REGULATORY FINANCIAL PERFORMANCE REPORTING (RFPR)

Scottish and Southern Energy Power Distribution Limited

Financial Year 2022/2023

Scottish & Southern Electricity Networks

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. The RIIO-ED1 period ended 31st March 2023, as such the 2023 RFPR submissions reflect outturn data. Consequently, analysis of average expected RoRE over the period demonstrates the outcomes for each licensee pre RIIO-ED1 close out, 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).

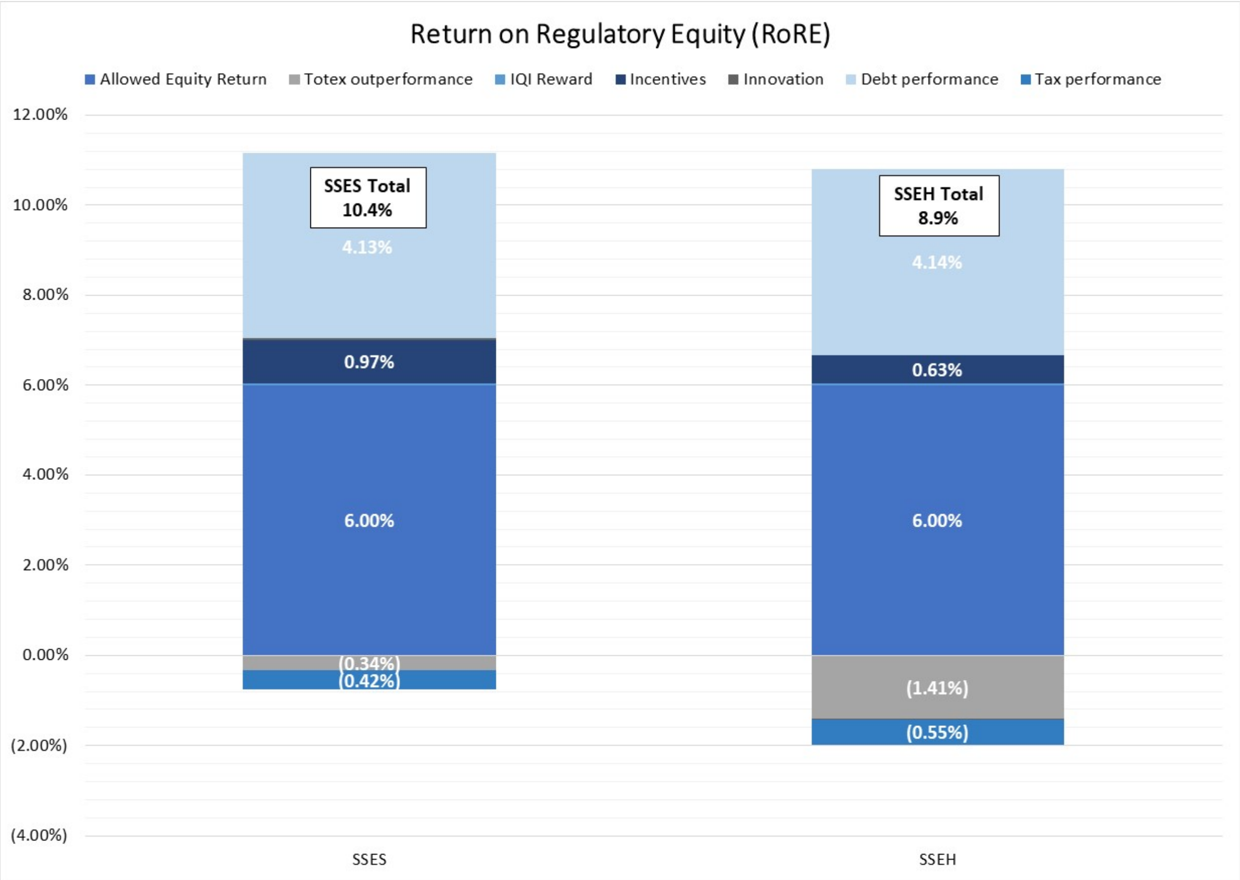
SSEN Distribution will be working through the RIIO ED1 close out process with Ofgem and have therefore not included closeout assumptions within the 2023 RFPR submission.

2. Key Financial Performance / Operational Measures

2.1. The RoRE for the RIIO-ED1 period on average for the SSEPD licensees can be seen in Figure 1 below. Each of the licensees can earn above its base return on equity (allowed return on equity) through 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. If 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. In other words, if the RoRE were to increase this translates to better service levels and lower consumer bills and not the opposite.

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.

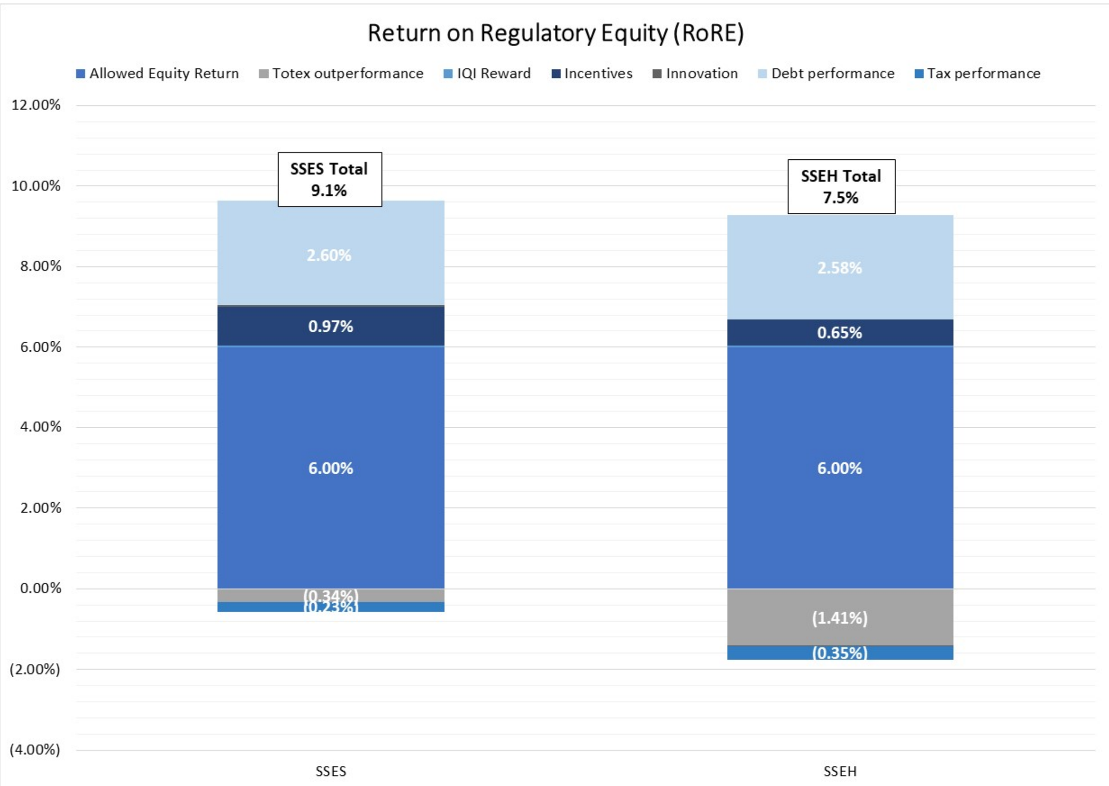
Figure 1 – Return on Regulatory Equity (RoRE) based on notional gearing for the RIIO-ED1 period for SSEPD Licensees



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.0.8% increase to RoRE in Distribution. SSES are making above their allowed or base return on equity at an operational level due to the incentives achieved outweighing totex overspend. This is not the case for SSEH, which overspent its totex allowance by c.5%, and therefore performed 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.

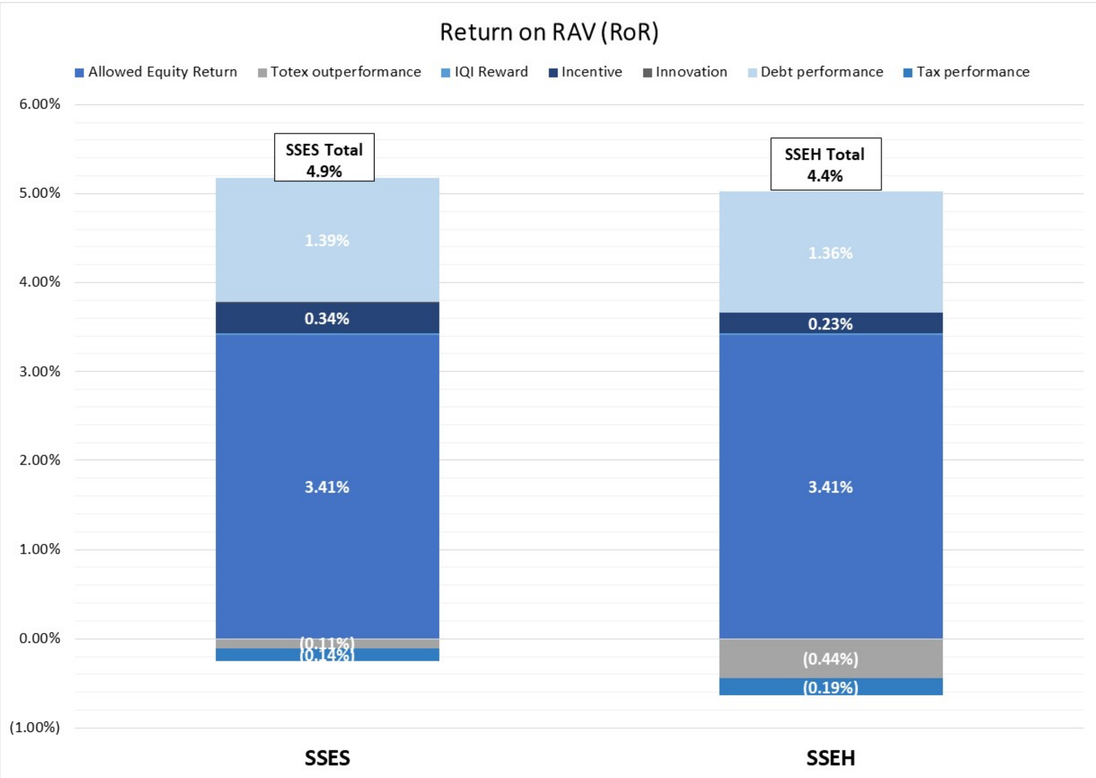
2.4. As noted above, at the operational level, SSES are achieving above base return (6.7%), with SSEH forecast to achieve below base return (5.3%). The impact of financing and tax performance improves the overall return for both SSEPD licensees in Figure 1. Both licensees outperform the cost of debt 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. Outturn inflation also had a positive impact on SSEPD's debt outperformance due to circa 90% of our debt book being fixed. The Bank of England targeted 3% inflation for year-end 2023, in line with long term forecasts and historical averages. Figure 2 below restates RoRE using this target, which reduces the impact of debt performance on overall RoRE by circa 1.5% for both licensees (Figure 2). This calculation does not account for the proportion of notional Index Linked Debt. We also note that debt should be reviewed over the long term, similar to inflation due to the maturity of debt instruments/bonds which tend to be well in excess of 10 years.

Figure 2 – Restated Return on Regulatory Equity (RoRE) based on notional gearing for the RIIO-ED1 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



At an operational level, SSES and SSEH are making returns of just above 3.5% 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 2022 RFPR vs 2023 RFPR

	SSES		SSEH	
	2022	**2023**	**2022**	**2023**
Allowed Return	6.0%	6.0%	6.0%	6.0%
Totex Outperformance	(0.6%)	(0.3%)	(1.2%)	(1.4%)
IQI	0.0%	0.0%	0.0%	0.0%
Incentives & Innovation	1.0%	1.0%	0.7%	0.6%
Operational RoRE	**6.5%**	**6.7%**	**5.6%**	**5.3%**
Financing & Tax	2.1%	3.7%	2.0%	3.5%
Total RoRE	**8.6%**	**10.4%**	**7.6%**	**8.9%**

2.6. SSES operational RoRE has increased marginally versus the prior year RFPR submission due to a reduction in totex underperformance. Conversely, SSEH operational RoRE has reduced due to an increase in totex underperformance and reduction in incentives.

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

Totex performance is built into the RFPR and aligned with the Regulatory Reporting Pack (RRP) submitted to Ofgem by 31 July 2023.

SSEH cumulatively overspent by 5% against ED1 Allowance which is marginally higher than previously reported in the 2022 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 cumulatively overspent by 1% against ED1 Allowance, which is consistent with the reported performance in the 2022 RFPR. This 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. Both SSES and SSEH have earned incentive revenues in each year of the RIIO-ED1 price control under the Interruptions Incentive Scheme, Broad Measure and Time to Connect incentives with the exception of FY23 where SSEH received a penalty because whilst performance in response to unplanned network faults improved in comparison to 2021/22, reflecting investment in automation and operational response, a rise in planned interruptions to facilitate new connections has impacted IIS performance. Incentive performance is mainly driven by targeted improvements related to performance in availability and security of electricity supply and customer service.

3.5. Innovation

Historic innovation information is sourced from the Revenue Return submitted to Ofgem. 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. The methodology utilised therefore skews debt performance to appear higher compared to calculating this over a long period of time or reflecting the notional capital structure. We also would emphasise that debt is issued for long periods of time i.e. well in excess of 10 years, and therefore in-year movements or periods where inflation is above or below the long term Bank of England target may distort the underlying performance.

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. 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, with neither licensee paying a dividend since FY20.

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. SSEN Distribution are currently coordinating the 2023 Pension Reasonableness Review which will be submitted to Ofgem between July and September 2023.

4. Data assurance statement

4.1 This submission has been completed in line with the Data Assurance Requirements Standard Licence Condition 45. A Risk Assessment has been conducted and the Total Risk Rating has been scored as Low. 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 2022/23 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 delivered 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.
2. **Load Related Reopener (SSES and SSEH)** – SSEN's expenditure, when excluding our innovation saving is below the re-opener threshold. We will be discussing with Ofgem how it intends to evaluate these as part of the ED1 Close Out assessment. Therefore, SSEN has not reflected any adjustment for the Load Related Reopener.

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.