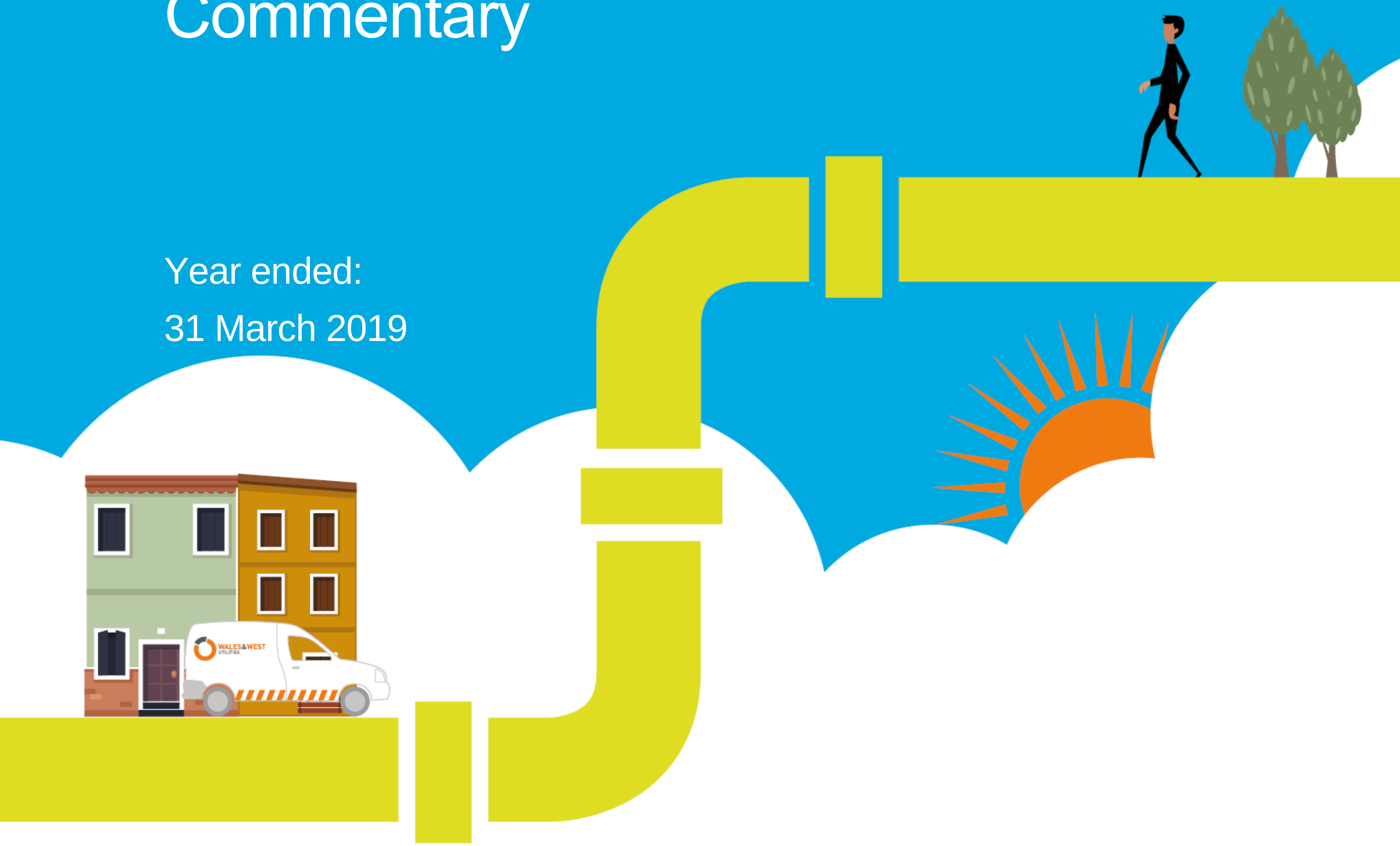
RIIO-GD1
Regulatory Financial Performance Reporting (“RFPR”)
Commentary

Year ended:
31 March 2019



WALES&WEST
UTILITIES

Contents

Executive Summary

The purpose of the Regulatory Financial Performance Reporting ("RFPR") is to provide a framework to allow Ofgem to collect accurate and consistent information from licenced network operators (Licensees), in particular in the calculation of Return on Regulatory Equity ("RoRE").

The RoRE calculation is presented on tab R1 of the RFPR. It should be noted that Wales & West Utilities Limited's ("WWU") RORE would be lower if it reflected only cash distributions to shareholders.

Enduring value adjustments have been entered into tab R4 – Totex. There has been a lack of detailed guidance in this area, which may impact the consistency of the enduring value calculations between each Licensee. For future RFPR submissions we will be seeking further direction from Ofgem for the calculation of enduring values. WWU has included enduring value adjustments where the workload performed to date, as a proportion of the workload expected to be performed over the eight years of the RIIO-GD1 price control, is materially different to the equivalent proportion of the workload upon which the allowances were set under the RIIO-GD1 price control.

The RFPR Submission can be located on the WWU website, as required by Ofgem for 2018/19 onwards, by following the link below:

https://wwutilities.co.uk/media/3080/2018-19-wales-west-utilities-rfpr-tables.xlsx

For further information, please refer to the WWU RIIO-GD1 Sixth Year Annual Report, Strategic Performance Overview, which was submitted to Ofgem on the 31 July 2019. The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

Key Financial Performance measures

Commentary on key financial performance measures can be found within the WWU RIIO-GD1 Sixth Year Annual Report, pages 8 – 18, which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

Key Operational Performance measures

Key operational performance measures are discussed within the WWU RIIO-GD1 Sixth Year Annual Report, pages 22 - 30, which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

Further detail can be found within the 2018/19 WWU Annual Stakeholder Report and WWU 2018/19 Statutory Accounts. The link to the Annual Stakeholder document is provided below.

https://wwutilities.co.uk/media/3081/wales-west-utilities-annual-stakeholder-report-2018-19.pdf

Overview of Regulatory Performance

R1 - RORE

Commentary on WWU's Return on Regulatory Equity (RoRE) can be found within the WWU RIIO-GD1 Sixth Year Annual Report, page 12 which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

RORE on a notional gearing basis

1. RORE operational is **11.9%.** This compares to 11.6% reported by Ofgem for 2017/18. Increased outperformance of 0.3% is mainly due to higher incentive income relating to an adjustment to split the shrinkage cost true up from the shrinkage allowance revenue adjustment in tab R5.

2. RORE including financing and tax is **10.0%.** This compares to 9.4% reported by Ofgem for 2017/18. Increase of 0.6% due to:

   a. higher operational RORE of 0.3%, explained above
   b. higher tax outperformance of 0.3% stemming largely from:
      i. Use of the Ofgem PCFM rate of 21% in the WWU model from previously used rates of 19% and 17% for 19/20 and 20/21 respectively.
      ii. Lower capital allowances rate on long life assets from 8% to 6%

RORE on an actual gearing basis

1. RORE operational is **13.8%.** This compares to 13.1% reported by Ofgem for 2017/18. Increase of 0.7% outperformance is due to:

   a. higher incentive income largely due to a positive change on the shrinkage allowance revenue adjustment.

2. RORE including financing and tax is **10.3%.** This compares to 9.3% reported by Ofgem for 2017/18. Increase of 1% due to:
   a. higher operational performance of 0.7% explained above
   b. higher tax outperformance of 0.3% mainly from
      i. use of the Ofgem PCFM rate of 21% in the WWU model from previously used rates of 19% and 17% for 19/20 and 20/21 respectively,

ii. Lower capital allowances rate on long life assets from 8% to 6% and
iii. Slightly lower clawback of £2.2m

R2 – Revenue

This sheet reflects the data contained within the Revenue Return 2018/19, submitted to Ofgem on 31 July 2019 in line with Licence Condition SSC A40.

For commentary on these figures, please refer to the WWU RIIO-GD1 Sixth Year Annual Regulatory Reporting Pack ("RRP") commentary, page 11, which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

R3 / R4 – Totex Performance

Data included within the R3 and R4 sheets was also included within the 2018/19 RRP, submitted to Ofgem on 31 July 2019 in line with Licence Condition SSC A40.

R3 - Rec to Totex reflects the data from the consolidated financial statements of Wales & West Utilities Limited reconciled to the Totex costs for the regulatory year.

The purpose of the R3 Rec to Totex schedule is to show a reconciliation of the statutory financial statements to Totex, (WWU has used audited regulatory accounts where the statutory year ends were not coterminous with the regulatory year – for the years ended 31 March 2013, 2014, 2015 and 2016 – which can be reconciled back to the statutory accounts after adjusting for timing). From 1 April 2016 onwards the statutory and regulatory year are coterminous. From 1 April 2018 the consolidated statutory financial statements of Wales & West Utilities Limited have been used as the basis for the reconciliation to Totex, following Ofgem's consent to withdraw the requirement for Consolidated Regulatory Accounts.

WWU has made no further adjustments to Totex to achieve the reconciliation to the PCFM.

The statutory financial statements of Wales & West Utilities Limited for the current year are the starting point for the R3 Rec to Totex and can be found on the Companies House website.

The Consolidated Regulatory Accounts of Wales & West Utilities Limited for the prior year is the starting point for the R3 Rec to Totex and can be found on the WWU website.

Link below is to the Consolidated Regulatory Accounts for the year ended 31 March 2018.

https://www.wwutilities.co.uk/media/2778/wales-west-utilities-regulatory-accounts-year-ended-31-march-2018.pdf

R4 – Totex reflects the data contained within table 2.2 Totex costs summary: Summary tables, see link below

https://wwutilities.co.uk/media/3079/2018-19-wales-west-utilities-rrp-cost-and-volumes-tables.xlsx

For commentary on the totex figures, please refer to the WWU RIIO-GD1 Sixth Year Annual Report, which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

R5 – Output Incentive Performance

Data within this tab mirrors the data contained within the Revenue Return 2018/19, submitted to Ofgem on 31 July 2019 in line with Licence Condition SSC A40. In the 2017/18 submission the shrinkage and exit capacity incentive figures within R5 included the true ups relating to these costs. For the 2018/19 submission these amounts have been split out from the true incentive figures and included in tab R2 – Revenue, within the adjustment for pass through costs line.

Please refer to the WWU RIIO-GD1 Sixth Year Annual Report, which was submitted to Ofgem on the 31 July 2019.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

R6 – Innovation

Please refer to the WWU RIIO-GD1 Sixth Year Annual Report, pages 19 - 21, which was submitted to Ofgem on the 31 July 2019.

In the 2017/18 RFPR submission, the allowed NIA adjustment was stated net of the company compulsory contribution of 10%. In the 2018/19 submission this has been split out.

The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/3078/2018-19-wales-west-utilities-rrp-strategic-performance-overview.pdf

Further information on innovation at WWU can be found in our 2018/19 WWU Innovation Report. The link to this report on the WWU website is as follows:

https://wwutilities.co.uk/media/3086/network-innovation-allowance-annual-summary-2018-19.pdf

R7 / R8 – Finance and Net Debt Position

Cost of Debt (excluding derivatives)

WWU continues to have a significant shortfall against the Cost of Debt allowance for GD1. WWU's cost of debt has been efficiently incurred[1] but is not fully compensated for by the rolling 10 year iBoxx index used by Ofgem for calculating Allowed Cost of Debt. WWU commissioned an independent report by Oxera to investigate this serious matter. Oxera concluded that WWU's debt was raised efficiently and that the methodology used by Ofgem is flawed.

Swap Portfolio

WWU has a £1bn notional, long dated RPI Linked Swap portfolio converting a high percentage of the group's fixed and floating rate debt into synthetic RPI Linked debt. This approach means that the overall real cost of debt is largely fixed and hedged against inflation. Therefore, during periods of low or negative inflation, WWU's nominal cost of debt will reduce, and conversely during periods of high inflation, WWU's nominal cost of debt will increase. £300m of this portfolio will expire in November 2023.

The long term maturity of the swap portfolio was determined prior to real interest rates going negative from 2010/11, with significant market reductions to nominal interest rates following the financial crisis in 2007/08 [and at a time when Ofgem provided a fixed debt allowance]. WWU believes that swap portfolio costs are efficiently incurred, and this position is supported by an independent report from Oxera. However, the methodology to determine the Allowed Cost of Debt results in the allowed real cost declining over RIIO-GD1, whereas WWU's real cost of debt is largely fixed. The impact of ongoing unrecovered efficiently incurred costs in respect of debt and derivatives will threaten WWU's A- rating ahead of the RIIO-GD2 settlement and will further pressure credit rating and financeability in RIIO-GD2.

Simplification of inter-group debt

WWU restructured its inter-group loans either side of the 2017/18 regulatory year end to simplify these arrangements. The old shareholder loans were part of a vertical and complex inter-group financing structure, which together with dividend payments (but not out of WWU) was the only mechanism for payment of returns to the ultimate shareholders because WWU has not had any distributable reserves since inception in 2005. The loan to the immediate parent of WWU has now been almost completely repaid, and replaced by £645m long term deeply subordinated loan finance directly from Hong Kong resident subsidiaries of the ultimate shareholders to WWU at a market tested, lower rate of interest, being LIBOR plus 6.5% p.a.

The new inter-group loan is deeply subordinated, and is not treated as debt for ratings purposes or debt for senior lender financial ratio purposes. Interest is not deductible for tax purposes. The background and details to the intra-group debt restructuring were shared with Ofgem in a meeting in their offices in summer 2018. Further details on the loan restructuring and new loan finance are provided in account note 12(iv) of the regulatory accounts to 31 March 2018.

[1] For a demonstration and discussion of this please see the Oxera report dated 26 April 2018, “RIIO-GD2 preparation: cost of debt.

R9 - RAV

Data reported within tab R10 reflects the latest published Price Control Financial Model (“PCFM”) results. The latest published PCFM was finalised in November 2018 following the 2018 Annual Iteration Process. Closing RAV reflects line 44 of the “Return&RAV” tab within the latest published PCFM.

R10 – Taxation

Reconciliation to the Regulatory Year

For years prior to 2017, WWU’s statutory reporting periods were not coterminous with the Regulatory Year. Accordingly, in preparing the R10-Tax submission the tax liability per latest submitted CT600 has been taken as the CT600 tax liability per the Regulatory Accounts for 2014 to 2016 inclusive. No CT600 tax liability arises under either the statutory reporting periods or regulatory years for 2014 to 2016 inclusive (as a result of the utilisation of brought forward tax trading losses) and accordingly no reconciliation of these amounts is provided.

Regulatory performance in respect of taxation

Prior to 2017, WWU had no regulatory tax liability, and accordingly no net tax allowance, as a result of the utilisation of brought forward regulatory tax losses.

The brought forward regulatory tax losses were utilised in full during 2017, resulting in regulatory tax liabilities and associated forecast net tax allowances arising in 2017 to 2021 inclusive. Wales & West Utilities forecast net tax allowances for 2017 and subsequent years are reduced by tax clawback as a result of actual gearing being in excess of notional gearing.

As per the 2012 Final Proposals document the total tax allowance for Wales & West Utilities was £81.2m. Based on the RFPR submission, the total tax allowance for GD1 is forecast as £92.9m (or a net forecast tax allowance of £66.8m after tax clawbacks of £26.1m).

The tax performance in the RoRE calculation (in line with section 1.14 of the Regulatory financial performance annex to RIIO-1 Annual Reports - 2017-18) compares Wales & West Utilities actual tax liability against the tax allowance set as part of the RIIO-1 price control including the impact of deviating from notional levels of gearing in the form of tax clawback.

R11 – Dividends

WWU has not paid dividends in the current or prior years and is not forecasting to pay dividends in future years. However shareholder loan note interest payments are classified as distributions as they are paid to Companies affiliated to WWU through the Group Structure.

WWU made a shareholder loan interest payment in December 2018 of £34m. In June 2019 a shareholder loan interest payment of £20m was made. The future forecast distributions for shareholder loan interest payments are based on the medium term plan and are forecast to be paid bi -annually in June and December

On 27 March 2018, WWU issued, for cash, £645.0m of 20 year subordinated loan notes expiring on 26 March 2038 to affiliated companies resident and incorporated in Hong Kong and controlled by the 4 members of the Hong Kong based consortium that jointly own West Gas Networks Limited and Western Gas Networks Limited (The owners of WWU's Parent Company).

Details of these loan notes are included on page 70 of the WWU 2017/18 regulatory accounts within Note 12 – Financial Instruments (iv).

https://www.wwutilities.co.uk/media/2778/wales-west-utilities-regulatory-accounts-year-ended-31-march-2018.pdf

R12 – Pensions

Please refer to section 9.2 starting on page 105 of the RRP Commentary (submitted to Ofgem - 31 July 2019) and the PDAM (submitted to Mick Watson, Ofgem – by email 30 August 2017).

Please refer to these submissions for explanations.

Narrative on Pensions should consider the Pension Deficit Allocation Methodology ("PDAM") submission to Mick Watson on 30 August 2017.

R13 – Other activities

WWU has not incurred any Ofgem penalties or fines throughout RIIO-GD1.

Guaranteed Standards of Service payments (“GSOP”) are statutory payments at rates set by Ofgem.

WWU incurred £24k of additional compensation for the year ended 31 March 2019 following the decision to double the Ofgem compensation rates from July 2017. This has been included within the return together with other discretionary payments.

The data to 31 March 2019 has been extracted from table 8.3 Guaranteed Standards of Service within the 2018/19 Regulatory Reporting Pack (RRP), submitted to Ofgem on 31 July 2019 in line with Licence Condition SSC A40.

The table 8.3 is also published on the WWU website – see link below

https://wwutilities.co.uk/media/3079/2018-19-wales-west-utilities-rrp-cost-and-volumes-tables.xlsx

The forecast GSOP payments are based on a 6 year average of the costs incurred during the RIIO-GD1 price control to date.

The GSOP payments have been adjusted for tax within the return to show the net effect of the amount to be disallowed.

As per the instruction below from Ofgem, WWU resubmitted all RIIO-GD1 RRPs for the period of 2013/14 to 2017/18 removing of all associated discretionary payments.

Extract from Ofgem letter to Regulatory managers dated 22 October 2018

> *Appendix 2 (paragraph 1.3) of the RIGs states that totex excludes compensation payments made in relation to standards of performance, i.e. GSOPs. Consistent with that approach, any GSOP discretionary payment (i.e. ex gratia payments, including voluntary scheme) should also be excluded from totex. This is consistent with the approach in electricity distribution.*
>
> *To date, all GDNs have included such payments in totex. GDNs have informed us that there was an understanding that they should be included in totex but this goes against the RIGs and the practice in electricity distribution. We think it is important that the RIGs are followed, i.e. that these payments are not included in totex, so that consumers do not partially fund them. We think this should apply on a retrospective basis as well as for the remainder of the price control.*

In order to ensure the correct treatment of GSOP payments, please resubmit all RIIO-GD1 RRPs (i.e. for 2013/14 to 2017/18) by 22 February 2019. For the avoidance of doubt, compensation payments under GSOPs (discretionary or non-discretionary) should not be *included in totex. We intend to use the revised data in the 2019 annual iteration process to recover the sums erroneously included in totex to date. All future RRPs submissions should also exclude these costs from totex.*

Data Assurance Statement

This is the second year that WWU has submitted Ofgem's RFPR return and Commentary. Ofgem require that the 2018/19 submission be uploaded on the Company's website.

The 2018/19 RFPR has been completed in line with the RIGs and on this basis a full DAG process has been conducted.

Management prepared methodology statements and completed risk assessments for each RFPR table and these were provided to Internal Audit for review. All tables were subject to the requisite first line assurance i.e. data preparer, second person review, business lead sign-off and executive sign-off, and these review stages included the following checks:

- Agreeing data to already published information where possible, including the RRP, Regulatory Accounts and Consolidated statutory financial statements, where such information has already been subject to varying levels of validation and data assurance;
- Agreeing data to the underlying workbooks;
- Reperforming calculations to ensure the correct results within the tables; and
- Ensuring the commentary is aligned with the tables.

A final review has been undertaken by members of the WWU Executive team including the Director of Regulation & Commercial and the Director of Finance.

Additionally, following review of the risk assessments and discussion with management a sample of submission tables were selected for review by Internal Audit. Independent data and process audits were performed which involved detailed reviews to agree the submissions details to source data and reperforming calculations where required to ensure correct results were recorded.

Appendices

1 Reconciliation where licensees have a different statutory reporting year to the Regulatory Year

2 Enduring Value Adjustments

Appendix 1

Reconciliation where licensees have a different statutory reporting year to the Regulatory Year

For the past data where the statutory and regulatory year ends were not co-terminus WWU has referenced the audited Regulatory accounts for the years ended 31 March 2013, 2014, 2015 and 2016, such Regulatory accounts having been subject to review by WWU's auditors. From 31 March 2016 onwards the statutory and regulatory year end are coterminous.

Appendix 2

Enduring Value Adjustments

Enduring value adjustments have been entered within tab R4 – Totex and tab R9 - RAV. These adjustments have sought to apply a re-phased allowance to items within Totex, for the calculation of outperformance and to calculate the impact these adjustments would have in RAV.

The re-phased allowance is based on actual and forecast workload over RIIO GD1. The re-phasing has been applied to Capex, Repex and gas holder demolition within Opex. The purpose of the rephrasing is to account for timing differences between workload delivery forecast in final proposals compared with latest actual and forecast workload data.

Overall WWU is set to meet, or exceed, its RIIO-GD1 targets and therefore the net adjustment over the whole of the RIIO-GD1 period is forecast to be nil.

Although enduring value adjustments have been entered, a caveat should be applied given the lack of detailed guidance in this area. In addition, no enduring value adjustments have been calculated in respect of non-controllable costs and incentives which are trued up within allowed revenue on a two-year lag basis.

WWU has not applied any enduring values in relation to close out mechanisms, such as NARMs (currently NOMs for RIIO-GD1). We are not expecting to submit any further reopener claims and do not currently forecast any significant impact as a result of NARMs.