RIIO-GD2 Regulatory Financial Performance Reporting ("RFPR")

Commentary

Year ended: 31 March 2022

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Executive Summary

Regulatory Financial Performance Reporting ("RFPR") is a regulatory licence requirement pursuant to Standard Special Condition A40.[1]

This report should be read in conjunction with WWU's Strategic Performance Overview for the year ended 31 March 2022 and WWU's audited statutory accounts for the same period.[2]

A key measure of performance required by Ofgem is "RoRE" (Return on Regulated Equity). This measure is calibrated by Ofgem for two different levels of performance, one for operating performance which excludes debt financing and tax and referred to as "Operational RoRE" and the other measure which includes debt financing and tax. Each of these two measures is then calibrated for notional regulated equity and actual regulated equity. "Regulated equity" is the portion of Regulated Asset Value ("RAV") attributed to equity.

The table below includes adjustments by WWU to the Ofgem formulas calculating debt financing and tax out/under performance at notional gearing. The changes remove the tax adjustment from debt financing because other elements of out/under performance are presented gross of tax e.g., Totex, row 66; therefore, for consistency debt performance is shown gross of tax.

1 The RFPR Submission can be located on the WWU website, as required by paragraph 1.26 of the RFPR Regulatory Instructions and Guidance (RIGs), by following the link below:

https://www.wwutilities.co.uk/media/4566/2021-22-wales-west-utilities-rfpr-tables.xlsx

For further information, please refer to the WWU RIIO-GD2 Year One Strategic Performance Overview, which was submitted to Ofgem on 29 July 2022. The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/4525/wwu_riio-gd2_year_one_strategic_performance_commentary.pdf

2 WWU's audited financial statements for the year ended 31 March 2022 provide further information throughout, and are or will be shortly available using the link below:

https://beta.companieshouse.gov.uk/company/05046791/filing-history

RoRE Performance

RoRE based on Notional Regulated Equity of 40% of RAV	2021/22	2022/23	2023/24	2024/25	2025/26	GD2 Average
Allowed cost of equity	4.5%	4.6%	4.5%	4.6%	4.6%	4.6%
Totex performance, net of customer share	1.8%	-0.3%	-2.6%	-2.1%	-1.7%	-1.0%
Incentives, penalties, other items	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Operational RoRE	**6.4%**	**4.4%**	**2.0%**	**2.5%**	**3.0%**	**3.6%**
Cost of debt performance	-3.2%	-6.9%	-8.2%	-5.2%	-5.1%	-5.7%
Tax	2.4%	1.1%	2.5%	3.3%	2.9%	2.4%
RoRE including debt financing and tax	**5.6%**	**-1.5%**	**-3.7%**	**0.6%**	**0.8%**	**0.3%**

Key remarks:

- Operational RoRE for 2021/22 is 6.4%, which is 1.9% above the allowed cost of equity. However, this includes outperformance on Totex of 1.8% which is largely due to non-recurring items mainly associated with the termination of the contractual arrangements with repex contractors following WWU's decision to insource repex contractual work.
- Operational RoRE projected across GD2 at 3.6% is less than the allowed cost of equity of 4.6%, due to a 1% negative impact from Totex underperformance mainly caused by inadequate allowances for repex.
- The cost of debt performance, which includes derivatives (as required by Ofgem for performance assessment, yet Ofgem excludes derivatives when determining the allowance for cost of debt) is significantly adverse over GD2 of 5.7% of RoRE. This is due to an inadequate allowance for WWU's efficiently and prudently incurred cost of debt and derivatives.
- The tax component shows a positive contribution to RoRE over GD2 of 2.4%, largely a function of the significant underperformance on cost of debt of 5.7%.
- Overall, despite both operational and financial efficiency, WWU projects an average RoRE of 0.3% for GD2 against an average allowed cost of equity of 4.6%. This is largely due to inadequate allowances for repex and cost of debt. This adverse position impairs shareholder value and WWU's financeability and investment grade credit profile.

When RoRE is evaluated using actual regulated equity, the position across GD2 is a RoRE of 0.4%, not materially different to the 0.3% above. However, actual regulatory gearing as calculated in row 58 of table R6 – Net Debt is understated as Ofgem's RFPR assumes no new debt financing is raised post March 2022 which in turn leads to a material overstatement of RoRE. Consequently, cost of debt underperformance will likely be worse than projected as debt costs will be higher and revenues for tax would be lower due to higher tax clawback impacts from higher actual leverage and higher debt interest.

Key Financial and Operational Performance Measures

For further key financial and operational performance measures, please refer to pages 16 – 18 of WWU's RIIO-GD2 Year One Strategic Performance Overview submitted to Ofgem on 29 July 2022, for which a link is provided in footnote 1 in the Executive Summary.

Overview of Regulatory Performance

This section provides commentary for each of the tables within the RFPR submission to Ofgem in accordance with paragraph 4.3 of the RFPR RIGs.

R1 – RoRE

For information on RoRE, please refer to the Executive Summary.

R2 – Reconciliation of regulated revenue and profit to statutory revenue and profit

This table reports allowed and collected regulated revenues per the latest published Price Control Financial Model (PCFM) and reconciles collected regulated revenues to revenues in the statutory audited financial statements.

As a result of the reconciliation to revenue on R2 using the latest published PCFM (i.e., the re-published GD2 PCFM November 2021 published on 31 January 2022) in accordance with the RFPR RIGs there is a regulatory reconciling difference in row 39 of £3.4m because the latest PCFM, issued on 22 July 2022, has not been used (latest being Dry Run 1 of the 2022 Annual Iteration Process (AIP)).

Directly remunerated services revenue above the de minimis reporting threshold of £500k has been included within table 2.10 of WWU's RRP, but the reconciliation in R2 excludes alterations income of £2.1m. The remaining reconciling items of £6.0m represents other non-transportation revenue primarily related to metering services of £4.7m and £0.5m emergency works for Independent Gas Transporters.

The R2 reconciliation in RIIO-GD1 was limited to revenue. In RIIO-GD2 the R2 reconciliation extends to profits after tax, though this does not actually represent a "Reconciliation: Regulated Network Profit to Statutory Accounts" and is a simple comparison between the two.

Statutory audited EBITDA figures have been linked to the revenue and totex reconciliations within R2 and R3, respectively. Depreciation and amortisation of £84.1m and tax of £59.1m have been taken from WWU's statutory financial statements, with the net Interest in row 95 which links to R5 – Financing adjusted to include fair value swap losses of £225.3m which are included within the statutory accounts but not the RFPR. The total reconciling difference of £412.6m in row 107 reflects the overall difference in arriving at a post-tax profit/loss figure between the statutory and regulatory regimes.

R3 – Totex reconciliation

The 'Totex per the latest PCFM' section of R3 has been taken from the latest PCFM to be submitted to Ofgem by 31 August 2022, which is based on the Variable Values included within table 3.01 of WWU's RRP. Commentary in respect of Totex performance against allowances is included on pages 7 – 14 of WWU's RIIO-GD2 Year One Strategic Performance Overview for which a link is provided in footnote 1 in the Executive Summary.

The second half of R3 reflects the data from the financial statements of WWU for the year ended 31 March 2022 reconciled to reported Totex costs for the regulatory year per the RRP. The reconciliation is detailed and self-explanatory.

Enduring Value Adjustments (EVAs)

No EVA's have been identified in R3. As per the RFPR RIGs Glossary EVAs are defined as the 'true value of the regulated business over the course of the price control.' The enduring value of the business factors in the financial impact of any decisions or future events, which have yet to be reflected in Revenue and RAV but are known at the time of estimation. The enduring value represents the 'establishment of sustained long-term value to the regulatory network or to its operation.' Because of the introduction by Ofgem of a significant number of additional Variable Values in RIIO-GD2, particularly variant allowances, and the AIP allowing for these PCFM Variable Values to be updated during the course of the price control for outturn actual data as well as forecast data, WWU does not consider any EVAs currently exist. We would however welcome further guidance from Ofgem in this area.

R4 – Incentives and Other Revenue

This table reflects annual actual and forecast performance against the RIIO-GD2 price control incentives as well as Other Revenue Allowances (ORAs).

Data included within R4 – Incentives and other revenue was also included within the RRP and commentary from page 19 of WWU's RIIO-GD2 Year One Strategic Performance Overview is relevant. Absent any fixed Company Compulsory Contribution (including % contribution funded by the licensee) towards "Strategic Innovation Fund" funding it has been assumed on row 53 for forecast years that the % contribution funded by WWU will be 10%.

R5/R6 - Financing and Net Debt position

Cost of debt

In line with RIIO-GD1, WWU continues to have a significant shortfall against the cost of debt allowance for RIIO-GD2, and as noted in the Executive Summary, this reduces RoRE by 5.7%, and the main reason why overall RoRE is 0.3% compared to an allowed cost of equity of 4.6%. WWU's cost of debt including derivatives has been efficiently and prudently incurred but is not fully compensated by Ofgem.

The formula for calculating the 'Inflation in Interest Charge' reported on row 38 in R5 has been amended to reflect net debt; previously this reflected gross debt.

In table R5 the 'Cost of Debt Allowance per latest published PCFM (prior year AIP)' on row 77 reflects the values from the latest PCFM being Dry Run 1 of the 2022 AIP and not the latest published PCFM.

Leverage

WWU's average actual leverage for GD2, using Ofgem's approach (which assumes no new debt is issued) is projected at 59.3%, against Ofgem's notional leverage of 60%. WWU's projected actual leverage over GD2 is expected to be higher, notwithstanding an expected significant reduction to shareholder distributions over RIIO-GD2.

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R7 – RAV

Data reported within table R7 reflects the latest PCFM submitted to Ofgem as part of the 2022 AIP.

R8 – Taxation and Tax Reconciliation

Due to the timing of statutory filing requirements in respect of corporation tax computations and CT600 returns relative to the submission of the RFPR, there is an agreed (with Ofgem) one-year lag in the completion of the tax reconciliation sections of the RFPR, included within top half of R8 and R8a. Commentary in respect of the reconciliations will be prepared as the templates are completed from August 2023 onwards.

The forecast regulated tax liability and tax allowance included within R8 have been taken from the latest PCFM submitted to Ofgem as part of the 2022 AIP in August 2022. The regulated tax liability, and therefore tax allowance, for 2021/22 and 2022/23 have been adjusted for tax trigger events in respect of capital allowances, to reflect the introduction by the UK Government of the super-deductions, in the 2021 Budget. The forecast regulated tax liability and tax allowance (for 2023/24 and subsequent years) have also been updated for General and Special Pool Opening Balance Adjustments (OGPAt and OSRPAt respectively) to reflect the reduction required to the opening Tax Written Down Value of these regulatory capital allowances pools as at 1 April 2024, for the super-deductions claimed as part of the tax trigger events.

The tax performance in the RoRE calculation compares WWU's forecast CT600 tax liability against the tax allowance set as part of the RIIO-GD2 price control including the impact of deviating from notional levels of leverage in the form of tax clawback where RoRE is measured on actual leverage, instead of notional leverage.

R9 – Corporate Governance

Corporate Ownership (RIGs 4.13 - 4.16)

The section below on UK group structure and ultimate ownership is taken from the annual financial statements of Wales & West Utilities Ltd.

The immediate parent company is Wales & West Utilities Holdings Limited (WWUH), a private company limited by shares and registered in England and Wales with registered number 07092596. WWUH is the parent undertaking of the smallest group of undertakings to consolidate these financial statements.

The Company's ultimate parent Company is Wales & West Gas Networks (Holdings) Limited (UK), a private company limited by shares and registered in England and Wales with registered number 05095454. Wales & West Gas Networks (Holdings) Limited, the Group, has no controlling party as it is immediately owned by consortium members. Copies of the annual consolidated financial statements of Wales & West Gas Network (Holdings) Limited and Wales & West Utilities Holdings Limited may be obtained from their registered office, The Company Secretary, Wales & West Gas Networks (Holdings) Limited, Wales & West House, Spooner Close, Celtic Springs, Coedkernew, Newport, NP10 8FZ.

The shares in the ultimate parent company, Wales & West Gas Networks (Holdings) Limited, are owned equally by West Gas Networks Limited and Western Gas Networks Limited. These two companies are ultimately owned by a consortium comprising CK Hutchison Holdings Limited ("CKH") (30%), CK Infrastructure Holdings Limited ("CKIH") (30%), Power Assets Holdings Limited (30%) and CK Asset Holdings Limited (10%). The 10% shareholding previously held by the Li Ka Shing Foundation was transferred to CK Asset Holdings Limited on 21 May 2021.

No decision-making responsibilities within WWU in respect of the matters listed in paragraph 4.15 of the RFPR RIGs are reserved for any parent or group company.

Directors (RIGs 4.16)

Details of the Directors are shown below. More information on the role of the Directors and Corporate Governance Framework can be found from page 30 of the WWU statutory accounts for the year ended 31 March 2022.

All statutory corporate filings can be obtained from Companies House: https://find-and-update.company-information.service.gov.uk/company/05046791/filing-history

Andrew Hunter**	Chairman	(R)	Appointed 10 October 2012
Graham Edwards*	Chief Executive Officer	(H, R)	Appointed 1 June 2005
Dominic Chan**		(A, H, T)	Appointed 10 October 2012
Grant Hawkins***		(A, R, T)	Appointed 27 March 2014
Hing Lam Kam**		(R)	Appointed 10 October 2012
Duncan Macrae**		(A, R, H, T)	Appointed 10 October 2012
Michael Pavia***		(A, R, H, T)	Appointed 1 January 2012
Charles Tsai**		(A)	Appointed 10 October 2012

Neil Henson*	(Alternate Director to Graham Edwards)	Appointed 10 June 2013
Neil McGee**	(Alternate Director to Dominic Chan)	Appointed 10 October 2012
Wendy Tong-Barnes**	(Alternate Director to Hing Lam Kam)	Appointed 10 October 2012

(A) Member of the Audit Committee

(R) Member of the Remuneration Committee

(H) Member of the Health & Safety Committee

(T) Member of the Treasury Committee

** Executive director*

*** Non-executive director*

**** Independent non-executive director (the sufficiently independent directors in accordance with Standard Special Condition A42)*

Executive Remuneration Policies (RIGs 4.17 - 4.22)

The executive Directors' remuneration is based on their overall company responsibilities and the policy is to ensure that they are rewarded competitively by providing remuneration consisting of a basic salary, benefits and annual performance related bonus, part of which is deferred, which require the achievement of demanding performance targets designed to deliver regulatory requirements. These targets include safety, standards of service, customer satisfaction, environmental and financial and are weighted 50% based on personal targets and 50% based on corporate targets. Remuneration is at risk if deliverables are not achieved on an annual basis.

Bonuses are reviewed and approved by the Remuneration Committee (RemCo) and paid in respect of a calendar year. The performance bonus is apportioned between an amount due as a lump sum payable after the year end, and the balance payable under a long term incentive plan. The amount due under the long term incentive plan is payable three years after the year in which the award arose. The payment of the performance bonus is conditional on the director remaining in office on the payment date.

The CEO is responsible for ensuring leadership through effective oversight and review, setting the strategic direction of the business (as part of the Board). From an operational performance perspective, constantly striving to ensure the committed Price Control Deliverables within the current control period are met, whilst aiming to deliver sustainable shareholder value over the longer term.

Because executive remuneration policies are based on delivering the regulatory requirements for the year through setting safety, standards of service, customer satisfaction and financial targets, this ensures alignment with customer and stakeholder interests, the purpose, culture and values of the organisation; and long-term delivery of the licensee's strategy.

As a private limited company there is no company law requirement for CEO pay ratios to form part of WWU's remuneration policies and accordingly no comment is made as to whether

CEO pay ratios, reported for RFPR purposes only, are consistent with policies on remuneration.

The role of the RemCo is to consider and determine the terms and conditions of employment of senior management, including salary, bonus, and pension entitlements. The activities of the RemCo meetings are reported to the Board at least annually. The composition of the RemCo is outlined in the Directors section above.

The RemCo sets the performance targets at the start of the year and assesses performance against those targets on an annual basis both for personal and for corporate targets. The RemCo has the discretion to override the formulaic outcome of the annual performance targets in the event these are not seen as representative of the overall performance of the company.

Dividend policies (RIGs 4.23)

WWU has not paid dividends since its formation in 2005 and is not forecasting to pay dividends in future years due to a deficit in distributable reserves. However, shareholder loan note interest payments are made instead, and are treated as distributions for RFPR purposes because the loan notes are not treated as debt by rating agencies, senior lenders and by Ofgem for regulatory RoRE performance assessment and tax clawback purposes.

WWU made £60.0m shareholder loan interest payments in 2021/22 (2020/21 £nil) which included a £40.0m deferred interest payment due in respect of 2020/21 which had been deferred due to the Covid-19 uncertainty and to support financeability. Shareholder loan interest payments are expected to be significantly reduced in RIIO-GD2 to support financeability.

Details of shareholder loan notes are included on page 70 of the WWU statutory accounts for the year ended 31 March 2022 within Note 13 – External Borrowings.

R10 – Pensions & other activities

Pensions

During the year, the Defined Benefit section of the WWU pension scheme was closed to future accruals. This gave rise to a curtailment gain of £9.4m which has been disclosed separately in the WWU's statutory accounts as a material item.

WWU has continued to make pension deficit repair payments in line with the amounts agreed in the last valuation at 31 March 2019. The next valuation at 31 March 2022 will be completed in line with obligations with the Pension Regulator. The sum of these payments amounted to £9.0m in 2021/22 (2020/21 £9.3m).

The split of these repair payments into those amounts funded via specific allowances (pre 2013 deficit ~ the established deficit) and those funded through Totex (post 2013 deficit ~ the incremental deficit) has been consistently applied based on the 2019 valuation on a 75.7% to 24.3% split.

Other activities

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

WWU paid £409k of compensation for the year ended 31 March 2022 (2021: £241k) following the decision by Ofgem to double the compensation payments in RIIO-GD2 (WWU voluntarily doubled them from July 2017). This has been included within the RFPR.

The data to 31 March 2022 has been extracted from the Guaranteed Standards of Service within the 2021/22 RRP.

Data Assurance Statement

This is the fourth year that WWU has submitted Ofgem's RFPR template and Commentary. Ofgem require that the 2021/22 submission be uploaded on the Company's website.

The 2021/22 RFPR has been completed in line with the RIGs and on this basis a full Data Assurance Guidance (DAG) process has been conducted.

Management prepared methodology statements and completed risk assessments for each RFPR table. 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, and 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 the Director of Finance & IT.