Regulatory Financial Performance Reporting

Commentary

Scottish and Southern Energy Power Distribution Limited

Financial Year 2021/2022

1. Executive Summary

1.1. This commentary summarises the regulatory performance of the Scottish and Southern Energy Power Distribution Limited (SSEPD) licensees which consist of Southern Electric Power Distribution plc (SSES) and Scottish Hydro Electric Power Distribution plc (SSEH) in line with the Regulatory Financial Performance Reporting (RFPR) Guidance document.

1.2. The primary focus of the RFPR is to summarise the key components of the financial performance of regulated networks by way of the Return on Regulatory Equity (RoRE). The commentary has been prepared based as an average over the RIIO-1 period rather than prioritising in-year, cumulative, historical or year-on-year performance. Analysis of average expected RoRE over the period demonstrates the forecast outcomes for each licensee, influenced by improvements in service quality for customers alongside ensuring expenditure is incurred efficiently. It is important to therefore highlight the following for readers:

- RoRE is not a reflection of customer bills, whereby a higher RoRE does not equate to higher customer bills. RoRE is intended as a reflection of Network performance whereby higher RoRE is likely to mean greater cost efficiency which leads to lower customer bills while delivering better service levels;
- The RoRE measure does not include the interest costs on borrowing. Electricity network infrastructure is financed by both borrowing funds (debt) and shareholder investment (equity) and hence, a measure which only takes into account the part of the business financed by investment is not a complete measure. The overall Return on Capital Employed (ROCE), or as we have referred to the Rate of Return (RoR), is an alternative measure which more appropriately reflects the costs to customers for the overall electricity network. This commentary therefore sets out the RoRE and the RoR for completeness; and,
- RoRE must be interpreted across the full RIIO-1 period considering any Enduring Value (EV) adjustments and interpretation is needed as to what RoRE means for customers. Ofgem refer to EV as adjustments that are required to reflect the performance after completion of the price control including true-up and close out adjustments. We have not reflected any enduring value adjustments for either RIIO-1 or from RIIO-2 that may be interpreted as affecting the RIIO-1 performance i.e. RoRE.

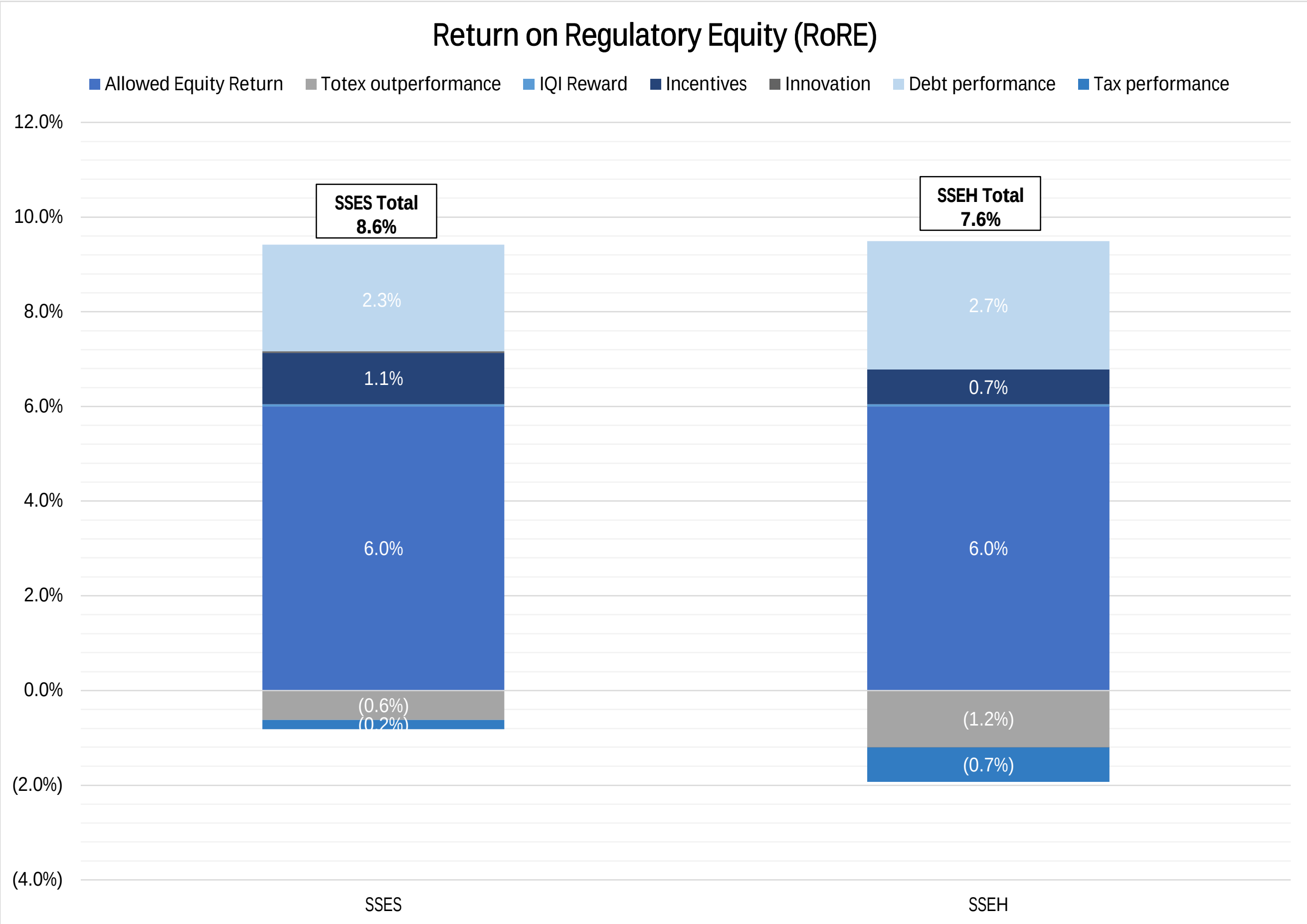
This document includes our Methodology for EV in Appendix 1 covering both SSEPD regulatory licensees. We have briefly summarised our financial performance in this document, which corresponds to information provided to Ofgem set out in documents submitted under the Regulatory Instructions and Guidance (RIGs). Note that the financial values required to be reconciled within the RFPR have been reconciled to the audited statutory accounts for each applicable year in accordance with the Regulatory Instructions and Guidance (RIGs).

2. Key Financial Performance / Operational Measures

2.1. The RoRE for the RIIO-1 period on average for the SSEPD licensees can be seen in Figure 1 below. Each of the licensees has the opportunity to earn above its base return on equity through (allowed return on equity) delivering efficiency savings on operating and capital expenditure (referred to as total expenditure or 'totex'). Additionally, if customer service levels improve against targets set by Ofgem, there is an opportunity to earn additional income through incentives. In the event that service levels fall below targets set, a penalty will be incurred which reduces network revenue and therefore customer bills. This ensures that customers only compensate networks where they receive improving service levels. Further, customers benefit from reduced bills when networks achieve efficiency savings on totex expenditure.

2.2. As Electricity Distribution Networks, we seek to improve customer service levels while also delivering efficiency savings. We believe this strategy ensures customers obtain a better service while targeting lower bills.

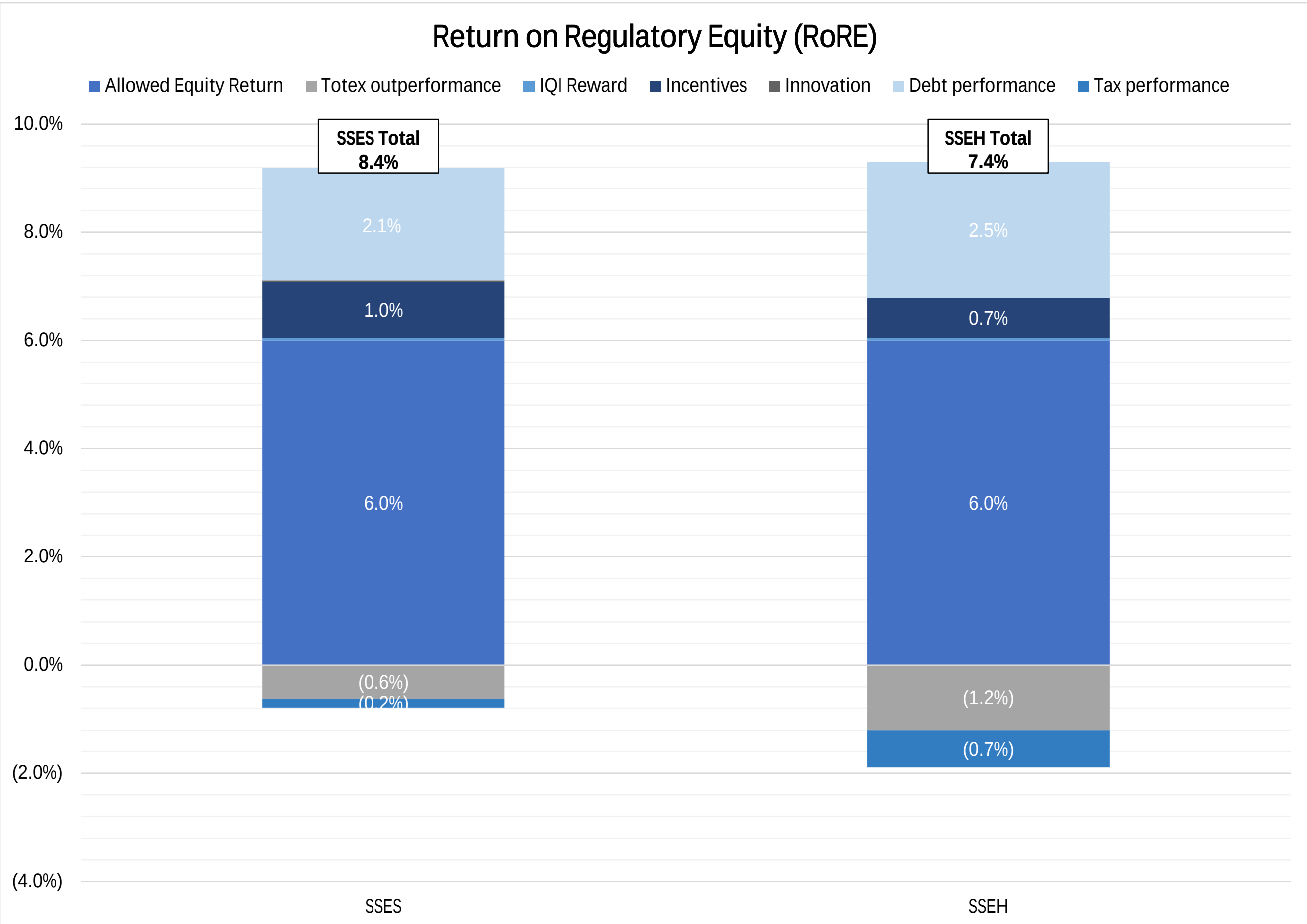
Figure 1 – Return on Regulatory Equity (RoRE) based on notional gearing for the RIIO-1 period for SSEPD Licensees



2.3. Each of the licensees are focussed on improving customer satisfaction and network reliability and this has been realised through incentive rewards of c.1.0% increase to RoRE in Distribution. SSES are making above their allowed or base return on equity at an operational level, this is not the case for SSEH, which is forecast to overspend its totex allowance by c.4%, and therefore perform below the base rate on equity over the full ED1 period. This is a measure of the performance of each SSEPD licensee excluding the impact of borrowing and tax costs, and is referred to as the operational RoRE.

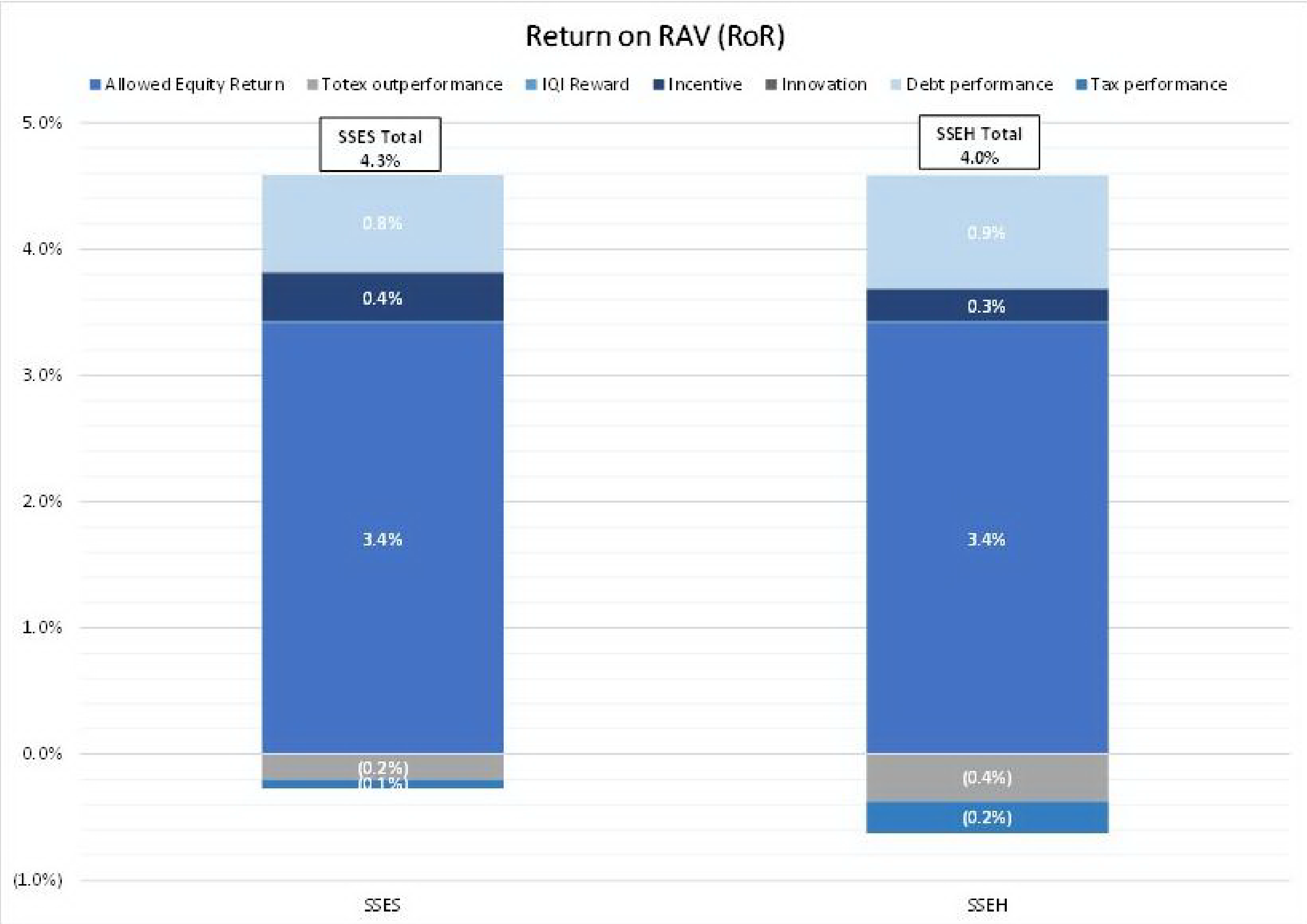
2.4. As noted above, at the operational level, SSES are achieving above base return (6.5%), with SSEH forecast to achieve below base return (5.6%). The impact of financing and tax performance improves the overall return for both SSEPD licensees in Figure 1. Ofgem's inflation forecast for the remainder of ED1 results in a real reduction in SSEPDs cost of debt, with c.90% of SSEPD's debt book being fixed. The result is an effective debt outperformance, increasing RoRE. The Bank of England target 2.7% inflation for year-end 2023, figure 2 below restates RoRE using this target, which reduces the impact of debt performance on overall RoRE by circa 0.2% for both licensees (Figure 2).

Figure 2 – Restated Return on Regulatory Equity (RoRE) based on notional gearing for the RIIO-1 period for SSEPD Licensees



2.5. Figure 3 below sets out the Rate of Return (RoR) as an alternate measure of performance (this is measured by a Return on RAV instead on Regulated Equity. This is reflective of the gearing and cost of borrowing that customers pay for through use of the Distribution Networks, as opposed to a shareholder focused rate of return in the form of RoRE.

Figure 3 – Return on RAV (RoR) based on notional gearing for the RIIO-1 period for SSEPD Licensees



2.6. At an operational level, SSES and SSEH are making returns of just above 3.4% on average. Both SSEPD licensees make a return above the allowed Weighted Average Cost of Capital (WACC) when including the impact of financing and tax performance due to inflation impact on debt performance outlined in paragraph 2.4.

Figure 4 – Comparison of RoRE from 2021 RFPR vs 2022 RFPR

	SSES		SSEH	
	2021	2022	2021	2022
Allowed Return	6.0%	6.0%	6.0%	6.0%
Totex Outperformance	(0.7%)	(0.6%)	(1.1%)	(1.2%)
IQI	0.0%	0.0%	0.0%	0.0%
Incentives & Innovation	1.0%	1.0%	0.9%	0.7%
Operational RoRE	**6.4%**	**6.5%**	**5.8%**	**5.6%**
Financing & Tax	0.5%	2.1%	(0.2%)	2.0%
Total RoRE	**6.8%**	**8.6%**	**5.6%**	**7.6%**

2.7. SSES operational RoRE has increased marginally versus the prior year RFPR forecast submission due to a reduction in forecast totex under-performance. Conversely, SSEH operational RoRE has reduced marginally due to an increase in forecast under-performance, combined with a reduction in forecast incentives with performance negatively impacted by unprecedented storms.

3. Overview of regulatory performance

3.1. RoRE

The RoRE and RoR have been summarised overall in section 2 above. These form part of SSEPD's Key Performance Indicators (KPIs) on a financial basis alongside underlying incentive and customer service performance and totex efficiency.

3.2. Revenue

Revenues are in line with the Price Control Financial Model (PCFM) and the revenue tariff setting process. This process allows each licensee to recover base revenue plus any incentive revenues earned and pass- through items. Allowed revenues captured within the RFPR are directly sourced from the Revenue RRP submitted to Ofgem.

3.3. Totex performance

Both the actual and forecast totex performance built into the RFPR is in line with the Regulatory Reporting Pack (RRP) submitted to Ofgem by 31 July 2022.

SSEH is currently 2% overspent cumulatively against ED1 Allowance and forecasting to be 4% overspent by the end of the price control, which is consistent with the reported performance in the 2021 RFPR. The cumulative overspend is largely due to SSEH having: (i) several subsea cables issues (Pentland Firth East Subsea Cable, Western Isles (Skye-Harris, etc.), which resulted in costly replacements that were not included in our allowances; (ii) higher IT investment to improve asset data and usage; and (iii) a stronger back-office function to help deliver an increased workload.

SSES is currently 1% overspent cumulatively against ED1 Allowance and forecasting to be 3% overspent by the end of RIIO-ED1, which is consistent with the reported performance in the 2021 RFPR. The cumulative overspend is largely due to SSES having: (i) higher Network Operating Costs as a result of increased temperatures adversely impacting our underground cables faults and continued higher level of tree cutting spend; (ii) higher IT investment to improve asset data and usage; and (iii) a stronger back-office function to help deliver an increased workload.

3.4. Output incentive performance

Incentive information for historic years is sourced from the Revenue Return submitted to Ofgem. Our forecast incentive performance is based on an average of historic performance during RIIO-1 as well as accounting for internal business targets.

Both SSES and SSEH have earned incentive revenues in each year of the RIIO-ED1 price control to date under the Interruptions Incentive Scheme, Broad Measure and Time to Connect incentives. Incentive performance is mainly driven by targeted improvements related to performance in availability and security of electricity supply and customer service. Incentives are forecast to be made for the remainder of the ED1 period, through effective and efficient delivery following the significant change made during this price control period to both licensees' operations, processes and standards to ensure the needs of customers remain at the forefront of decision making.

3.5. Innovation

Historic innovation information is sourced from the Revenue Return submitted to Ofgem. Our forecast innovation performance is based on average of historic performance during RIIO-1. Innovation performance continues to be a priority across all licensees ensuring progression of innovations that will improve network reliability, efficiency and customer service as well as the transition to Net Zero, Whole system and DSO.

3.6. Financing and Net Debt position

The actual gearing for the SSEPD licensees has generally been in line with the notional gearing set for RIIO-1, with annual variations due to the timing of expenditure, revenues and cash flows.

The cost of debt performance against allowance varies across each network due to the cost of embedded debt and differing cost of debt allowance mechanisms. It is worth highlighting that the methodology does not reflect the cash cost of interest and is instead the economic form of outperformance due to removal of inflation from the effective interest rates. Furthermore, the methodology does not allow for additional costs of borrowing such as transaction costs, liquidity costs and the impact of issuing longer or shorter-term debt depending on the most appropriate and efficient treasury policy.

Both licensees outperform the cost of debt allowance due to the low interest rate environment. This has pulled down the cost of debt index allowance while the licensees have been able to borrow in line with capital markets. As outlined in section 2, Ofgem's inflation forecast is also having a positive impact on SSEPD's debt outperformance due to circa 90% of our debt book being fixed.

3.7. Taxation

SSEH are underperforming with reference to their tax allowance, while SSES is in line with its overall price control tax allowance based on notional gearing. This is largely due to differences between statutory and regulatory asset lives and capital allowances. No adjustments have been made in respect to taxation for the licensees.

3.8. RAV

RAV is presented as per the PCFM. The totex forecast per the RRP has been reflected in forecast RAV additions, which are calculated based on the licensees set capitalisation rate. For SSES and SSEH, there have been no EV adjustments made to totex and therefore no adjustments for EV have been reflected in the RAV. The EV Methodology in Appendix 1 outlines the basis of SSEPD's EV assessment for both licensees.

3.9. Dividends

Dividends are paid based on cash flow management of the two licensees over a prolonged period. SSEPD's dividend policy is therefore subject to annual variations based on cash flow requirements and expectations of shareholders while maintaining actual gearing in line with notional gearing and continuing to invest in each electricity network accordingly. All Dividends are approved by the Board of Directors prior to payment.

3.10. Pensions

Pension allowances and deficit repair payments are in line with the Pensions Reasonableness Review carried out in 2020. No adjustments have been made post this review. Pension allowances do not directly affect the RoRE or RoR, except as part of a component of totex expenditure for ongoing service contributions.

3.11. Guaranteed Standards Payments

DNOs are required to meet the Guaranteed Standards of Performance (GSOP) under The Electricity (Standards of Performance) Regulations 2015. Failure to meet these standards, DNOs are liable to pay compensation to affected customers. In 2021/22, SSEN suffered the highest number of GSOP failures than any other year in RIIO-ED1 and paid a total of £13.9m (SSEH £9.8m; SSES £4.1m) of GSOP (Non-Connections) payments, which is a significant increase from previous year's payment of £0.7m. The main reason for the high failures and payments was due to the unprecedented number of severe storms, including Storm Arwen, Malek / Corrie and Eunice. For SSEH, Storm Arwen caused over 600 faults, more than 6 times the Severe Weather Exceptional Events (SWEE) category 2 threshold, and Storm Malek / Corrie had 372 faults, nearly 4 times the threshold. For SSES, Storm Eunice caused over 400 faults within 24 hours, nearly 4 times the SWEE category 2 threshold.

4. Data assurance statement

4.1 This submission has been completed in line with the Data Assurance Requirements Standard Licence Conditions 45 and B23. A Risk Assessment has been conducted and the Total Risk Rating has been scored as Medium. The appropriate level of Data Assurance has been employed based on this Rating including a submission plan, methodology and appropriate level of review and sign off.

Appendices

Appendix 1 - Enduring Value Methodology

A1.1 Introduction

The Enduring Value (EV) Methodology is based on a fundamental review of each licensee's regulatory price control, outputs, totex allowances and expenditure. SSEPD's approach to making EV adjustments is underpinned by a consistent approach in applying the principles of RoRE and the underlying drivers of the price control. Only adjustments that are considered material in nature to the outcome of RIIO-1 are considered to be appropriate in order to avoid overcomplicating the RFPR unnecessarily, whereby the full price control performance is most relevant compared to in-year or year-on-year performance. Therefore, SSEPD has focused primarily on price control Network Output Measures (NOMs) as known at the time of preparation of the RFPR, and the known or expected outcome of submitted regulatory reopeners for each licensee.

The assumptions for EV adjustments have been prepared consistently with the 2021/22 RRP submissions. Any EV adjustments are based on the assumptions by SSEPD management at the time of preparing the RFPR and RRP and are subject to change as matters arise and circumstances change during the price control.

There are no individual EV adjustments for SSES or SSEH on the face of the RFPR.

The methodology and approach considered for EV in the RFPR has been summarised below. This outlines how, in future years, SSEPD will consider these factors when preparing the RFPR. The EV Methodology will be reviewed annually for appropriateness as part of preparing the RFPR.

A1.2 Electricity Distribution (SSES and SSEH)

The EV adjustments considered are as follows:

1. **Network Output Measures (SSES and SSEH)** – SSEN forecasts to deliver the Health Index (HI) related outputs during RIIO-ED1 in full in both its license areas, therefore no adjustment to the expected outcome of RIIO-ED1 has been reflected. Separately, SSEN has considered whether there is a requirement to make phasing adjustments in relation to expenditure, allowances, and HI outputs delivered. In considering the phasing of output delivery compared to totex expenditure and allowances, SSEN has not made any adjustments on the basis of materiality and proportionality of delivery of outputs. At this stage of the price control, SSEN has delivered, proportionately, the HI outputs expected in comparison to the expenditure and therefore no adjustment has been made to reflect any EV impact accordingly.
2. **Load Related Reopener (SSES and SSEH)** – SSEN's forecast expenditure is below the re-opener threshold level when excluding our Innovation savings. We will be discussing with Ofgem how it intends to evaluate these and take an in the round assessment of ED1 Close Out. Therefore, SSEN has not reflected any adjustment for the Load Related Reopener.

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Other areas considered where no adjustment has been made on the grounds of the materiality of the impact on presentation of financial performance of SSEN's Electricity Distribution Networks are as follows:

1. **Smart Metering Interventions (SSES and SSEH)** – the allowances are subject to a volume driver mechanism whereby the number of interventions is multiplied by a unit cost allowance. No timing or output adjustments for Smart Metering Interventions have been made.
2. **Smart Metering IT (SSES and SSEH)** – Smart Metering IT is a pass-through allowance which is subject to an efficiency review. At this stage, no efficiency review or methodology has been developed to inform any enduring value adjustment. Additionally, expenditure is still being incurred in relation to this investment and therefore the conclusion is unknown at this stage of the price control.
3. **Worst Served Customers (SSES and SSEH)** – In SSEH, a specific allowance was provided in relation to network reliability and Worst Served Customers. For SSES, there is a volume driver mechanism based on the number of customers, a unit cost allowance and delivery of an agreed network performance improvement. This work is still underway and therefore it is too early to assess whether any adjustment for EV is required.
4. **Areas of Outstanding Natural Beauty (AONB) (SSES and SSEH)** – This is a standalone funding mechanism where expenditure is matched with allowances through the Annual Iteration Process (AIP) and therefore no adjustment has been considered necessary.
5. **Street Works, Enhanced Physical Site Security Costs and Link Boxes (SSES and SSEH)** – No adjustment has been considered for these elements of the price control given their status for reopener applications at this stage. However, Street Works will be considered again by Ofgem at closeout.

No EV adjustments have been considered for incentive mechanisms for RIIO-ED1. This has been deemed out of scope and is based on earned in year calculations or awards.

Appendix 2 - Basis of any estimates and allocations

Estimates are restricted to forecast information. Forecasts have been constructed as follows:

- Totex – forecasts match the 2021/22 submitted RRP. Within the reconciliation to totex, the 'Other' line includes elements of rounding in line with the materiality agreed with Ofgem.

- Incentives – forecasts are based on of the average incentives earned for the price control period to date as well as taking account of the future targets which licensees have set to the end of the price control. Incentives earned in year are based on the same model, with the 2-year lag and inflation adjusted out.

- Innovation – forecasts are based on the average innovation revenues for the price control period to date.

- Financing – forecasts for interest on existing debt are based on SSE Treasury forecasts of interest payable, based on the expected interest rate for each instrument. Forecast interest cost for new debt is based on the value of new debt multiplied by the price control cost of debt for the relevant year.

- Net debt – forecasts for existing debt are based on SSE Treasury forecasts of the movement in debt based on the arrangements in place. Forecast new debt is based on maintaining actual gearing at notional levels for SSES and SSEH.

- Tax – forecast tax liability is based on the proportion of the average adjusted actual tax liability for the price control to date versus the forecast regulated profit for the remainder of the price control period.

- Other Activities – guaranteed standards payments for SSES and SSEH are based on the average payments for the price control period to date.

There are no allocations in this submission.