

Regulatory Financial Performance Reporting

Scottish and Southern Electricity Networks
Financial Year 2019/2020



1. Executive Summary

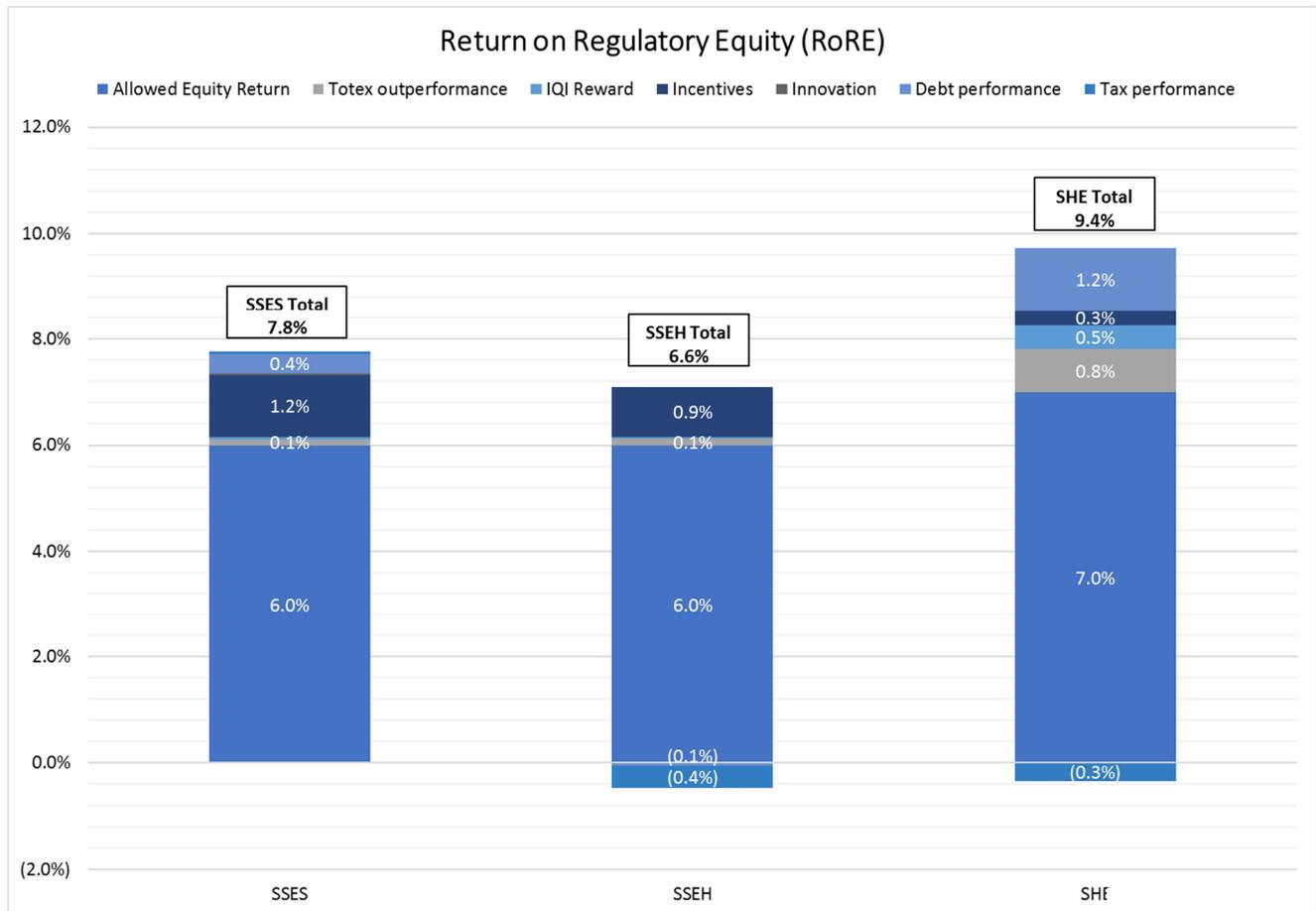
- 1.1. This commentary summarises the regulatory performance of the SSEN licensees which consist of Southern Electric Power Distribution plc (SSES), Scottish Hydro Electric Power Distribution plc (SSEH) and Scottish Hydro Electric Transmission plc (SHE) in line with the Regulatory Financial Performance 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 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. Our EV adjustments are therefore reflective of our expectation for these adjustments based on Ofgem Final Proposals, the Regulatory Licence and discussions with Ofgem over the price control period. We have not reflected any adjustments 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 our three regulatory licensees. We have also 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 RIGs.

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 (allowed return on equity) by 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 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



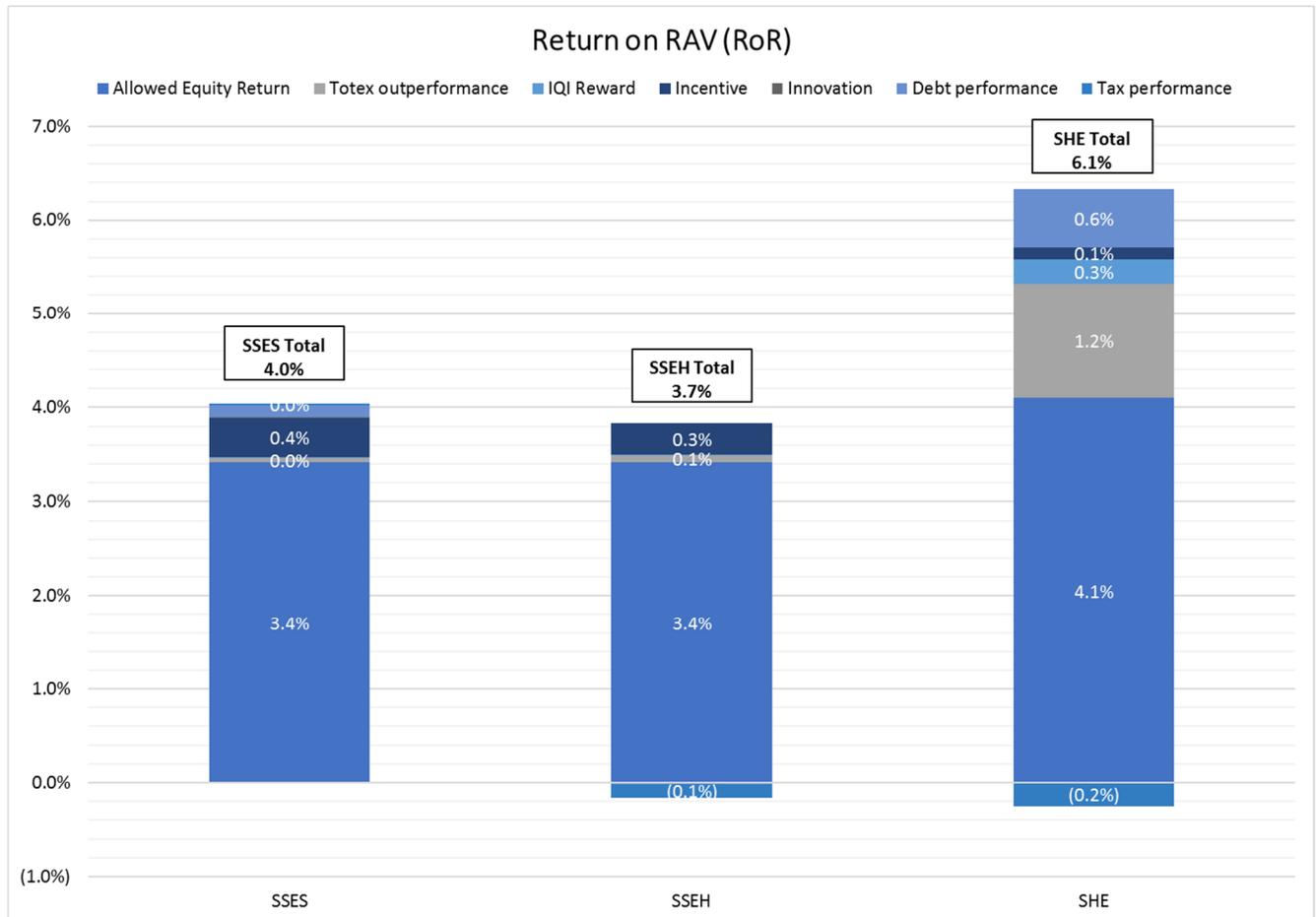
2.3. As can be seen in Figure 1, all three licensees are forecast to deliver totex efficiencies across the period, which will translate to lower bills for customers. SHE Transmission is forecasting efficiencies in totex on large capital projects across the period resulting in an outperformance of c.0.8% 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). Additionally, the base allowed return on equity was set at 7% for the period due to the risk faced at the time of setting the price controlled compared to the lower allowed return set for electricity distribution network operators (DNOs).

2.4. 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% on average in Distribution and 0.3% in Transmission. All three licensees are therefore making above their allowed or 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.

2.5. At the operational level, each of the licensees is achieving above base return (SSES 7.4%, SSEH 7.1% and SHE 8.5%). The impact of financing and tax performance improves the overall return for both SSES and SHE Transmission 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.

2.6. Figure 2 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 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



2.7. At an operational level, SSES and SSEH are making returns of c.3.9% on average, with SHE Transmission being slightly higher at c.6.1% 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.

Figure 3: Comparison of RoRE from 2019 RFPR vs 2020 RFPR

	SSES		SSEH		SHE	
	2019	2020	2019	2020	2019	2020
Allowed Return	6.0%	6.0%	6.0%	6.0%	7.0%	7.0%
Totex Outperformance	1.1%	0.1%	1.0%	0.1%	1.2%	0.8%
IQI	0.0%	0.0%	0.0%	0.0%	0.4%	0.5%
Incentives & Innovation	1.2%	1.2%	0.9%	0.9%	0.2%	0.3%
Operational RoRE	8.4%	7.4%	7.9%	7.1%	8.9%	8.5%
Financing & Tax	0.2%	0.4%	(1.4%)	(0.5%)	0.3%	0.9%
Total RoRE	8.6%	7.8%	6.5%	6.6%	9.1%	9.4%

- 2.8. At an operational level, SHE Transmission has reduced by c.0.4% versus our forecast included in the 2019 RFPR mainly due to additional EV adjustments reducing our anticipated totex outperformance including the impact of close out adjustments. EV adjustments are explained in further detail in Appendix 1.
- 2.9. SSES and SSEH have both reduced in operational RoRE versus the prior year RFPR forecast submission which is mainly driven by reduction in totex outperformance (SSES (1.0%), SSEH (0.8%)). SSEH totex outperformance reduction is a result of reduced allowances against last year's forecast due to the rejection of the Pentland Firth East subsea cable reopener as well as confirmation of a reduced allowance for the subsea cable protection reopener. SSES totex outperformance relates to forecast additional expenditure mainly driven by Non Load and Operating Costs, further explained in section 3.3.

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 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 August 2020.

Electricity Distribution

The overall totex for SSEH has seen an upward trend across ED1 forecast to continue to 2022 with a slight decrease in the final year of the price control. The trend in SSEH is largely due to the phasing of projects. SSEH is currently forecasting an outperformance of c.0.5% in ED1 (outperformance of c.3.5% reported in 2019 RFPR), the reduction in outperformance versus last year is due to the reduction in forecast allowances following Ofgem's decision to reject the Pentland Firth East Subsea Cable Reopener proposal as well as the reduction in allowance applied to the Subsea Cable Protection Reopener.

SSES has seen an initial upward trend at the beginning of the price control followed by a decrease in planned expenditure levels for the remaining years, largely due to the phasing of projects, including large scale Load and Non-Load Capex projects, and IT project spend. The forecast reduction in spend going

forward is attributable to expected operating and investment efficiencies in the latter part of the price control period. SSES ED1 outperformance is currently forecast at c.0.5% (compared to outperformance of c.5% reported in 2019 RFPR). The reduction in outperformance is due to increased costs forecast to the end of ED1. The increased costs mainly relate to additional load related projects identified, increased complexity in non-load projects as well as rebasing of forecast operating costs. This accounts for both increased temperatures causing increased underground cable faults, and the continued higher level of tree cutting expenditure. Any other relevant adjustments required under our EV methodology, set out in Appendix 1, have been considered and determined not required at this stage.

Electricity Transmission

SHE Transmission is forecasting a c.3% (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. This does not consider any impact of RIIO-T2 on the close out of RIIO-T1 as a result of Ofgem's recent Draft Determinations for RIIO-T2.

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. In contrast, 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

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.

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 improvements related to performance in availability and security of electricity supply and customer service. Incentive improvements 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.

Electricity Transmission

SHE Transmission 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.

3.5. 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 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 Transmission 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 Transmission was recapitalised through an equity injection during RIIO-T1 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 external 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. In 2019/20 internal loan stock was issued in both SSEH and SSES.

Electricity Transmission

SHE Transmission is outperforming the cost of debt allowance due to the low interest rate environment. This has pulled down the cost of debt index allowance while SHE Transmission has been able to borrow in line with capital markets.

3.7. Taxation

Both SHE Transmission and 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. Six EV adjustments have been made to totex for SHE Transmission, with the impact being reflected in RAV. The EV Methodology in Appendix 1 outlines details of the EV adjustments made for SHE Transmission as well as the basis of SSEN's EV assessment for all three licensees.

3.9. 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. 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.

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. 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 2019/20 RRP submissions. 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.

There are no individual EV adjustments for SSES or SSEH on the face of the RFPR. There have been adjustments made for SHE Transmission 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 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 above the re-opener threshold level. 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.

A1.3 Transmission (SHE)

For Electricity Transmission the RIIO-T1 price control is in its final year 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 is subject to close out and therefore 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.
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, Beaully 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). adjustments have been made for the delivery of load related outputs whereby the completion of an output within the first two years of the T2 period based on the specification of the licence generated regulatory allowance.

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 these will be adjusted for as part of the RIIO-T1 close out and RIIO-T2 settlement 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.
7. **Potential SWW Allowance Adjustments** -There is expenditure being incurred in the final year of RIIO-T1 in relation to the Shetland Link for which we have equalised the allowance to ensure no under or out performance is shown in the period.

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 2019/20 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.