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

Commentary

Year ended: 31 March 2023

WALES&WEST UTILITIES

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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 2023 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.

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%	5.3%	5.2%	5.3%	5.0%
Totex performance, net of customer share	2.2%	0.0%	-3.3%	-1.8%	-1.7%	-1.0%
Incentives, penalties, other items	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Operational RoRE	**6.8%**	**4.6%**	**2.1%**	**3.5%**	**3.7%**	**4.1%**
Cost of debt performance	-1.5%	-6.0%	-8.3%	-9.1%	-12.4%	-7.5%
Tax	1.8%	0.6%	1.3%	2.5%	2.4%	1.7%
RoRE including debt financing and tax	**7.2%**	**-0.8%**	**-5.0%**	**-3.0%**	**-6.2%**	**-1.7%**

1 The RFPR submission can be located on WWU's website, as required by paragraph 1.26 of the RFPR Regulatory Instructions and Guidance (RIGs), by following the link below in the "Reguatory Accounts" folder of the "Our Performance" section:

https://www.wwutilities.co.uk/about-us/publications/

For further information, please refer to WWU's RIIO-GD2 Year Two Strategic Performance Overview, which was submitted to Ofgem on 31 July 2023 together with the RRP. The link to this report on the WWU website is as follows:

https://www.wwutilities.co.uk/media/4840/2022-23-wwu-strategic-performance-commentary.pdf

2 WWU's audited financial statements for the year ended 31 March 2023 provide further information throughout, and are available using the link below:

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

Key remarks:

- Operational RoRE projected across RIIO-GD2 at 4.1% is less than the average projected allowed cost of equity of 5.0%, due to a 1% negative impact from totex underperformance mainly caused by inadequate allowances, and despite efficient spend.
- The cost of debt performance, which includes derivatives (as required by Ofgem for performance assessment) is significantly adverse over RIIO-GD2 of 7.5% 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 RIIO-GD2 of 1.7%, largely a function of the significant underperformance on cost of debt of 7.5%.
- Overall, despite both operational and financial efficiency, WWU projects an average RoRE of negative 1.6% for RIIO-GD2 against an average allowed cost of equity of 5.0%. This is largely due to inadequate allowances for repex, capex 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 RIIO-GD2 is a RoRE of negative 1.3%, not materially different to the negative 1.6% above.

Key Financial and Operational Performance Measures

For further key financial and operational performance measures, please refer to pages 8 – 20 of WWU's RIIO-GD2 Year Two Strategic Performance Overview submitted to Ofgem on 31 July 2023, 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 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 for Allowed Revenue on row 11, but the latest PCFM for Collected Regulated Network Revenue on row 24, RRt reconciling items arise on rows 39 and 41, respectively.

Directly remunerated services included within table 2.09 of WWU's RRP have been included in R2 to the extent the values represent revenue as reported in WWU's audited statutory accounts. Some alterations income included in the RRP does not feature in R2 because it is reported outside of revenue for statutory purposes and therefore does not constitute a reconciling item. The remaining reconciling items on row 37 "Non Regulated Revenues (excluding Directly Remunerated Services and De Minimis above)" primarily relates to metering services.

A significant reconciling item in 2022/23 is Supplier of Last Resort (SoLR) revenue of £95.9m. SoLR revenue constitutes a reconciling item because it is included within allowed/collected regulated revenues but for statutory reporting purposes SoLR revenues and costs are presented net within turnover.

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.

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 29 September 2023, which is based on the Variable Values included within table 3.01 of WWU's 2023 RRP. Commentary in respect of Totex performance against allowances is included on pages 8 – 20 of WWU's RIIO-GD2 Year Two 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 2023 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 Totex 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 2022/23 RRP.

For 2021/22, data for Carry Over RIIO-1 Network Innovation Allowance (CNIA) and Strategic Innovation Fund (SIF) have been taken from the 2021/22 RRP submission. This is due to the functionality of the RRP tables and there being no data submitted relating to these Other Revenue Allowances within the 2022/23 RRP submission.

The Vulnerability and Carbon Monoxide Allowance (VCMA) is included within Other Revenue Allowances of the PCFM. There has been a significant increase in this allowance based on revised planned spend and updates to the VCMA Expenditure Cap. Further information is included in WWU's RIIO-GD2 Year Two Strategic Performance Overview. Absent VCMA's inclusion within the ORA section in R4, it is therefore not included within RoRE for performance assessment purposes.

Company Compulsory Contribution (including % contribution funded by the licensee) towards "Strategic Innovation Fund" funding on row 53 for forecast years is assumed to be 10%. Compared with the prior year's RFPR submission, SIF for 2022/23 has reduced due actual SIF approved being lower than forecast and because forecast SIF for future years is no longer included within the RRP.

Network Innovation Allowance (NIA) has increased for the second half of RIIO-GD2 partly relating to re-phasing of the allowance and partly due to an increase in projects expected which in turn impacts the allowance.

R5/R6 - Financing and Net Debt position

Cost of Debt (excluding derivatives)

WWU continues to have a significant shortfall against the Cost of Debt allowance for RIIO-GD2. WWU's cost of debt has been efficiently incurred but is not fully compensated for by the methodology used by Ofgem for calculating Allowed Cost of Debt. As noted in the Executive Summary, this reduces RoRE by 7.5%, and is the main reason overall RoRE, based on notional gearing, is negative 1.6% compared to an allowed cost of equity of 5.0%.

Whilst the RFPR submission includes listed shareholder loan note debt beyond 2022/23, it should be noted that WWU intends to repay these loan notes in October 2023 via shareholder cash equity injection[3].

R7 – RAV

Data reported within table R7 reflects the Latest PCFM submitted to Ofgem as part of the 2023 AIP.

R8 – Tax

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 2023 AIP in September 2023. The PCFM includes adjustments to Variable Values updated following the 2022/23 RRP submission. WWU's AIP 2023 PCFM Dry Run 1 Commentary and RIIO-GD2 Year Two Strategic Performance Overview includes detailed commentary in respect of the updates to actual and forecast values.

The regulated tax liability, and therefore tax allowances, for 2021/22 through 2025/26 have been adjusted for tax trigger events in respect of capital allowances, to reflect the introduction by the UK Government of the super-deductions, full expensing and 50% first year allowances, in the 2021 and 2023 Budgets. 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 2023 to 1 April 2025 for the enhanced allowances claimed as part of the tax trigger events.

The tax performance in the RoRE calculation compares Wales & West Utilities 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 gearing in the form of tax clawback.

3 https://www.londonstockexchange.com/news-article/60ZJ/replacement-and-additional-equity/16140403

R9 – Corporate Governance

Corporate Ownership and Governance Framework (RIGs 4.13 - 4.15)

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 32 of WWU's statutory accounts for the year ended 31 March 2023.

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, E)	Appointed 1 June 2005
Dominic Chan**		(A, R, T)	Appointed 10 October 2012
Grant Hawkins***		(A, R, H, T, E)	Appointed 27 March 2014
Hing Lam Kam**		(R)	Appointed 10 October 2012

Duncan Macrae**	(A, R, H, T, E)	Appointed 10 October 2012
Michael Pavia***		Deceased 5 December 2022
Charles Tsai**	(A, H, E)	Appointed 10 October 2012
Mike Davis***	(A, R, H, T, E)	Appointed 1 April 2023

Neil Henson*	(Alternate Director to Graham Edwards)	Appointed 10 June 2013
Neil McGee**	(T, 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

(E) Member of the ESG 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)

Executive Directors' remuneration is based on 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 because it did not have 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 or senior lenders or by Ofgem for regulatory RoRE performance assessment and tax clawback purposes.

Shareholder loan note interest payments have been reduced for 2021/22 and 2022/23 to support WWU's financial position in the context of inadequate allowances, notably for totex, cost of debt and equity. WWU accrued £65.1m and made £10.5m shareholder loan interest payments in 2022/23 (2021/22 - accrued £50.1m and paid £60.0m, of which £40m was deferred from the last year of RIIO-GD1, 2020/21). Details of shareholder loan notes are included on page 76 of the WWU statutory accounts for the year ended 31 March 2023 within Note 13 – External Borrowings.

R10 – Pensions & other activities

Pensions

During the year, a full actuarial valuation as at 31 March 2022 was completed by Lane Clark & Peacock, showing a deficit, on a technical provisions' basis, of £49.4m. The calculations carried out to produce the results of that valuation were updated to the accounting date by an independent qualified actuary in accordance with FRS 102. As required by FRS 102, the value of the defined benefit liabilities were measured using the projected unit method.

The Company agreed a revised 9 year deficit recovery plan following the 31 March 2022 actuarial valuation, with contributions of £9.0m due for the year ended 31 March 2023 (2021/22 - £9.0m agreed per the 31 March 2019 valuation), £7.5m for the year ended 31 March 2024, £6.5m per annum until 31 March 2028 and £6.0m per annum until 31 March 2031.

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 and 2022 valuations on a 75.7% to 24.3% split.

Other activities

Guaranteed Standards of Performance payments (GSoP) are statutory payments at rates set by Ofgem. WWU paid £0.2m for the year ended 31 March 2023 excluding ex-gratia and voluntary GSoP payments (2022: £0.3m). This has been included within the RFPR.

Data Assurance Statement

The 2022/23 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.