Regulatory Financial Performance Reporting

Scottish and Southern Electricity Networks
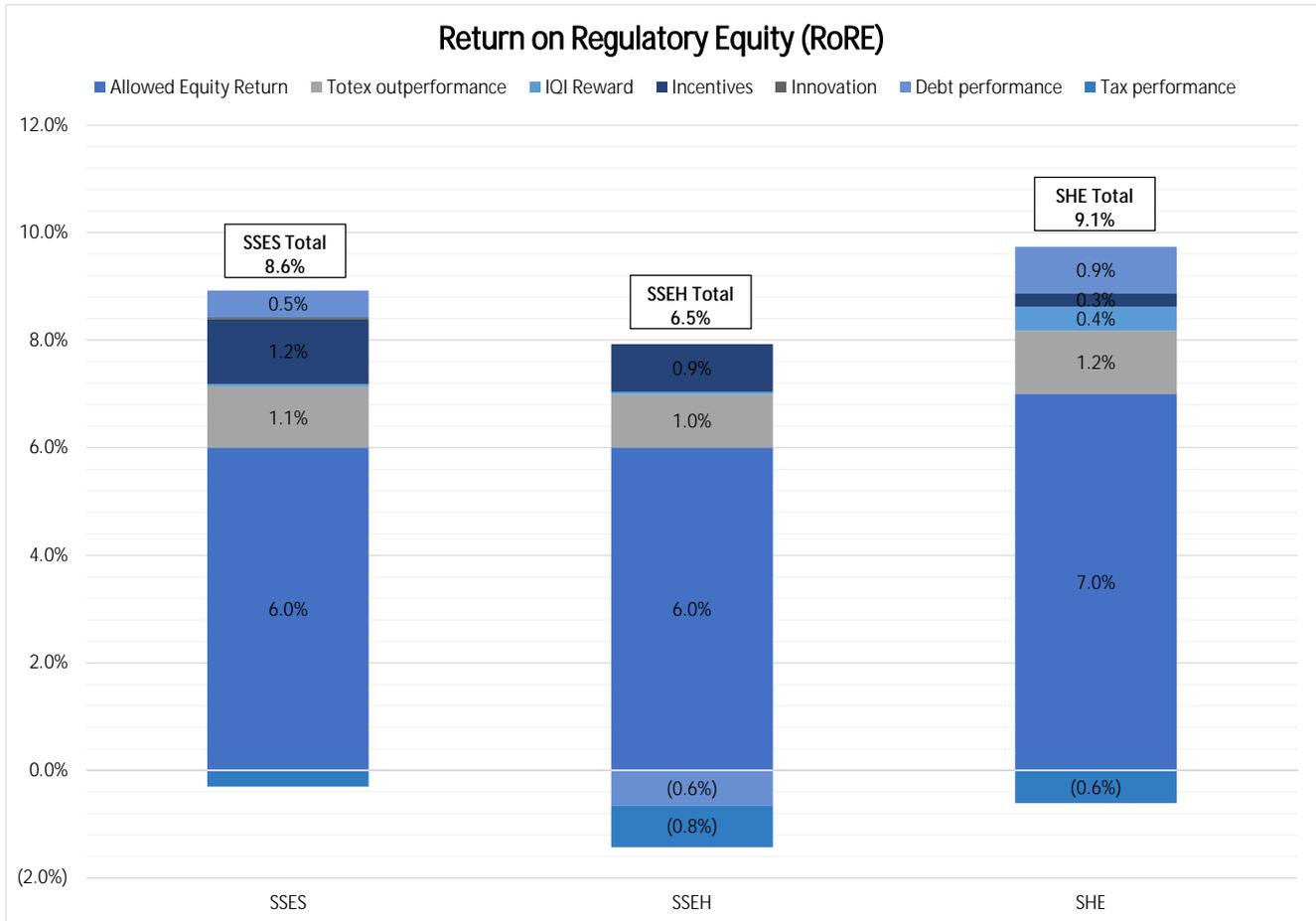
Financial Year 2018/2019

1. Executive Summary

1.1. This commentary summarises the regulatory performance of the SSEN licensees which consist of Southern Electric Power Distribution plc (SSES), Scottish Hydro Electric Power Distribution plc (SSEH) and Scottish Hydro Electric Transmission plc (SHE) 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 on the RIIO-1 period as an average 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 the higher the RoRE the higher the customer bill. RoRE is intended as a reflection of Network performance whereby higher RoRE means greater cost efficiency which leads to lower bills while delivering better service levels;
- The RoRE measure does not reflect the overall charge to customers for use of electricity networks; it does not include the interest costs on borrowing. Electricity network infrastructure is financed by both borrowing funds and shareholder investment 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.

This document includes our Methodology for EV in Appendix 1. We have also briefly summarised our financial performance in this document, which corresponds to information provided to Ofgem set out in the Strategic Performance Overview (SPO) document submitted under the Regulatory Instructions and Guidance (RIGs) on 31 July 2019. Note that the financial values required to be reconciled within the RFPR have been reconciled to the audited statutory accounts for each applicable year.

2. Key Financial Performance / Operational Measures

2.1. The RoRE for the RIIO-1 period on average for the SSEN licensees can be seen in Figure 1 below. Each of the licensees has the opportunity to earn above its base 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, there is an opportunity to earn additional income through incentives. In the event that service levels fall below targets set out in the price control, a penalty will be incurred which reduces network revenue and therefore customer bills. This ensures that customers only compensate networks for improving service levels. Further, customers benefit from reduced bills when network providers achieve efficiency savings on totex expenditure.

2.2. As Electricity Distribution and Electricity Transmission 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) for the RIIO-1 period for SSEN Licensees

2.3. As can be seen in Figure 1, all three licensees are forecast to deliver totex efficiencies across the period, which will translate to lower bills for customers. SSES and SSEH are forecasting efficiencies in totex spend, translating to c.1.1% and 1.0% on RoRE.
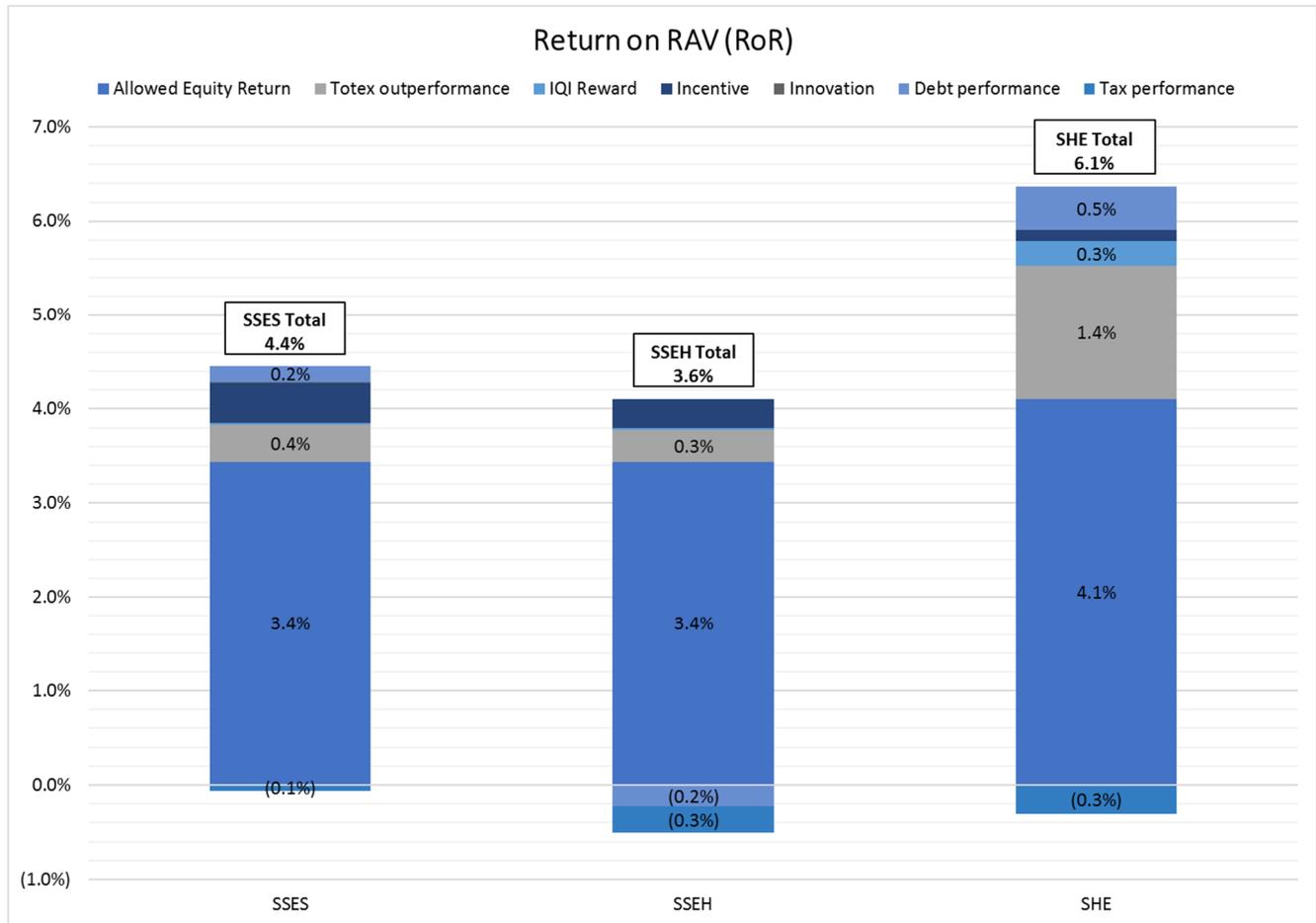
2.4. SHE is also forecasting efficiencies in totex on large capital projects across the period resulting in an outperformance of 1.2% on RoRE. It is worth emphasising that the incentive framework for RIIO-T1 was predominantly focused on totex efficiency as earned from the Totex Incentive Mechanism (TIM) due to the large capital programme expected across Transmission Operators (TOs).

2.5. Each of the licensees are focussed on improving customer satisfaction and network reliability and this has been realised through incentive rewards of c.1.1% on average in Distribution and 0.3% in Transmission. All three licensees are therefore making above base return on equity at an operational level. This is a measure of the performance of each Network excluding the impact of funding for borrowing and tax costs. This is referred to as the operational RoRE.

2.6. At the operational level, each of the licensees are achieving above base return (SSES 8.4%, SSEH 7.9% and SHE 8.9%). The impact of financing and tax performance improves the overall return for both SSES and SHE as can be seen in Figure 1. SSEH continues to make above base return including finance and tax despite this performance reducing the overall RoRE mainly due to the timing of debt being raised.

2.7. Figure 2 below sets out the Return on RAV (RoR) as an alternate measure of performance. This is reflective of the gearing and cost of borrowing that customers pay for through use of the Distribution and Transmission Networks, as opposed to a shareholder focused rate of return in the form of RoRE.

Figure 2 – Return on RAV (RoR) for the RIIO-1 period for SSEN Licensees

Figure 2 – Return on RAV (RoR) for the RIIO-1 period for SSEN Licensees

2.8. At an operational level, SSES and SSEH are making returns of c.4% on average, with SHE being slightly higher at c.6% due to a higher base cost of equity and efficiencies made on totex. The licensees continue to make a small return above the allowed Weighted Average Cost of Capital (WACC) when including the impact of financing and tax performance.

3. Overview of regulatory performance

3.1. RoRE

The RoRE and RoR have been summarised overall in section 2 above. These form part of SSEN'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 tariff setting process. This process allows each licensee to recover base revenue plus any incentive revenues earned and pass through items to be recovered.

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3. Overview of regulatory performance (continued)

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 on 31 July 2019.

Electricity Distribution
The overall totex for SSES and SSEH has seen an initial upward trend at the beginning of the price control (to 2018 for SSES and 2020 for SSEH) followed by a decrease in planned expenditure levels for the remaining years for the respective licensees. The trend is largely due to the phasing of projects. Significant IT investment has materialised during the period which has influenced higher spend at the beginning of RIIO-ED1. The forecast reduction in spend going forward is attributable to expected operating and investment efficiencies in the latter part of the price control period.

Totex forecasts include known re-openers (SSEH –submarine cables and high value projects; SSES – rail electrification). Any other relevant adjustments required under our EV methodology, set out in Appendix 1, have been considered. We have not made any adjustments for the Load Related Reopener (LRR) or Network Output Measures (NOMs) in Electricity Distribution.

Electricity Transmission
SHE Transmission is forecasting a c.4% (including EV adjustments) underspend of totex allowances during the eight-year RIIO-T1 period. This aggregate position reflects underspend on load related outputs, overspend on non-load related outputs and non-operational capital expenditure, and broadly neutral spend on operating costs. Material savings have been achieved in load related outputs due to innovative solutions adopted to achieve output delivery, efficiency in project management and effective risk management. To the contrary, additional costs have been incurred in non-load related outputs due to poorer asset condition than originally anticipated within the Business Plan driving increases in work scope and hence cost. Substantial investment in new information technology, including an asset management system, has resulted in significant overspend of non-operational capital expenditure allowances.

Totex forecasts include relevant EV adjustments, see Appendix 1 for EV Methodology and detail on the adjustments made.

3.4. Output incentive performance

Electricity Distribution
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 forecast to improve across both SSES and SSEH to the end of the RIIO-ED1 period, mainly driven by targeted network improvements related to performance in availability and security of electricity supply. Incentive improvements are also expected to be achieved 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 its customers remain at the forefront of decision making. The RoRE and RoR are reflective of the continuation of average total incentive performance from the first half of the price control for the remainder of the period. This shows an improvement on the 2017/18 and 2018/19 performance in future years.

3. Overview of regulatory performance (continued)

3.5. Output incentive performance (continued)

Electricity Transmission
SHE is forecasting to meet the required incentive targets to the end of the RIIO-T1 period to ensure continuous improvement regarding network reliability, safeguarding the environment and stakeholder engagement.

3.6. Innovation
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 informing industry-wide improvements.

3.7. Financing and Net Debt position
The actual gearing for the SSEN 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. SHE in particular has been subject to significant new financing during the RIIO-1 period due to the large-scale capital investment programme which has influenced growth in RAV by a multiple of four. As such, SHE was recapitalised through an equity injection during the period to reduce actual gearing to bring it closer to notional alongside maintaining our investment grade credit rating, which is consistent with our licence obligations.

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.

Electricity Distribution
SSES is outperforming the cost of debt allowance, whereas SSEH is underperforming. This is due to the timing of debt being raised as well as the tenor of loan stock, with forecast new debt driving the SSEH underperformance. No new debt has been raised for either licensee across RIIO-ED1 to date, during the period of lower interest rates. As these recent lower interest rates are embedded in the cost of debt index allowance, variances arise when comparing actual cost of debt, which was raised prior to the low interest rate period, to allowance.

Electricity Transmission
The outperformance in SHE has been steadily declining due to the weighted cost of debt mechanism which moves in line with changes in the RAV. As a result of the significant capital investment programme and growth in the RAV, the low interest rate environment has pulled down the cost of debt index allowance while SHE has been able to borrow in line with capital markets.

3.8. Taxation
Each of the licensees is underperforming with reference to its tax allowance. 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.

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3. Overview of regulatory performance (continued)

3.9. RAV

RAV is presented as per the PCFM. The totex forecast per the RRP has been reflected in forecast RAV additions. 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. Three EV adjustments have been made to totex for SHE, with the impact being reflected in RAV. The EV Methodology in Appendix 1 outlines details of the EV adjustments made for SHE as well as the basis of SSEN's EV assessment for all three licensees.

3.10. Dividends

Dividends are paid based on cash flow management of the three licensees over a prolonged period. SSEN'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.

3.11 Pensions

Pension allowances and deficit repair payments are in line with the Pensions Reasonableness Review carried out in 2017. 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.

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.

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Appendices

Appendix 1 - Enduring Value Methodology

A1.1 Introduction

The Enduring Value (EV) Methodology is based on a fundamental review of each licensees' regulatory price control, outputs, totex allowances and expenditure. SSEN'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, SSEN 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 RRP submissions on 31 July 2019. Any EV adjustments are based on the assumptions by SSEN 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.

Only those adjustments already reflected in the RRP totex forecast have been built into SSES and SSEH in relation to EV. There are therefore no individual EV adjustments on the face of the RFPR. There have been adjustments made for SHE based on expectations of close out adjustments for the RIIO-T1 price control.

The methodology and approach considered for EV in the RFPR has been summarised below. This outlines how, in future years, SSEN 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 expects and plans to deliver the Health Index (HI) related outputs during RIIO-ED1 in full, 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)** – The Load Related Reopener is a close out mechanism for which the methodology is currently being developed for RIIO-ED1. SSEN's forecast expenditure is marginally below the re-opener threshold of 80% of total allowances but within the materiality threshold defined in the licence. Therefore, when considering the status of the close out methodology drafting, the application of the materiality threshold and the cost efficiencies expected from implementation of innovative solutions, SSEN has not reflected any adjustment for the Load Related Reopener.
3. **Subsea Cable Reopener (SSEH)** – The Subsea Cable Reopener was submitted in February 2019. At the time of submitting the RRP, the forecast costs were built into the totex forecast at our current view of reopener level following our submission and subsequent conversations with Ofgem. This has therefore been reflected within the totex forecast feeding through to the RFPR and hence no specific EV adjustment is required.

A1.2 Electricity Distribution (SSES and SSEH) (continued)

4. **High Value Projects Reopener (HVP) (SSEH)** – The HVP Reopener was submitted in May 2019. At the time of submitting the RRP, the forecast costs were built into the totex forecast based on the amount submitted to Ofgem as part of the reopener application. This has therefore been reflected within the totex forecast feeding through to the RFPR and hence no specific EV adjustment is required.

5. **Rail Electrification Reopener (SSES)** – The Rail Electrification Reopener was submitted in May 2019. At the time of submitting the RRP, the forecast costs were built into the totex forecast at reopener level. This has therefore been reflected within the totex forecast feeding through to the RFPR.

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 to address the North of Scotland geographical costs in relation to Worst Served Customers. For SSES, this is a volume driver mechanism based on the number of customers, a unit cost allowance and delivering 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.

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.

A1.3 Transmission (SHE)

For Electricity Transmission the RIIO-T1 price control is in its final years and close out methodologies are being developed by Ofgem. SSEN has adopted the following approach and considerations in relation to the EV adjustment:

1. **Network Output Measures** – NOMs for HI are still under development and at this stage any EV adjustment for RIIO-T1 would be highly uncertain and therefore no adjustment has been made. Due to the large-scale projects and capital investment required for Transmission infrastructure which span multiple years, no adjustment has been proposed for phasing of delivery of NOMs HI in the RFPR. No adjustments have been made for the delivery of load related outputs whereby the completion of an output is either defined in the licence under Strategic Wider Works or forms part of the Generation Connections Volume Driver licence condition.

A1.3 Transmission (SHE) (continued)

2. **Phasing adjustments for totex expenditure** – Electricity Transmission totex expenditure is unevenly phased due to the large-scale projects undertaken, such as Caithness Moray, Kintyre Hunterston, Beauly Mossford and large-scale generation connection infrastructure. It would therefore be appropriate to consider whether phasing adjustments should be made in relation to totex allowances to address material year-on-year variations in Regulatory Financial Performance. SSEN has considered the phasing of expenditure of large identifiable schemes, as well as the completion of the output being delivered. In doing so, SSEN has not identified any EV adjustments for timing as it does not distort the overall RIIO-T1 financial performance. Furthermore, as Caithness Moray completed in 2018/19 in line with the output delivery date, the historical phasing of this project is not considered relevant given the RFPR is considering the most recently completed financial year and what we know about specific projects now. Additionally, SSEN has focused the RFPR for RIIO-T1 on the overall eight-year price control period, with in year adjustments therefore not influencing the overall view. We have considered adjustments to the phasing of totex expenditure as part of delivering RIIO-T2 outputs but incurring expenditure in RIIO-T1 (see point 3 below).

3. **RIIO-T2 Outputs and expenditure** – There are a number of projects and related expenditure spanning from the final years of RIIO-T1 into the first years of RIIO-T2. These are primarily in relation to Generation Connections driven infrastructure which complete in RIIO-T2 (pre-31 March 2023).

4. **RIIO-T1/RIIO-T2 crossover schemes** – There are specific projects for which SHE is incurring expenditure within the RIIO-T1 period, with the output being delivered in RIIO-T2 for Generation Connections (delivery post 31 March 2023). There is therefore no allowance for this expenditure within the RIIO-T1 period. Our expectation is that there will be a 'true-up' to allowances at the end of the RIIO-T1 period to reflect the expenditure on these projects given there is an output associated with them but no mechanism to fund these costs in RIIO-T1. We have therefore included allowances equal to this expenditure as an EV adjustment within the RFPR to reflect the expectation of the close out of RIIO-T1 on these items.

5. **Sole use exit/entry connections** – Final Proposals for RIIO-T1 define that the sole use exit connections allowance will be trued-up to actuals at the end of RIIO-T1. Our expectation is that sole use entry connections will also be treated in the same way as well as the forecasted income deducted from base revenue in the PCFM. There is therefore an EV adjustment within the RFPR to reflect the allowances to actual for both sole use exit and entry connections.

6. **Strategic Wider Works (SWW) pre-construction spend**– Final Proposals define that there will be a 'true-up' of SWW pre-construction allowances to actual at the end of RIIO-T1. There is therefore an EV adjustment within the RFPR to true-up the allowances to actual for this spend.

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No EV adjustments have been considered for incentive mechanisms for RIIO-T1. 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 July 2019 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. Forecast new debt is based on actual gearing levels levelling around the notional level towards the end of the price control period for SHE.

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.

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