RIIO-GD2 Year One Strategic Performance Overview

July 2022

Table of contents

Strategic performance overview

Chief Executive's update

I'm pleased to present the first report of the GD2 price control period, looking back on a challenging year for our business.

The ongoing disruption of Covid, the new relationship with the EU, the impact of the war in Ukraine and the wider economic issues have all collectively brought disruption on a scale not imagined just a few short years ago.

However, I am pleased to say that as a business we have risen to the challenge – all down to the fantastic efforts of our people. Our continued excellent delivery for customers across Wales and south west England is a testament to their efforts and something that I, alongside my leadership team are proud of.

Despite the positive performance in this last year though, we anticipate significant challenges over the rest of the price control period – not least based on the financial challenges facing the business.

At the start of GD2, we undertook a number of actions to respond to the substantial cost challenges associated with the price determination. This included a fundamental review of our work and how we do it, leading to a major organisation restructure, the insourcing of our mains replacement work and a significant headcount reduction across the business.

We also took the opportunity to update our business priorities and values. This resulted in an enhanced focus on sustainability, something all our stakeholders told us was important.

Despite the significant challenges associated with the price control we have continued to deliver excellent performance.

- **Demanding Safety Always:** We continue to respond to over 97% of gas emergencies within 1 hour, and have replaced more than 410 kilometres of old metal gas pipes in the year – further removing risk from the network. As anticipated, the cost of delivering mains replacement has increased dramatically, and this represents a continued significant challenge through the rest of GD2.
- **Driving Outstanding Service:** Funding through the Vulnerability & Carbon Monoxide Allowance has allowed us to give further support to those most in need. Working with organisations such as the Fuel Bank Foundation, we are helping more people in vulnerable situations than ever before. And on the customer service front, an enhanced drive on performance, improved our scores in the second half of the regulatory year – something that has continued into the 2022/23 year.
- **Delivering Value for Money:** Our proportion of the customer bill has stayed at £131 in year one of GD2 however unfortunately, the money we will collect from customers in 2022/23 will need to increase to £171. The disappointing news for customers here is that whilst our own charges have remained flat, the vast majority of this increase is driven by Supplier of Last Resort costs. This is the result of the unprecedented failure of numerous energy suppliers over 2021/22 year.

- **Providing Sustainable Energy:** In 2021/22 we secured the first exemption from the Health & Safety Executive (HSE) allowing us to inject gas containing with up to 1% hydrogen into our network in Swindon. Elsewhere the connection of the 20th biomethane site to our network means we have now decarbonised the annual heating demand of circa 160,000 homes.
- **Designing our Future:** Like many organisations we have been impacted by significant turnover in our people. To ensure we remain 'an employer of choice', we continue to invest significantly in the development and wellbeing of our colleagues – and in this regard are proud to retain our Investors in People Silver Level accreditation.

As we navigate a period of huge volatility in the energy sector and respond to the cost of living and, geopolitical challenges, we are also focused on the future. The threat facing us could not be starker. Earlier this year, the United Nations Intergovernmental Panel on Climate Change (IPCC) reported that 'time was running out' to reverse climate change, with around 40% of the world's population 'vulnerable' to its impacts. Responding to this by reducing carbon emissions will impact much of what we do as a country, and as a company – from the gas we transport through our network, to transitioning our fleet to electric and hydrogen vehicles.

We are committed to doing everything we can for the customers we serve to meet the Net Zero carbon emission target in the most efficient, and least disruptive way possible. This includes an ambition to deliver a Net Zero ready network by 2035 (subject to funding) - so our network is ready to transport green gases like hydrogen and biomethane to allow us to play our part in decarbonising heat, power, and transport.

Research and development projects we have undertaken in 2021/22 have helped our understanding of the implications of the energy transition for our communities - building the evidence base for hydrogen conversion and understanding the implications for consumers. This includes partnering with Northern Gas Networks on the Redcar Hydrogen Community, supplying around 2,000 homes and businesses with green hydrogen from 2025.

Looking ahead, we expect to face continued challenges, not least in terms of our financial performance. Our 2021/22 Totex outperformance is driven by one-off cost reductions resulting from a number of significant business initiatives in the first year of the new control period – something that will not be repeatable for the rest of the period, as well as some work deferred into later years of the price control.

Of continued concern is the increase in costs we are experiencing across all parts of the business - well in excess of inflation. In the past twelve months for example the cost of pipe has increased by 43% and fittings by 54%. Such significant cost increases, coupled with the challenge which already existed as a result of the price determination itself makes delivery against GD2 allowances extremely challenging. All this influenced our decision to appeal to the Competition & Markets Authority against the determination.

Despite the significant uncertainties ahead, we will endeavour to do all we can to continue to delivery for the communities we service.

Graham Edwards – Chief Executive

Board Statement

We are pleased to share our report on the first year of the new regulatory control period, RIIO-GD2. 2021-22 has seen several challenges – the continued global pandemic, and political and economic shocks. The year saw the implementation of a number of actions, including an organisational restructure and contract insourcing to make sure Wales & West Utilities are ready to face these challenges, as well as continue to meet the needs of customers within the GD2 price control.

As a company serving both England and Wales, we continue to act in accordance with all Government advice on Covid-19, from both the UK and the Welsh Governments. The safety of our customers and colleagues is our top priority and at times, the difference in approach between the Government's has led to difficulty in our operation and internal communications.

As a Group we continue to strive towards our ambition to be '*Trusted to expertly serve customers and communities with safe, reliable and affordable energy services today, whilst investing wisely to create a sustainable, greener future.'*

The role and effectiveness of the Board

Our Board is responsible for ensuring leadership through effective oversight and review. Supported by its principal committees – Audit, Health & Safety, Remuneration and Treasury – the Board continues to set the strategic direction and aims to deliver sustainable shareholder value over the longer term. The work of the Board complements, enhances and supports the work of the Executive Committee and Wales & West Utilities leadership team.

We believe that effective governance is realised through leadership and teamwork and collaboration across all levels within the Board structure drives a culture of continuous improvement. Operating performance is managed on a daily basis by the local Executive and leadership team who are committed to meeting GD2 price control deliverables, and delivering what customers want and need.

Andrew Hunter

Chairman

Performance Summary

Our key deliverables for customers are set out below and discussed in further detail in the supporting sections.

Totex Performance

Our annual performance is documented below; we are currently £43.0m (16.7%) underspent against adjusted allowances[1] in year 1, however, over the duration of the price control we expect to overspend the adjusted allowances[1] by £30.0m (2.4%).

We explain the current year outperformance through this section; however, this year cannot be viewed in isolation with our overall performance spread across the 5 years and our price control deliverables being cumulative targets.

We move into the 5-year position following the 1 year performance section.[2]

Our key messages for our year 1 outperformance are:-

- This outperformance is not repeatable, with many one-offs in the year
- Organisational changes have been embedded
- Increased utilisation of our workforce has reduced costs for customers
- We have received allowances in year 1, yet some work is not planned to commence until Year 2

TOTEX PERFORMANCE (18/19 prices)	
	£m
Opex	85.5
Repex	71.8
Capex	56.8
Totex	**214.1**
Allowance	**256.0**
Out/(Under) Performance	**41.9**
% Performance	**16.4%**
Reopener Adjustment	1.1
Adjusted Allowance[1]	**257.1**
Out/(Under) Performance	**43.0**
% Performance	**16.7%**

[1] Adjusted Allowances is our assumption of allowances uplifted for reopeners assumed at 100% recovery matched to costs included in the forecasts and actuals. In the year which they are incurred – not the revenue reopener windows.

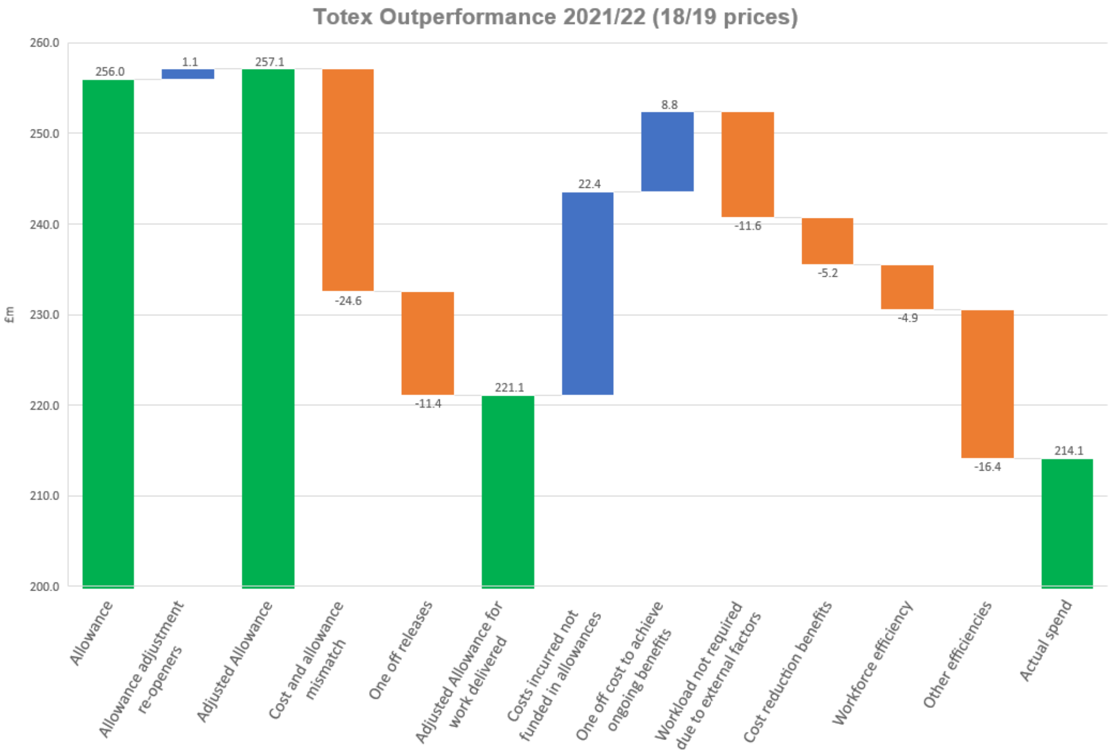
[2] Commentary included in this document is provided against total Opex, Repex & Capex allowances. This is due to the disaggregation of allowances by Ofgem in the Final Determinations only being available at this level, therefore limiting any detailed commentary against these. We are currently waiting on Ofgem to disaggregate allowances across the price control, and these will be included in future years submissions.

All prices are reported in 2018/19 prices (unless stated otherwise).

Our true underlying position

The waterfall below shows our true underlying position for year one. It recognises that a large part of our apparent year one outperformance relates to work not yet delivered and one-off contract releases which are not repeatable.

On an adjusted basis, a fair comparison of our out-performance is an adjusted allowance of £221.1m (third total bar in green) compared to our actual spend of £214.1m (fourth total bar in green), a £7.0m outperformance. The sections below explain each bar in the waterfall graphic from left to right.



GDNs have not received disaggregated totex allowances from Ofgem. The identification and categorisation of our performance is on a best endeavours basis.

Allowance adjustment: re-openers (£1.1m) recognises that our actual spend includes £1.1m of cost relating to large load connections which we expect to contribute to the reopener mechanism, we have neutralised the over/underperformance in the year. *(Ofgem category: not applicable)*

Cost and allowance mismatch (£24.6m) represents allowances in year 1 but the cost is now expected to be incurred in later price control years. This includes:

- Our high-pressure pipeline replacement project, HN039, which will be delivered in future years in a different phasing to our allowances
- A different phasing of cost compared to the assumptions for our "Use it or Lose it" allowances, costs which will be incurred in future years
- A favourable volume variance on mains replacement. We still have this work to deliver in future years of the price control

- A delay in year 1 vehicle spend into year 2 due to supply issues and purchasing lead times. These vehicles are on order, and we will incur this cost next year.

(Ofgem category: External factors 20%, Provision in the price control settlement 80%)

One-off releases (£11.4m) include two one-off contractual benefits as a result of the closure of the RIIO-GD1 Mains Replacement Contract. These are:

- The Alliance contract pain/gain mechanism which protected WWU and consumers from price increases for the first 3 months (to 30th June 2021) at which point the contract ceased and we brought in house mains replacement delivery.
- The release of unutilised contract provisions on closure of the Alliance contract

(Ofgem category: External factors 100%)

Costs incurred not funded in allowance (£22.4m) represents specific areas of totex spend that are outside of our totex allowance. This includes:

- A significant adverse price variance on mains replacement given the price increases and cost pressures we have experienced, which are in excess of the allowances awarded.
- The cost of building our new Bristol depot which was not part of our business plan
- An increased cost base above allowances of delivering our strategic investment in IT and cyber

(Ofgem category: Provision in the price control settlement 100%)

One-off cost to achieve ongoing benefits (£8.8m) includes the cost incurred in 2021/22 of carrying out a voluntary severance exercise, resulting in 126 employees leaving the business.

(Ofgem category: Efficiency 100%)

Workload not required due to external factors (£11.6m) represents factors outside the control of GDNs and unforeseeable at the time of setting the price control, including weather and economic conditions. This includes:

- A milder winter leading to reduced leakage and maintenance volumes. This has allowed us to utilise our workforce on other activities such as metering and mains replacement to ensure that productivity is maintained and displacing contractors who we would have otherwise used.
- A downturn in customer connections work, with volumes lower than included in our allowances.

(Ofgem category: External factors 65%, Provision in the price control settlement 35%)

Cost reduction benefits (£5.2m) includes the estimated savings of closing the Defined Benefit section of the pension scheme to future accrual in July 2021 with the existing Defined Contribution section of the scheme now in place across the organisation.

(Ofgem category: Efficiency 100%)

Workforce efficiency (£4.9m) represents non-Regulatory work (Metering and third party work) where we have targeted the productivity of our workforce, especially our Emergency First Call Operatives (FCO's) who are required to maintain a headcount sufficient to manage the demand of a 24-hour emergency service, requiring FCOs to be on call 24/7/365 in case they are required to respond to an emergency across our network. In order to mitigate potential non-productive time, FCO's are delivering Metering work, Repex purge and relights and surveys to ensure the necessary, but unproductive element of their role is utilised on value adding activities where

possible. Third party contracts are short term, not guaranteed contracts which end within the RIIO-GD2 period.
(Ofgem category: Efficiency 100%)

Other efficiencies (£16.4m) includes incremental cost reductions across totex. As we have not received disaggregated allowances from Ofgem, there are some allowances and costs that we are not able to directly attribute to drivers of cost reduction or overspend. Equally, any differences due to allowances being calculated on a top-down econometric model basis are included here.
(Ofgem category: Efficiency 100%)

Totex Forecast

Our forecast totex performance for RIIO-GD2 is displayed below. As mentioned in the totex annual performance section all totex spend needs to be looked at in conjunction with the 5-year allowances.

Our key messages with this 5-year forecast are:

- Year 1 outperformance is not repeatable
- Phasing of work not completed in year 1 will mean future years are overspent
- There are a number of cost pressures we are experiencing above the cost of real price effects
- We are forecasting to overspend the 5yr allowances by 4.6% which reduces to 2.4% after reopener adjustments

	Actual	Forecast	Forecast	Forecast	Forecast	
	2021/22	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**Total**
Opex	85.5	87.7	101.2	102.9	100.9	**478.1**
Repex	71.8	108.6	105.5	103.5	103.8	**493.3**
Capex	56.8	59.3	72.3	62.2	55.7	**306.3**
Totex	**214.1**	**255.7**	**279.1**	**268.5**	**260.4**	**1,277.7**
Allowance	**256.0**	**251.9**	**237.9**	**237.0**	**238.3**	**1,221.2**
Out/(Under) Perf.	**41.9**	**(3.7)**	**(41.1)**	**(31.6)**	**(22.0)**	**(56.5)**
% Perf.	**16.4%**	**(1.5%)**	**(17.3%)**	**(13.3%)**	**(9.2%)**	**(4.6%)**
Reopener Adjustment	1.1	5.6	7.7	6.9	5.3	**26.6**
Adjusted Allowance	**257.1**	**257.5**	**245.7**	**243.9**	**243.6**	**1,247.7**
Out/(Under) Perf.	**43.0**	**1.9**	**(33.4)**	**(24.7)**	**(16.8)**	**(30.0)**[3]
% Perf.	**16.7%**	**0.7%**	**(13.6%)**	**(10.1%)**	**(6.9%)**	**(2.4%)**

Performance in totex over the price control is forecast to be overspent by £56.5m (4.6%) against the allowances.

Reopeners

The 'Adjusted Allowance' category above includes an uplift for reopeners, assumed at 100% recovery matched to costs in the year which they are incurred – not the revenue reopener windows.

There are a number of reopeners within this price control which we have rated as a high probability of triggering a submission:

Cyber resilience OT and IT non-baseline – we have a clear plan to improve the cyber resilience of our network with a combined cost of c.£10m across the price control.

Diversions and loss of development claims - We continue to receive requests for significant projects that meet the criteria of the development claim re-opener, with our RIIO-GD2 total spend now forecast at c.£9m. This includes several significant development claims

[3] This table does not adjust for Volume Drivers, which reduce our future revenues by £20.2m due to under delivery against workload volumes allowed in our Final Determination. This is explained on the following page.

within the year relating to Transport for Wales train-line adaptations which result in us diverting our mains network at our cost.

New Large Load Connections – we have a list of new power generation or non-domestic connections which fall within this reopener, currently forecast at £6.8m across the price control.

HSE policy reopener – we continue to monitor closely the impact of changes to fatigue management on our business.

We are monitoring the likelihood and impact of each reopener on a monthly basis and have rated others as medium or low likelihood based on our current view after year one, albeit recognising this may change as the price control progresses.

Our Adjusted Allowance recognises our re-opener forecast spend of £26.6m for which we expect to receive a corresponding increase in allowances. This will reduce our overspend against the allowances to £30.0m (2.4%) across the price control.

Volume Drivers

Volume Drivers will reduce our future revenues by £20.2m due to under delivery against workload allowed in our Final Determination. Our volume drivers are:

- Fuel Poor Network Extension Scheme volume driver
- Domestic Connections volume driver
- Tier 2A mains and services replacement volume driver

Our workload forecasts show a significant reduction to Domestic Connection and Fuel Poor Network Extension Connection workloads. Using the calculation set in the price control, this will result in a £20.2m reduction to revenue.

Drivers of our Totex under-performance

There are three key areas which are driving totex deterioration over the next four years of the price control; Cost pressures, IT and Cyber costs, and Large load connections.

Cost pressures

We continue to experience significant cost pressures across all of our major cost categories including:

Contract Labour – the contractor market impacting mains replacement continues to be turbulent, with teams leaving and joining on a weekly basis. Our contract partners are not only being approached by other GDNs, but also by other industries (electric, water and telecoms).

WWU industrial staff – we have experienced a 7% churn of industrial staff which is unlike anything we have seen previously, creating a skills drain and programme disruption. We have revamped all of our recruitment and retention processes, but we continue to see our staff leave - and of particular concern is the move of labour out of our industry completely.

Pipe and fittings – We have seen a staggering 43% increase in the price of pipe over the 12-month period, and a similar 24% for fittings. Since 1st April 2022 a further 54% of price increases have already been incurred for pipe, 41% for fittings, with further contractual price increases post 1st September 2022 not yet known. There are very few pipe and fittings producers, limiting our competitive opportunity to keep costs down.

Reinstatement – the labour and material price increases have been too high for our outsourced reinstatement contractors to bare and are above the cost of real price effects also.

We continue to competitively tender for contracts to ensure we get the best value for money through the work we deliver however these contracts are significantly higher in cost due to the above mentioned.

General increases – we are experiencing a number of increases associated with general operating costs such as fuel prices and vehicle hire along with increases in service contracts in areas such as Property Management and Training, as the cost of living and material prices increase rapidly.

All of these cost pressures are only increasing as we continue into 2022/23, however we have taken some bold steps over the last two years to actively mitigate these including:

- Full review and rationalisation of the organisational structure right across the back office, operational support and front-line management structures. For instance, a one-off voluntary redundancy scheme was carried out in readiness for this tough price control, and the inclusion of best practice FLMs (First Line Managers) in the new operational organisational structure is providing tangible benefits.
- Transitioned to an in-house managed Mains Replacement programme. With a larger direct labour workforce and greater control of all spend categories, we now have better visibility and flexibility to tackle issues as they arise. This also reduced the cost of contractor fees and associated costs.
- The introduction of a financial incentive scheme across operations, focused on driving and rewarding our staff for incremental operational productivity and efficiencies.
- Increased recruitment, the continued use of apprenticeships and escalated training. Unlike others in our industry, we have a long term five year CPI-H linked pay deal agreed which provides our employees with certainty over their pay terms for the whole of RIIO-GD2.
- Continued commercial retendering and negotiation of key contracts that drive our cost base including reinstatement, pipe and fittings, traffic management and plant hire.

Even after all this our forecasts show an increasing cost base and further cost pressures to come.

Business Operations

IT & Cyber – Continuation of our strategic investment to deliver consistent integrated business processes, built upon a suite of next generation SAP S/4 HANA products matched to our business needs. Further investment is planned over the coming years to ensure our systems continue to be suitable to operate efficiently and effectively.

Our ongoing management of the risk of interruption or Cyber-attack progressed in 2021/22 and continues into future years going above and beyond delivery of the investment set out in our agreed Roadmap for Cyber IT and OT.

Workload Forecast

Our Forecast workload for RIIO-GD2 is displayed below, as mentioned in the totex annual performance section all workload forecasts need to be looked at in conjunction with the 5 year workloads and deliverables.

Our key messages with this 5 year workload forecast are;-

- Our workload forecasts are broadly in line with our business plan
- We plan to achieve workloads linked to price control deliverables for GD2
- We continue to see a downturn in the number of connections including a reduction in Fuel poor connections
- The small shortfall of mains replacement workload in Yr1 is forecast to recover in future years
- Mains and service condition reporting follows the assumption of an 'Average' winter

Summary Workload Forecast - RIIO GD2							
	Actual 2021/22	Forecast 2022/23	Forecast 2023/24	Forecast 2024/25	Forecast 2025/26	Total	Ave
Mains condition reports	4,105	4,734	4,734	4,734	4,734	**23,040**	**4,608**
Service condition reports	5,779	5,678	5,678	5,678	5,678	**28,490**	**5,698**
No. of holders removed	0	0	3	0	0	**3**	**1**
Mains reinforcement	15km	22km	22km	22km	22km	**103**km	**21**km
New housing services	3,008	2,715	2,500	2,000	500	**10,723**	**2,145**
Existing housing services (excl Fuel poor)	3,628	3,400	3,200	3,000	2,800	**16,028**	**3,206**
Fuel poor services	1,177	550	300	200	100	**2,327**	**465**
Governor intervention*	26	0	0	0	0	**26**	**5**
T1 length decommissioned	282km	339km	315km	315km	315km	**1,567km**	**313km**
T2a length decommissioned	2km	0km	0km	0km	0km	**3km**	**1km**
T2b length decommissioned	11km	17km	38km	38km	38km	**143km**	**29km**
T3 length decommissioned	0km	1km	3km	3km	3km	**11km**	**2km**
Diversions decommissioned	24km	24km	24km	24km	24km	**122km**	**24km**
Steel length decommissioned	59km	57km	43km	43km	43km	**244km**	**49km**
Other length decommissioned	34km	18km	29km	29km	29km	**139km**	**28km**
No. of services transferred	12,168	18,329	17,503	17,503	17,503	**83,007**	**16,601**
No. of services re-laid	14,010	18,329	18,117	18,117	18,117	**86,691**	**17,338**

*We believe governor intervention should be 1 as per RRP table 5.05 – this will be raised with Ofgem to clarify post submission"

Our forecasting considers our business plan workload, the final proposals and then overlays our best view of workloads. We utilise customer quotes, asset management systems and mapping data to inform our forecast each year. We fully intend to achieve workloads linked to price control deliverables for GD2.

Outputs and incentives

RIIO-GD2 Outputs summary

The following table sets out our current view of delivery of the RIIO-GD2 outputs by the end of the price control.

Our key messages with this 5 year outputs forecast are:

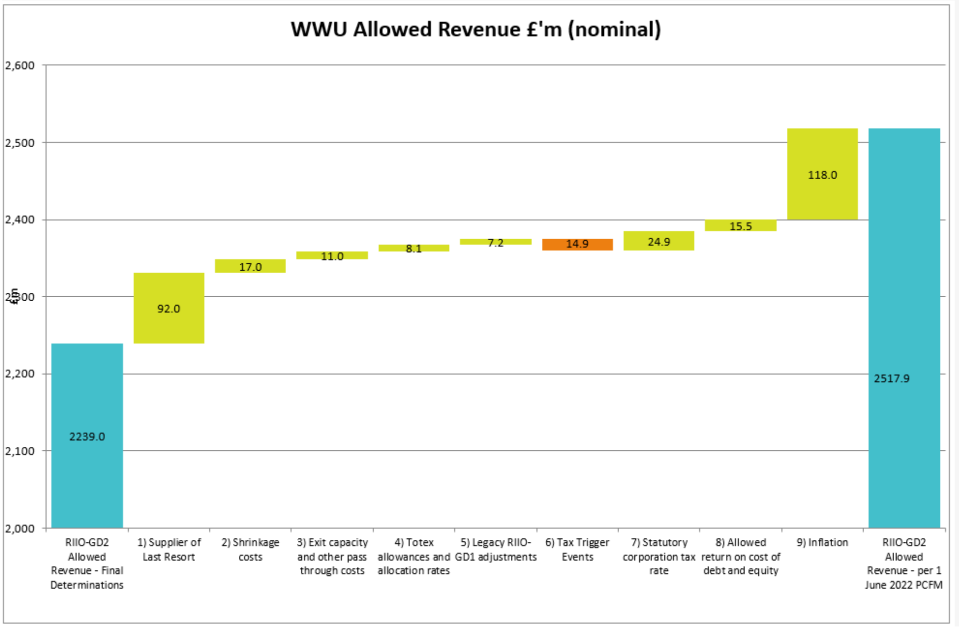
- We are on track and forecasting to meet all outputs
- However, we continue to see a downturn in Fuel Poor connections
- Ambitious plans are in place to support delivery of our environmental action plan

Output category	Output	5yr RAG
Meeting the needs of consumers and network users	Consumer vulnerability minimum standards	
	Fuel poor connections (no.)	
	Complaints metric	
	Guaranteed standards of performance	
	Emergency response - 97% controlled gas escapes	
	Emergency response - 97% uncontrolled gas escapes	
	Loss of supply – number of unplanned interruptions	
	Loss of supply – duration of unplanned interruptions	
	Loss of supply – number of planned interruptions	
	Loss of supply – duration of planned interruptions	
	Planned interruptions survey (score out of 10)	
	Emergency response and repair survey (score out of 10)	
	Connections survey (score out of 10)	
Maintaining a safe and resilient network	Repex – tier 1 mains replacement	
	Repex – tier 1 services	
	Capital projects	
Delivering an environmentally sustainable network	Shrinkage and environmental emissions	
	Biomethane connections information	
	Environmental action plan and annual environmental report	
	Business Carbon Footprint (BCF) reporting	
	Carbon monoxide awareness	
	Introduce distributed gas entry standards (scmh connections)	

Financial performance

Allowed revenue versus allowance

Our allowed revenue performance for RIIO-GD2 is set out below, between Final Determinations and the latest PCFM published by Ofgem on 1st June 2022. This shows a nominal increase in allowed revenue of £278.9m across the price control.



1. **Supplier of Last Resort** - Unprecedented increases in wholesale global gas prices has led to many more suppliers than usual exiting the energy market during 2021.
2. **Shrinkage costs** - The unprecedented increases in wholesale global gas prices over the past twelve months.
3. **Exit capacity and other pass-through costs** - Exit capacity charges have increased since Final Determinations as periodically confirmed by National Grid, resulting in additional Allowed Revenue over RIIO-GD2 of £8.6m, with other pass-through costs increasing by £2.4m.
4. **Totex allowances and allocation rates** - Changes in totex allowances and allocation rates between Final Determinations and the 1st June 2022 PCFM published by Ofgem result in increased Allowed Revenue, partly impacted by the removal of Ofgem's estimate of ongoing efficiency by 0.2% p.a. following the Competition and Markets Authority's Final Determination of the RIIO-GD2 appeals in November 2021
5. **Legacy RIIO-GD1 adjustments** - Net overall RIIO-GD1 adjustment arising from legacy adjustments and final Allowed Revenue position for 2020/21. Further legacy adjustments in respect of the RIIO-GD1 close out consultation published on 14th April 2022 are expected.
6. **Tax Trigger Events** - The Tax Trigger Events relate to changes to the statutory capital allowances regime introduced by the UK Government in the 2021 Spring

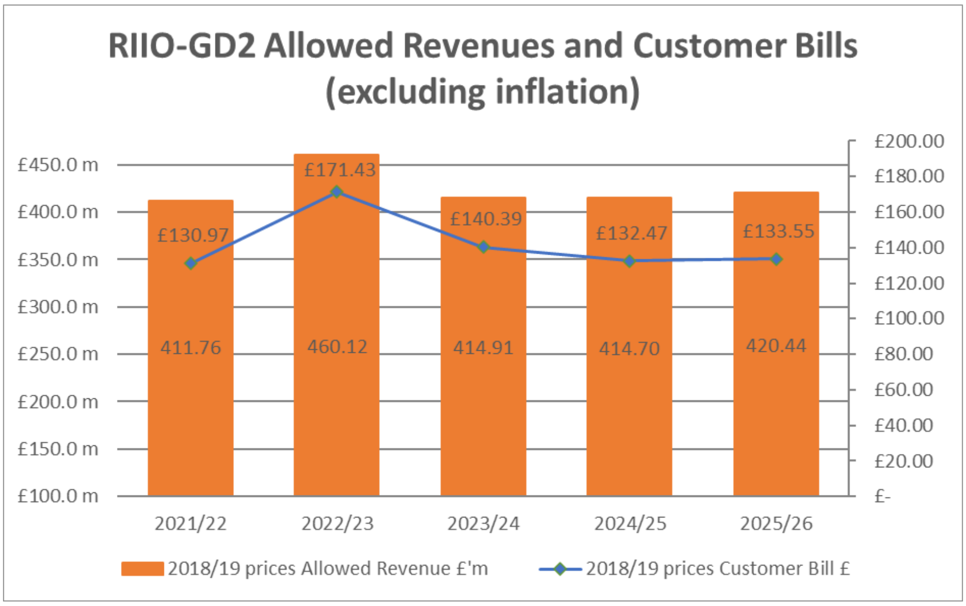
Budget, to introduce super-deductions of 50% and 130% in 2021/22 and 2022/23 for expenditure on special rate and general pool assets respectively. These adjustments reduce Allowed Revenue over RIIO-GD2.

7. **Statutory corporation tax rate** - The UK Government announced in the 2021 Spring Budget that the mainstream rate of corporation tax would increase from 19% to 25% with effect from 1st April 2023.
8. **Allowed return on cost of debt and equity** - Following the Competition and Markets Authority's Final Determination of the RIIO-GD2 appeals in November 2021, the removal of the outperformance wedge of 0.25% on the cost of equity increases the cost of equity allowance by £12.5m. There is also a relatively small increase in the cost of debt allowance of £3m.
9. **Inflation** - Significant increases in actual and forecast inflation since Final Determinations to 1st June 2022 has resulted in additional Allowed Revenue over RIIO-GD2. In RIIO-GD2, both debt and equity returns are indexed, so these numbers will likely change annually.

Company view of customer bills

Customer bill movements fall into two elements; movements in our "Allowed Revenue" and changes in customer numbers and volumes of gas flowing through our network each year i.e., if there is an increase in the number of customers, then the revenue to be collected from each customer will decrease.

As the annual quantity of customer numbers and volumes is expected to remain broadly consistent across RIIO-GD2 (with domestic customer base forecast to increase, and the average gas used by each customer forecast to decrease), the change in estimated and actual customer bills is due to the current volatility within the gas market as a whole. Supplier of Last Resort Payments, exit capacity costs and wholesale gas prices are the main elements that impact Allowed Revenue and therefore customer bills.



Customer bills will increase by £40 from £131 to £171 between 2021/22 and 2022/23.

The majority of the increase, over £39, is attributable to non-controllable Opex; with Supplier of Last Resort around £30 of the total. Shrinkage cost increases, as a result of unprecedented wholesale gas prices represents £7 of the balance, with other non-controllable Opex the remaining £2.

Other smaller differences arise in respect of totex and cost of debt and equity allowances following the Competition and Markets Authority's Final Determination of the appeals in respect of RIIO-GD2.

Customer bills are forecast to fall significantly by £31 in 2023/24 as the Supplier of Last Resort charges experienced in 2022/23 are expected to be non-recurring. A further reduction to 2024/25 is expected due to the 2023/24 Supplier of Last Resort charges estimated at £8 per customer bill falling to minimal amounts from 2024/25.

Below is a walkdown of customer bills over the period excluding the supplier of last resort costs and exit capacity.

Walkdown of domestic customer bills excluding SoLR and Exit Capacity (18/19 prices)	2021/2022	2022/2023	2023/2024	2024/2025	2025/2026	RIIO-GD2 average
Total customer bills	£130.97	£171.43	£140.39	£132.47	£133.55	£141.76
Exclude SoLR element	£0.00	-£29.82	-£7.91	£0.00	£0.00	-£7.55
Exclude Exit Capacity	-£6.31	-£11.80	-£11.02	-£9.41	-£10.36	-£9.78
Customer bills excluding SoLR and Exit	£124.67	£129.81	£121.46	£123.06	£123.19	£124.44

Innovation and futures

At Wales & West Utilities, we are committed to doing everything we can to help our network and our customers meet Net Zero carbon emissions in the most efficient, least disruptive way possible. The projects we have undertaken in 2021/22 have helped increase understanding of the implications of the energy system transition for our communities; build the evidence base for managing hydrogen conversion; and understand the opportunities and implications for consumers.

Our key messages within this section are:

- We are undertaking a range of activities and projects to deliver a Net Zero energy system and support customers through the transition
- Our team participates in national programmes to support key programmes such as research and trials of hydrogen, alongside work focussed on options for the communities we serve
- We work with partners across the industry and use our strategy and priorities to guide our activity

Summary of innovation activity

In 2021/22 we invested £1.4m combined NIA and CNIA (2020/21: £1.1m) funding on 32 (2020/21: 36) Network Innovation Allowance (NIA) projects. We also secured Strategic Innovation Funding (SIF) to invest in a Round One Discovery Phase project. We used the Net Zero and Reopener Development 'Use it or lose it' allowance to support the development of an Outline Feasibility project for a hydrogen village trial, which is now informing our joint work with NGN on development of the Redcar Hydrogen Community.

Our "Network Innovation Annual Summary" details how we, alongside our innovation partners, and through collaboration with other networks, have delivered innovation projects during the first year of the new price control (the annual summary is available to read on our website).

Focus in the first year of the new price control has been channelled into developing a robust and balanced portfolio of Net Zero & Vulnerable Customer projects, that aligns with our strategy and priority areas and reflects the urgency in meeting decarbonisation targets and changes in funding direction.

Our strategic themes are prioritised and woven through organisational culture, embedded in our business plan, the collaborative Energy Network Association (ENA) strategy, and our work with partners and UK Research and Innovation (UKRI) on the annual SIF challenges.

Our strategically aligned project portfolio will progress our net zero strategy with research, evidence, and initial projects that pilot innovative solutions and demonstrate the critical role of gas networks in achieving net zero.

Strategic Themes and Priorities

Our innovation strategy is guided by the themes and priorities we have identified to safely and securely deliver the Energy System Transition, support our customers, and protect the environment. We developed our thinking in our RIIO-GD2 business plan and the Energy Networks Innovation Strategy and have also identified priority areas for our network. These are communicated with our innovation stakeholders, for example through our annual innovation report, to help guide future activity.

Our Business Plan (this can be downloaded from our website)

- Meeting the needs of consumers and network users; support projects that bear uncertainty or where benefits are valid to society but difficult to commercialise
- Delivering an environmentally sustainable network; deliver customer benefits and provide the lowest cost pathway to heat decarbonisation
- Maintaining a safe and resilient network; support projects that help our business to adapt to a changing environment that will be fit to provide energy for generations to come

The ENA Strategy (this can be downloaded from the ENA website)

- Data and Digitalisation
- Flexibility and Market Evolution
- Net Zero and the Energy System Transformation
- Optimised Assets and Practises
- Supporting Consumers in Vulnerable Situations
- Whole Energy System

Our Priority Areas

- Hydrogen: this includes the role of hydrogen at blended and 100% levels e.g., research, evidence building, practical demonstration and delivery of commercial solutions such as through the development of **hydrogen village trials**
- Data and Modelling; future evidence for forecasting and capacity, sharing of data, alongside data to support local area planning particularly in reference to **Regional Decarbonisation Pathways** and projects using our **Pathfinder whole systems model**
- Transport: understanding and exploring the role of gas in transport and investigating fuel choices, particularly our own fleet, to provide consumer choice and fuel solution options, particularly around hydrogen. This work has included our **Hypark** project.
- Consumer Heating Solutions: exploring consumer options for use of hydrogen to support hybrid heat development such as our **Hycompact project**
- Biomethane; includes new production capacity on our network including through the **Biomethane Study project**

Further details on these projects and other activity are provided in the “Future of energy and Innovation” section of this document. We have a strong pipeline of projects to build on this work and are working collaboratively with other network licensees and wider stakeholders to develop this further and deliver against our strategic themes and priorities.