 Financing and Net Debt position

FY21 Net Debt	Scotland (£m)	Southern (£m)
Opening Net Debt	**1,292**	**2,903**
Issuances	0	250
Repayments	0	-215
Accretion	4	4
(Net inflow) / Net outflow of cash equivalents and short-term deposits	8	-28
Closing Net Debt	**1,304**	**2,914**

Financing

During the financial year Southern Gas Networks plc had a £215m 4.875% fixed public bond mature. In order to refinance this and to cover totex investments in FY21, we took the decision to issue a £250m 1.25% fixed public bond due December 2031 at Southern.

Southern and Scotland have not made use of their respective revolving credit facilities during the year, both of which mature on 14 March 2025. These were undrawn at year end (FY20: both undrawn).

RPI impacted our index-linked debt by accruing £7.9m of accretion in FY21 (FY20: £23.7m).

Risk management

During the year the group had £215m of fixed interest rate commitments maturing, no floating interest rate or index-linked commitments maturing. To maintain a good degree of certainty of the Group's interest cost all new debt issuance (£250m) was put in place at fixed interest rates.

3.7 Taxation

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.

Trust and co-operation

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

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 £406.3m (2020: £429.2m), these consist of the following contributions:

- Corporation tax of £59.9m (2020: £116.4m) paid on our taxable profits
- VAT of £158.1m (2019: £125.2m)
- Business rates of £121.7m (2020: £120.4m) paid to local authorities
- Employment taxes of £66.6m (2020: £67.2m) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions

A change in UK tax payment legislation meant that all large companies moved to a payment regime of paying all corporation tax in the year in which it arises. This resulted in the Group paying an additional £41.3m of Corporation Tax in the previous year.

3.8 RAV

The table below sets out the RAV movement between the 31st March 2020 and the end of GD1 (31st March 2021):

Nominal Prices £m	Scotland	Southern	SGN
Opening RAV (Nominal Prices)	1,818	4,058	5,875
Indexation Effect	40	89	129
Net Additions	112	267	378
Depreciation	-120	-258	-378
Closing Nominal RAV	**1,849**	**4,155**	**6,004**

Our nominal RAV increased by 2.4% for Southern and 1.7% for Scotland in 2020/21. Indexation for 2020/21 (financial year end) is 2.2%. The capitalisation rate for Scotland is 35% and for Southern is 32%.

At the start of GD2 there will be a downward RAV adjustment representing property disposals within the first four years of GD1 - this is provisionally £58m (2018/19 prices).

3.9 Dividends

Our dividend policy is to manage the level of distributions after taking into consideration the expected cash flows and investment plans across the business, the level of committed funding available as well as the gearing covenants and targets set by the Board. The inherent risk in the business and wider economy is also considered. In the year ended 31 March 2021 Scotland paid cash dividends of £75.4m (2020: £28.1m) and Southern paid cash dividends of £80.6m (2020: £52.7m). These payments were made from our regulatory networks to MidCo.

3.10 Pensions

The R12 template of our submission shows the movement of the pension deficit for the defined benefit scheme. The pension deficit repair payment reduced by £9.5m in the year.

We have included within totex the incremental pension deficit payment of £5.9m in Southern and £3.2m for Scotland representing the share of the deficit payments relating to service post April 2013 consistent with the pension deficit allocation methodology (PDAM). These payments were allocated across opex, repex and capex activities.

For the latest valuation section within the accompanying data table, we have used our 2019 valuations, in line with our latest Pension Deficit Allocation Methodology submission.

4 Data Assurance

The Covid-19 pandemic has required the way we have worked as a company to change for an uncertain period of time, as our operations were halted and office-based staff transitioned to remote home working in line with national guidelines from 23rd March 2020. Many of our staff are still working from home.

For our company, the lockdown aligned with our financial reporting year end and the beginning of our regulatory reporting for Ofgem. As our staff adjusted to the new working guidelines and adapted to their new working spaces, we felt that to ensure the same level of quality was maintained in our reporting, that we would add an additional layer of approval. Therefore, all our templates, regardless of the risk score, that have gone through iComply (our regulatory submission document repository system) as a part of the assurance process, are also subjected to an 'Internal Expert Review'.

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

APPENDIX 1 – INCENTIVE INCOME BY YEAR

SGN								
Incentive £m	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Shrinkage	0.8	0.8	0.6	0.8	0.9	1.2	0.7	0.5
EEI	2.4	3.7	3.4	4.7	4.5	5	6.1	5.1
NTS Exit Incentive	2.6	1.1	1.9	5.5	6	9.7	4.9	2.7
Customer Satisfaction	4.2	4.6	5.2	5.3	5.3	5.5	5.5	5.6
Customer Complaints	0	0	0	0	0	0	0	0
Stakeholder Engagement	2.1	2.4	1.8	3.2	2.3	3	2.4	2.4
DRS Award	0	0.7	0	0	0.5	0	0	0
Total	**12.1**	**13.4**	**12.9**	**19.5**	**19.4**	**24.4**	**19.7**	**16.4**
	Southern							
Shrinkage	0.7	0.7	0.6	0.6	0.7	1	0.6	0.5
EEI	2	2.9	3	3.5	3.5	4	5.1	5.2
NTS Exit Incentive	2.5	1.2	2	5.5	6	9.7	4.9	2.7
Customer Satisfaction	2.8	3.1	3.7	3.7	3.7	3.9	3.9	3.9
Customer Complaints	0	0	0	0	0	0	0	0
Stakeholder Engagement	1.5	1.7	1.3	2.2	1.6	2.1	1.7	1.7
DRS Award	0	0.5	0	0	0.3	0	0	0
Total	**9.5**	**10.1**	**10.4**	**15.5**	**15.8**	**20.7**	**16.2**	**14**
	Scotland							
Shrinkage	0.1	0.2	0.1	0.2	0.2	0.2	0.1	0
EEI	0.3	0.8	0.4	1.2	0.9	1	1	-0.1
NTS Exit Incentive	0.1	0	0	0	0	0	0	0
Customer Satisfaction	1.4	1.5	1.5	1.6	1.6	1.6	1.6	1.7
Customer Complaints	0	0	0	0	0	0	0	0
Stakeholder Engagement	0.6	0.7	0.5	1	0.7	0.9	0.7	0.7
DRS Award	0	0.2	0	0	0.1	0	0	0
Total	**2.5**	**3.3**	**2.5**	**4**	**3.5**	**3.7**	**3.5**	**2.4**

Note that this is income earned and ignores the 2-year lag for income purposes