Making a positive difference
for energy consumers

Report

Regulatory financial performance annex to RIIO-1 Annual Reports - 2017-18

Publication date:	8 March 2019	**Contact:**	Mick Watson, Senior Advisor
		Team:	Regulatory Finance
		Tel:	020 7901 7416
		Email:	mick.watson@ofgem.gov.uk

This annex provides Ofgem's view on RIIO-1 companies regulatory financial performance. This view is based on the information that the companies have reported using the new regulatory financial performance reporting process.

Contents

Regulatory financial performance **4**
Introduction and context 4
Return on Regulatory Equity 5
Background 5
RoRE performance 6
What is RoRE and how do we calculate it? 8
Reconciliation with previous RoRE models 9
Allowed Revenue and the Annual Iteration Process 9
Base Revenue, Allowed Revenue and the MOD 9
AIP for 30 November 2018 10
The AIP under RIIO 11
Gearing and Financing 12
Regulatory Asset Value 16

Appendices **17**

Appendix 1 **18**
Supporting data file 18

Regulatory financial performance

Introduction and context

1.1. This annex sets out our assessment of RIIO-1 network companies' regulatory financial performance. This view is based on the information that the companies have reported using the new regulatory financial performance reporting (RFPR) process.

1.2. In August 2018[1] we said we wanted to see a step change in the how financial performance is reported by network companies. Reporting using the RFPR will provide more targeted detailed financial information on their RIIO performance. In particular, this new reporting will provide an insight into the impacts of each company's level of gearing, its cost of debt, and actual tax payments on its returns under the price controls.

1.3. We recognise that this is the first time we have asked network companies to report their financial performance this way. We wanted the RFPR to be consistent where possible across all sectors. However, in some areas there has not been consensus in how different companies interpret parts of the reporting. Where this has happened we have used an approach that we consider appropriate, which may not have been fully agreed by all companies. Since the companies submitted their RFPR in November 2018 we have reviewed their submissions and where necessary made methodological changes to them[2]. We have not made changes to companies input data, unless agreed with them. Over time we expect to see and improvement in the consistency of reporting, and believe this can be achieved through collaborative working between companies, sharing of data and having transparent reporting, with clear methodologies, available to stakeholders.

1.4. We asked companies to report Enduring Value adjustments (see para 1.15) to reflect the true value of the regulated business over the course of the price control. Most companies provided limited or no Enduring Value adjustments in their November 2018 submissions, where we expected to see more. Especially in areas such as known future reopener claims and their performance in relation to the network asset reliability measures[3] (NARMs) incentive. We consider that estimates can be made even where methodologies in some areas have yet to be finalised. For future reporting we expect to see improvement in reporting that gives an understanding of any adjustment and the impact on RIIO-1 price control performance.

1.5. The remainder of this Annex is structured as follows:

- Return on Regulatory Equity
- Allowed Revenue and the Annual Iteration Process

---

[1] RIIO Accounts way forward and alternative approach - https://www.ofgem.gov.uk/publications-and-updates/riio-accounts-way-forward-and-alternative-approach
[2] Examples of this are adjusting for the inflation in interest charge and making an adjustment for tax performance based on the company's actual gearing.
[3] Also previously referred to as network output measures (RIIO-GD1 and T1) or network asset secondary deliverables (RIIO-ED1)

- Gearing and Finance
- Regulatory Asset Value

1.6. Appendix 1 contains the data file and the companies Ofgem adjusted RFPRs that supports this Annex.

Return on Regulatory Equity

1.7. We assess the overall financial performance on regulated equity of network companies using a measure called the Return on Regulatory Equity (RoRE). RoRE is an estimate of the financial return achieved by shareholders during a price control period from the licensee's forecast out-turn performance under the price control. It is a useful way to gain an overall picture of how regulated equity is performing under the price control compared to the assumed return used in setting allowed revenues.

1.8. RoRE is just one measure that can be used. A company's RoRE performance can be driven by many factors, both within and outside their control. It should not be seen, in isolation, as a measure of the return realised on regulated equity earned by shareholders or a company's efficiency. We will look to develop further measures for future reporting.

Background

1.9. In previous RIIO-1 annual reports RoRE has been calculated using certain regulatory assumptions, such as the notional gearing ratio of the companies. Using this approach there are a number of factors which are not reflected in previous RoRE calculations, but which would impact the return realised by shareholders. For example, we have not included the potential end-of-period review on the delivery on NARMs or re-profiling of volume drivers that impact on future revenue. Our RoRE analysis also excludes companies' actual debt costs and tax liability relative to our regulatory assumptions. In the 2016-17 RIIO annual reports we said we may include some of these items in the future as we continue to refine our RoRE model.

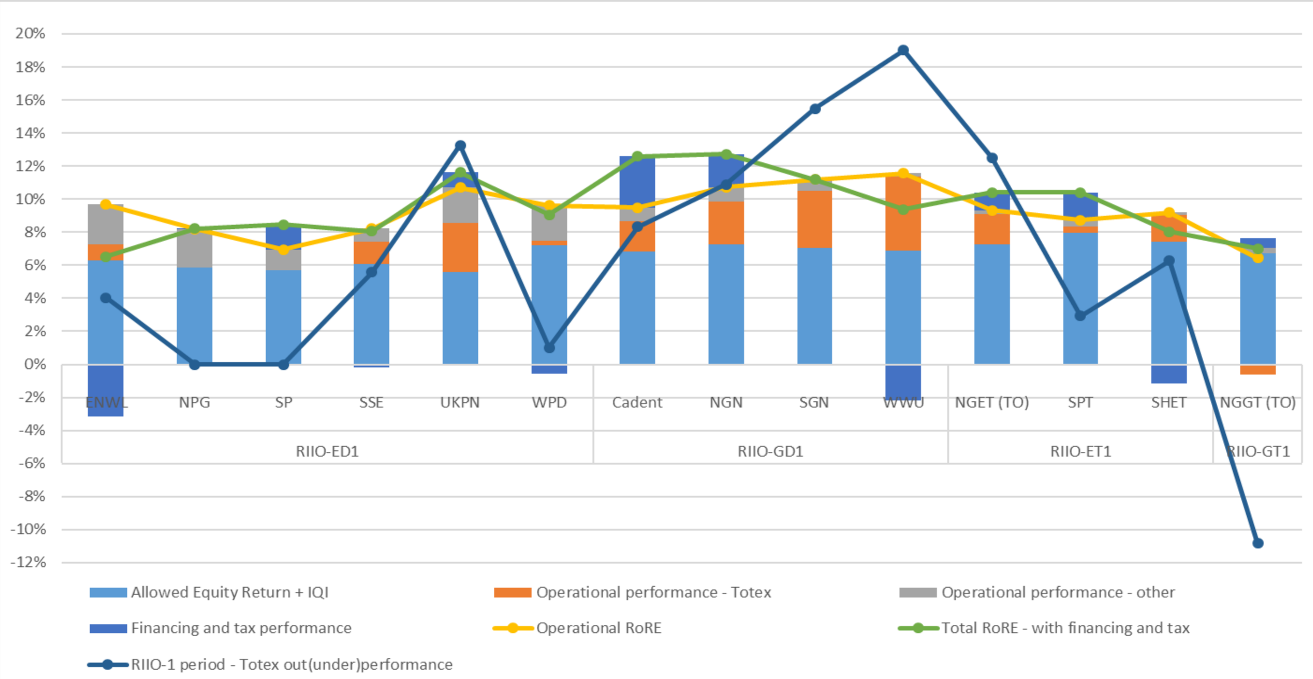
1.10. We also consider it appropriate to report companies RoRE based on companies' actual debt costs and gearing ratios to give an indication of their actual performance against the cost of debt and tax assumptions we set for RIIO-1.

RoRE performance

1.11. Figures 1 and 2 set out the RoRE performance,[4,5] based on notional and actual gearing, by sector for the RIIO-1 period, this includes actual performance to date and licensee forecast performance for the remainder of RIIO-1. More detailed disaggregated company and licensee performance can be found in Appendix 1.

1.12. Notional gearing represents the assumed percentage of net debt to RAV for a notional company for each sector, this was set as part of RIIO-1 price control. Figure 1 shows RoRE based on a notional financing structure (see Financing and Gearing section).

Figure 1: Company RoRE based on Notional Gearing - RIIO-1 period



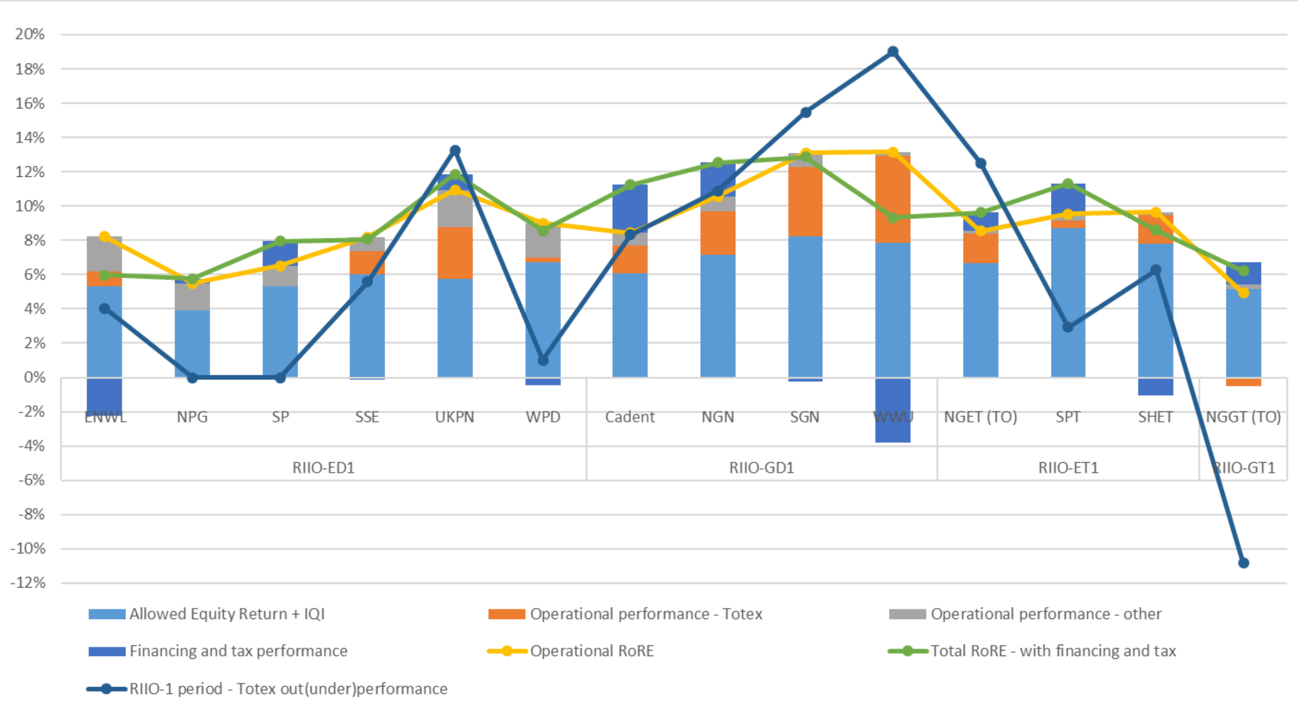
RIIO-1 period	RIIO-ED1						RIIO-GD1				RIIO-ET1			RIIO-GT1
RoRE based on Notional Gearing	**ENWL**	**NPG**	**SP**	**SSE**	**UKPN**	**WPD**	**Cadent**	**NGN**	**SGN**	**WWU**	**NGET (TO)**	**SPT**	**SHET**	**NGGT (TO)**
Allowed Equity Return + IQI	6.3%	5.9%	5.7%	6.0%	5.6%	7.2%	6.8%	7.3%	7.0%	6.9%	7.3%	8.0%	7.4%	6.7%
Operational performance - Totex	1.0%	0.0%	0.0%	1.3%	3.0%	0.3%	1.8%	2.6%	3.5%	4.5%	1.8%	0.4%	1.6%	-0.6%

[4] If Cadent's financing performance is adjusted for the economic cost of debt including the costs of restructuring old debt (which was completed shortly prior to the sale of the gas distribution business by National Grid) then Cadent's financing performance and RoRE fall by approximately 1% over the RIIO-1 period.
NGET commented in their submission that they believed £481 million of refinancing costs should be included in their financing costs for the purposes of calculating RoRE including financing performance. However, following review of statements made in National Grid Plc's annual report and accounts and the Tender Offer Documentation dated 6th September 2016, Ofgem consider these to be exceptional costs wholly associated with the sale by National Grid to Cadent of the Gas Distribution business and that any allowance for these costs without also including a proportion of the GD business sale proceeds in NGET revenues would be inappropriate.
[5] Performance relates to RIIO-1 and does not include performance for NGET System Operator(SO), NGGT SO, Transmission Incentive Renewable Generation (TIRG) or non-regulated parts of the company.

Operational performance - other	2.4%	2.3%	1.3%	0.8%	2.1%	2.2%	0.8%	0.9%	0.7%	0.2%	0.2%	0.4%	0.2%	0.3%
Operational RoRE	**9.7%**	**8.2%**	**7.0%**	**8.2%**	**10.7%**	**9.6%**	**9.5%**	**10.7%**	**11.2%**	**11.6%**	**9.3%**	**8.7%**	**9.2%**	**6.4%**
Financing and tax performance	-3.2%	0.0%	1.5%	-0.2%	0.9%	-0.6%	3.1%	2.0%	0.0%	-2.2%	1.1%	1.7%	-1.1%	0.6%
Total RoRE - with financing and tax	**6.5%**	**8.2%**	**8.5%**	**8.0%**	**11.6%**	**9.1%**	**12.6%**	**12.7%**	**11.2%**	**9.4%**	**10.4%**	**10.4%**	**8.0%**	**7.0%**
RIIO-1 period - Totex out(under)performance	**4.0%**	**0.0%**	**0.0%**	**5.6%**	**13.3%**	**1.0%**	**8.3%**	**10.9%**	**15.5%**	**19.0%**	**12.5%**	**2.9%**	**6.3%**	**-10.8%**

1.13. Actual gearing is the actual percentage of regulated net debt to RAV of each licensee. Figure 2 shows RoRE based on their financing structure (see Financing and Gearing section).

Figure 2: Company RoRE based on Actual Gearing - RIIO-1 period



RIIO-1 period	**RIIO-ED1**						**RIIO-GD1**				**RIIO-ET1**			**RIIO-GT1**
RoRE based on Actual Gearing	**ENWL**	**NPG**	**SP**	**SSE**	**UKPN**	**WPD**	**Cadent**	**NGN**	**SGN**	**WWU**	**NGET (TO)**	**SPT**	**SHET**	**NGGT (TO)**
Allowed Equity Return + IQI	5.3%	3.9%	5.3%	6.0%	5.7%	6.7%	6.1%	7.1%	8.2%	7.8%	6.7%	8.7%	7.8%	5.1%
Operational performance - Totex	0.8%	0.0%	0.0%	1.3%	3.0%	0.3%	1.6%	2.5%	4.1%	5.1%	1.7%	0.4%	1.7%	-0.5%
Operational performance - other	2.0%	1.6%	1.2%	0.8%	2.2%	2.0%	0.7%	0.9%	0.8%	0.2%	0.2%	0.4%	0.2%	0.3%
Operational RoRE	**8.2%**	**5.5%**	**6.5%**	**8.2%**	**10.9%**	**9.0%**	**8.4%**	**10.6%**	**13.1%**	**13.1%**	**8.6%**	**9.6%**	**9.6%**	**4.9%**
Financing and tax performance	-2.2%	0.3%	1.4%	-0.1%	0.9%	-0.5%	2.8%	2.0%	-0.2%	-3.8%	1.1%	1.8%	-1.1%	1.3%
Total RoRE - with financing and tax	**6.0%**	**5.8%**	**7.9%**	**8.1%**	**11.9%**	**8.6%**	**11.2%**	**12.5%**	**12.9%**	**9.3%**	**9.6%**	**11.3%**	**8.6%**	**6.2%**
RIIO-1 period - Totex out(under)performance	**4.0%**	**0.0%**	**0.0%**	**5.6%**	**13.3%**	**1.0%**	**8.3%**	**10.9%**	**15.5%**	**19.0%**	**12.5%**	**2.9%**	**6.3%**	**-10.8%**

What is RoRE and how do we calculate it?

1.14. RoRE measures the return on the equity regulatory asset value (RAV). Regulatory equity represents the proportion of average RAV that is funded by shareholders (also known as 'Equity RAV'). Equity RAV is derived from total RAV less gearing (financed by debt). RoRE performance set out in Figures 1 and 2 uses both notional and actual gearing. The return is the total of the following:

Allowed Equity Return and Information Quality Incentive

- Allowed equity return which was set at the start of the price control period and will not change throughout RIIO-1.

- Information Quality Incentive (IQI) income reward/penalty – A reward or penalty set as part of the RIIO-1, which reflects the accuracy and quality of the business plans submitted by the licensee. This was set at the start of the price control period and will not change throughout RIIO-1.

Operational performance - Totex

- Totex performance– the totex incentive mechanism (TIM) represents the amount that a licensee bears for an overspend against allowances or retains for an underspend against allowances.

Operational performance - other

- Output incentives – A financial reward or penalty based on the licensees' performance against defined incentives.

- Innovation – This represents the amount licensees cannot recover through revenue or contributions they make in relation to funded innovation projects.

- Penalties or fines – An adjustment is made to licensees return for any Ofgem related penalties and fines, and guaranteed standard payments made to customers. These costs are borne by the shareholders.

Financing and tax performance

- Debt performance – This compares licensees actual cost of debt against the cost of debt allowance set as part of the RIIO-1 price control.

- Tax performance - This compares licensees actual tax liability against the tax allowance set as part of the RIIO-1 price control.

1.15. The RFPR requires companies to include Enduring Value adjustments. Enduring Value is 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. Some examples of Enduring Value adjustments are estimates of:

- future uncertainty mechanism claims;
- close out mechanism (eg NARMs incentive);
- timing differences of delivery of outputs (eg volume drivers);
- known changes to future output delivery (eg volume drivers); and
- known adjustments not yet made as part of the AIP (eg mid-period review decisions, voluntary returns).

1.16. The RoRE measure is important for us to understand how well our price control approach encourages behaviours that are aligned to customers' interests. It will help us to identify ways we could improve settlements and associated incentives for RIIO-2.

Reconciliation with previous RoRE models

1.17. As we said in paragraph 1.9, previous RIIO-1 annual reports RoRE have been calculated using different regulatory assumptions. Due to the change to the new approach we considered it important that we reconciled this against the previous approach. The major differences are:

a) We have moved from a simple RIIO-1 average RoRE to a weighted-average (average return over RIIO-1 ÷ average RAV)[6];
b) Including Enduring Value adjustments; and
c) Introducing debt and tax performance.

Allowed Revenue and the Annual Iteration Process

1.18. Allowed Revenue is the total amount of money that a network company can earn on its regulated business through transportation and distribution charges.

Base Revenue, Allowed Revenue and the MOD

1.19. At the beginning of the price control period, we set an assumption for the level of Allowed Revenue for each network company, known as the Opening Base Revenue. During the course of the price control, we update this assumption through the Annual Iteration Process ("AIP"), wherein we calculate the annual modification (the "MOD") to Opening Base Revenues. The MOD will reflect updated allowances based on actual delivery of outputs; actual expenditure and resulting Totex Incentive Mechanism ("TIM") performance; updating the cost of debt allowance; and changes in tax rates.

[6] We consider this more appropriate for performance monitoring. For most companies this makes little difference, but where, for example, a company has a growing RAV over RIIO-1 (eg SHET and SPT) a weighted-average is more representative of performance. The difference between simple and weighted-average would be a 2.3% (SHET) and 0.2 (SPT) higher RoRE (based on notional gearing) using a simple average.

1.20. The MOD term represents the difference between Opening Base Revenue as assumed at the start of the price control and the annual recalculated Base Revenue and is applied to future revenues. Actual expenditure data is reported by each licensee at the end of the regulatory year and customer tariffs are set one regulatory year in advance here, hence there is a two-year lag between the calculation of the MOD term and its impact on allowed. A negative MOD reduces future Allowed Revenue for the network companies and therefore provides a saving to consumers through lower bill impact than were originally envisaged; the reverse is true where the MOD is a positive value. Note, the current price control for the transmission and gas distribution sectors began two years earlier than in the electricity distribution sector.

1.21. The sum of Opening Base Revenue and the MOD gives us the Recalculated Base Revenue, which along with a number of other adjustments gives the total Allowed Revenue for each network company[7].

1.22. The average annual total Allowed Revenue for the industry[8] is nearly £13 billion.

AIP for 30 November 2018

1.23. Base Revenue for the 2019-20 period was recalculated following the AIP completed on 30 November 2018.

1.24. As well as determining the value of the MOD term and the level of TIM reward/penalty based on actual expenditure, the AIP also accounts for other updates made in each period. For example, the 2018 AIP brought into effect previously announced decisions such as the changes in revenue from the re-openers in the gas and electricity transmission price controls as well as the voluntary handing back of allowances in the gas and electricity distribution price controls.

1.25. In addition, allowed revenues have been reduced across all four price controls following an update to the data set used to calculate the Cost of Debt ("CoD"). As a result of using the revised data set, the CoD value[9] has fallen and this has been reflected both in the 2019-20 value as well as being retrospectively restated for the 2018/19 CoD value. This restatement is due to the temporary suspension of an underlying data series used to calculate the CoD value, in 2018-19.

1.26. In total, the AIP will reduce future network company revenues in 2019-20 by £827 million (in 2019-20 prices) compared to the assumptions made at the start of the price controls.

---

[7] See *Appendix 2 – Details on how we determined Allowed Revenue* in the RIIO-ED1 Annual Report for 2015-16 for a more detailed explanation of how Base Revenue and Allowed Revenue are calculated. https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1_annual_report_2015-16.pdf

[8] The regulated parts of the Electricity and Gas Transmission and Distribution companies, including system operator and TIRG.

[9] The Cost of Debt value is calculated with reference to a trailing average index of debt costs but is calculated on a different basis for each sector. For GD1, GT1, ED1 Fast-track and most ET1 licensees, the trailing index covers a 10-year period up to the 31 October 2018. For SHE-Transmission, the index also covers 10 years but with bespoke weightings. For ED1 Slow-track, the trailing index covers a 14-year period up to the 31 October 2018, and will extend by a year at each AIP.

The AIP under RIIO

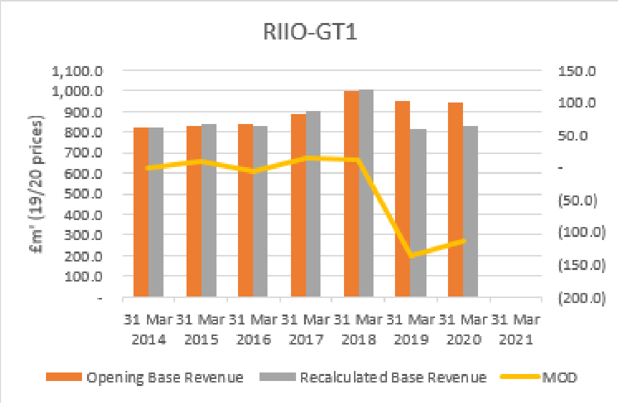
1.27. Table 1 compares the Opening Base Revenue set at Final Proposals/Determinations for each sector against the Recalculated Base Revenue following the annual calculation of the MOD term. This is presented in a consistent price base (2019-20 prices) and demonstrates the largely negative impact of the MOD term on Opening Base Revenues during the course of the RIIO price controls, to date. This represents a net saving to energy consumers.

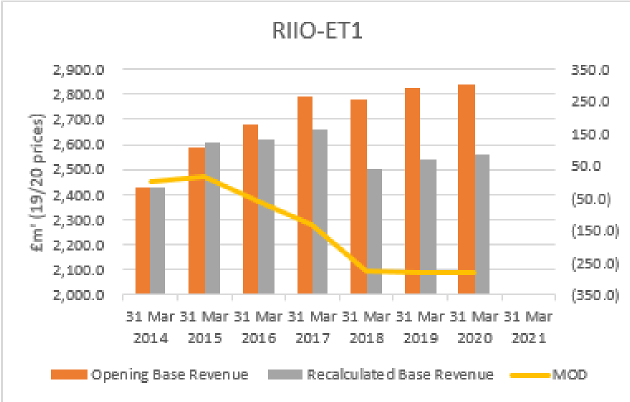
Table 1: Comparison of PCFM Opening Base Revenue against recalculated Base Revenue after MOD (£m, 2019-20 price base)

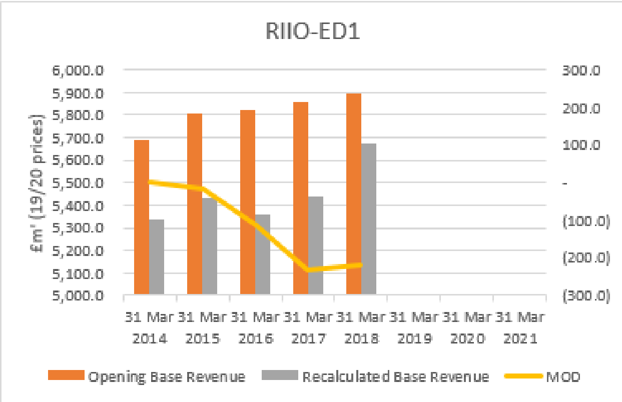
£m, 19/20 prices	31 Mar 2014	31 Mar 2015	31 Mar 2016	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020	31 Mar 2021
GAS TRANSMISSION								
Opening Base Revenue	823.0	829.5	838.2	887.9	995.1	950.7	946.5	
MOD	-	9.4	(5.3)	15.6	12.2	(136.3)	(112.7)	
Recalculated Base Revenue	823.0	838.9	832.9	903.5	1,007.3	814.4	833.9	
ELECTRICITY TRANSMISSION								
Opening Base Revenue	2,427.1	2,590.0	2,680.9	2,794.6	2,781.6	2,824.3	2,838.3	
MOD	-	17.8	(59.1)	(134.2)	(278.5)	(282.1)	(279.9)	
Recalculated Base Revenue	2,427.1	2,607.9	2,621.8	2,660.4	2,503.1	2,542.2	2,558.4	
GAS DISTRIBUTION								
Opening Base Revenue	4,223.5	4,111.7	4,163.8	4,128.0	4,139.0	4,139.9	4,117.1	
MOD	-	(18.1)	(89.5)	(37.9)	(167.4)	(186.3)	(270.3)	
Recalculated Base Revenue	4,223.5	4,093.6	4,074.3	4,090.1	3,971.6	3,953.6	3,846.9	

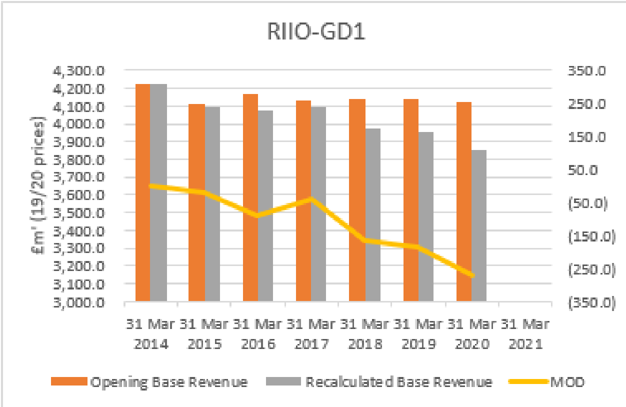
£m, 19/20 prices	31 Mar 2014	31 Mar 2015	31 Mar 2016	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020	31 Mar 2021
ELECTRICITY DISTRIBUTION								
Opening Base Revenue	5,692.6	5,809.4	5,824.2	5,858.0	5,898.0			
MOD	-	(18.0)	(112.0)	(232.8)	(219.7)			
Recalculated Base Revenue	5,338.9	5,431.6	5,357.3	5,442.0	5,678.3			

Figures 3-6 demonstrate the above saving to consumers graphically, over the RIIO-1 price control period.







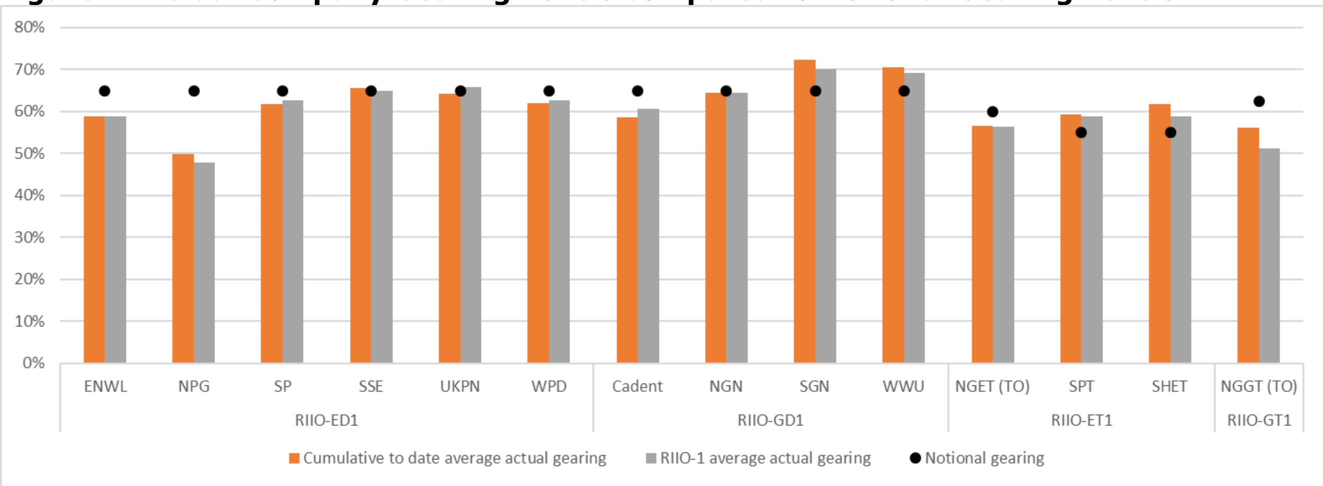


Gearing and Financing

1.28. The RIIO-1 price control allowances were set using notional gearing assumptions for each licensee (generally based on sector with some exceptions). However, each licensee is free to determine its own financing structure without intervention from Ofgem, assuming it still meets all of its licence obligations. One licence condition is that licensees maintain an investment grade credit rating. Some licensees elect to raise a higher proportion of their financing as debt (higher gearing) and some elect to raise a lower proportion as debt (lower gearing) than the notional level. All else being equal a licensee that has higher gearing than the notional company will boost their equity return in percentage terms. It is important to note that this does not impact the amount charged to consumers.

1.29. Our analysis illustrates that there is considerable variation in the approach to gearing across licensee groups, with gearing levels ranging from 48% to 70% and deviation from notional gearing levels of between –17% to +5%. We would note that our gearing calculation is based on our regulatory definition of net debt, which may differ from rating agency or other party definitions used for gearing calculations. In addition, we would note that this gearing calculation ignores any additional debt at holding company levels and that a number of groups include additional gearing at holding company level and that this would have an impact on ultimate shareholder return. However, as Ofgem regulates the licensees only we restrict our analysis to gearing included in the licensee entities only.

Figure 7: Actual Company Gearing Levels compared to Notional Gearing Levels



1.30. Company decisions on the level of gearing to include in their company structure often go hand in hand with an assessment of the cost of that debt and the ability for the company to service the debt and maintain their target credit rating (which may be different for different licensees, but would be expected to be investment grade given the licence requirement). Rating agencies typically consider not only the serviceability of debt in any particular year but also the sustainability and resilience of debt serviceability. These are factors that any licensee would be likely to consider in assessing financeability and gearing levels.

Table 2: Sector Average Actual and Notional Gearing Levels.

Full RIIO-1 Period	ED1	GD1	ET1	GT1
Average Actual Gearing	61.6%	64.7%	57.0%	51.3%
Average Notional Gearing	65.0%	65.0%	58.8%	62.5%

1.31. Figure 7 illustrates that there are a small number of companies with above notional gearing but that many companies have lower gearing than the notional company. In addition, Table 2 illustrates that on average (RAV weighted) each sector has slightly lower gearing than the notional assumption over the RIIO-1 period. These figures do include some company forecasts for debt to be raised during the remainder of RIIO-1. Some companies have noted that their forecasts for new debt are preliminary and may change following review of RIIO-2 sector specific consultation decisions and business planning for RIIO-2 so we will monitor over the coming years whether this picture changes and whether this has an impact on debt performance, actual gearing levels and RoRE over the remainder of RIIO-1.

1.32. Through the RFPR we have sought to assess licensees' actual debt costs compared to their cost of debt allowance, calculating the impact on RoRE on both a notional gearing and actual gearing basis.

1.33. During RIIO-1 the cost of debt allowance has been set with reference to the trailing average of a derived index (a combination of the published iBoxx A 10yr+ non-financial index and the iBoxx BBB 10yr + non-financial index, converted to real using breakeven inflation). This means that the allowance varies each year with movements in the underlying indices and/or movements in breakeven inflation. Over the RIIO-1 period so far the real cost of debt allowance has fallen from 2.92% in 2013-2014 to 1.91% for 2018-2019 (ET excluding SHET, GT & GD) and from 2.55% in 2015-2016 to 2.09% in 2018-2019 for ED (except WPD who's cost of debt allowance has fallen to 1.91% in 2018-2019). This is due to a falling interest rate environment and has the impact of reducing network operator revenues and correspondingly reducing customer bills compared to if a fixed (non-indexed) cost of debt allowance had been used.

1.34. The cost of debt allowance is provided on a real basis (because inflation is taken into account in RAV inflation) but company interest costs are generally on a nominal basis (even where their debt is inflation linked the interest expense is reported on a nominal basis including inflation accretion), so any cost of debt performance assessment either needs to adjust the cost of debt allowance to a nominal equivalent or strip inflation from the interest expense reported by companies. We have taken the second approach and stripped inflation from the interest charge using average outturn inflation. Financing performance is therefore not an assessment of cashflow performance but of the economic cost of debt compared to the cost of debt allowance and inflation applied to the RAV.

1.35. Actual cost of debt can vary from allowances due to a number of factors, including timing of debt raising and cost of debt relative to the index on the day of issue. The cost of debt can also be influenced by licensee decisions relating to maturity of debt raised and type of debt raised (fixed rate, floating rated or inflation linked) and any derivatives used to adjust the mix of interest payment type. Our analysis indicates there is significant variation between licensees relating to the type of debt raised and use of derivatives.

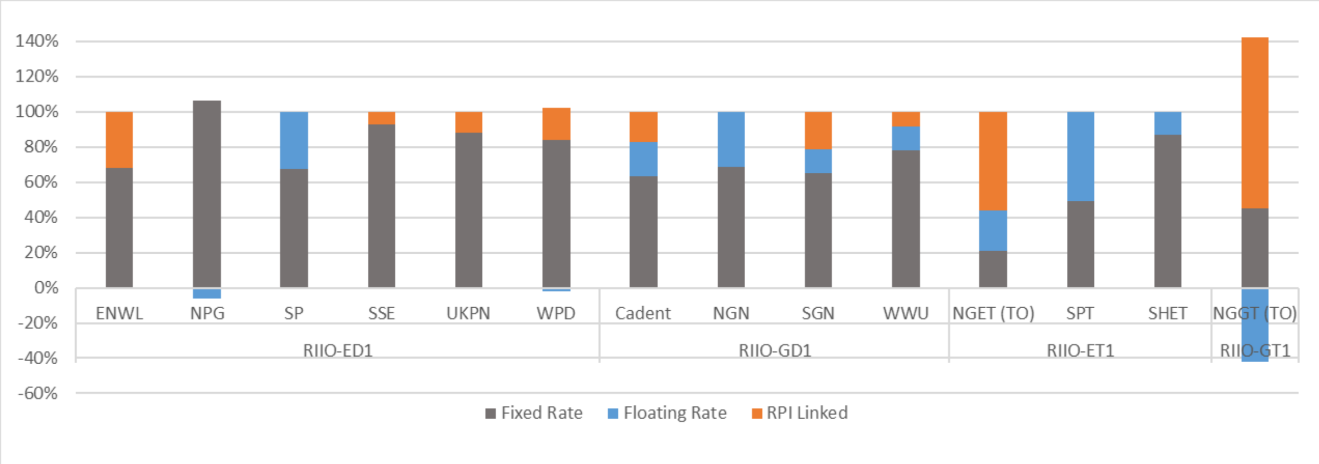
1.36. Over the full RIIO-1 period the RFPR returns would indicate that companies will outperform the debt index in all sectors on a weighted average basis but that this outperformance is relatively modest. In addition, if Cadent restructuring costs are factored in to the analysis GD1 debt out performance falls from 1.2% to 0.5% (actual gearing basis).

1.37. How a company is geared would have an impact on their tax liability. Table 3 sets out the sector average debt and tax performance for the RIIO-1 period.

Table 3: Sector Average Debt and Tax Performance (impact on RORE).

	Full RIIO-1 Period	ED1	GD1	ET1	GT1
Actual Gearing	Debt Performance	0.2%	1.2%	1.2%	0.8%
	Tax Performance	-0.1%	-0.1%	-0.3%	0.5%
Notional Gearing	Debt Performance	0.0%	1.3%	1.2%	0.2%
	Tax Performance	0.0%	0.2%	0.4%	0.3%

Figure 8: Net Debt Composition by Licensee Group (2018, pre derivatives)



1.38. Figure 8 provides a summary of debt type used by different Licensee groups. A small number of groups show a proportion of net debt as negative due to receiving interest through intercompany loans. Figure 8 provides net debt composition pre derivatives but we would note that a number of groups have adjusted debt composition using derivatives with some using derivatives to either increase or decrease the proportion of floating rate liabilities and some using RPI derivatives to increase the proportion of RPI linked liabilities.

1.39. Decisions relating to the type and maturity of debt raised can have a significant impact on performance against allowances and are linked to the risk appetite of licensee owners- outperformance today may involve taking risks that could lead to underperformance in future or vice versa. For example, companies that have a high proportion of floating rate liabilities could be expected to have relatively low interest costs currently (because LIBOR is low by historical standards) but they take the risk that their interest costs rise if LIBOR rises significantly over time. Therefore, debt outperformance or underperformance over a relatively short period of time cannot be assumed to lead to continuing outperformance or underperformance.

1.40. There has been significant variation in the use of inflation linked debt (from 0% to 97% of net debt), with an average across all network companies of approximately 25%. When derivatives are taken into account this average RPI linked proportion rises to approximately 32%. To date all inflation linked debt issued by network companies has been RPI linked. We note that in the water sector (where the decision has been made to transition to CPIH from 2020) some companies have issued some CPI linked debt (eg United Utilities, Thames Tideway and Affinity Water).

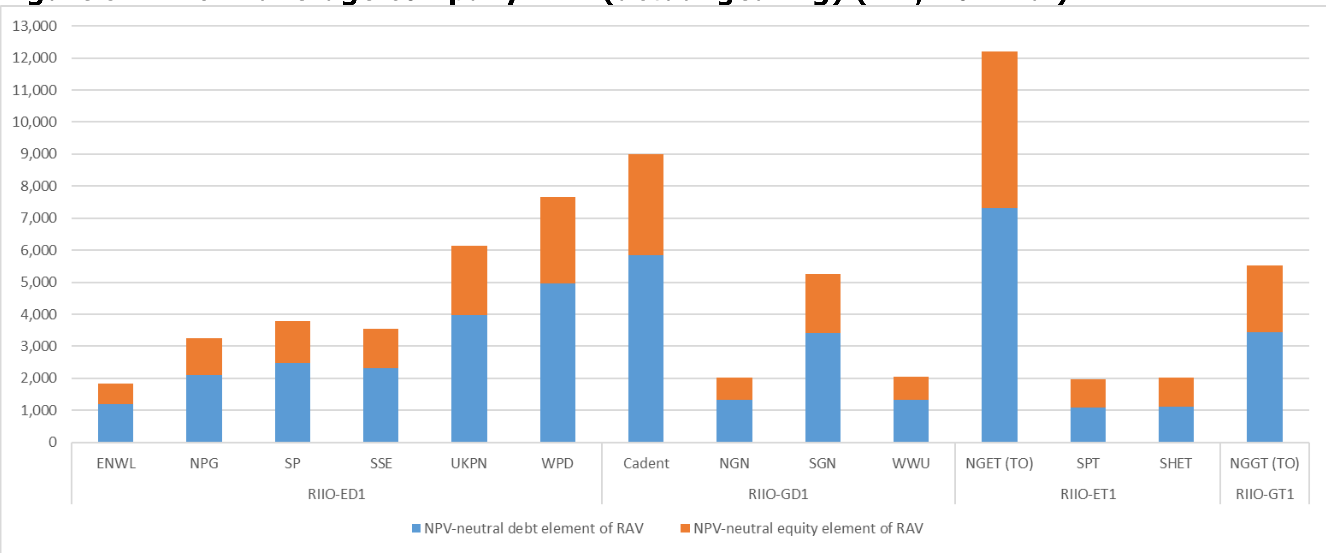
1.41. Although a small number of licensees have raised a small proportion of debt in currencies other than GBP when they have done so they have used derivatives to convert the exposure to a GBP liability. This indicates licensees are not exposed to movements in currency rates in relation to their debt exposure.

1.42. The use of intercompany loans by licensees could distort debt (and tax) performance because the rates charged or paid by other group companies may or may not reflect bond market levels on which the iBoxx indices are derived. There could be a number of reasons licensees use intercompany loans, including group capital structuring considerations, more efficient market access through group treasury operations and tax considerations for companies with group entities in other jurisdictions. We exclude intercompany loans that are treated as shareholder loans from our analysis of debt and debt costs.

Regulatory Asset Value

1.43. Regulatory Asset Value (RAV) is a financial balance representing the capitalised (on a regulatory basis) component of total expenditure. The licensee receives a return and depreciation on its RAV in its price control allowed revenues. Companies RIIO-1 average RAV is shown in Figure 9, this is split between actual debt and regulatory equity.

Figure 9: RIIO-1 average company RAV (actual gearing) (£m, nominal)



Appendices

Index

Appendix	Name of Appendix	Page No.
1	Supporting data file to Regulatory financial performance annex to RIIO-1 Annual Reports - 2017-18	1

Appendix 1

Supporting data file

Supporting data file to Regulatory financial performance annex to RIIO-1 Annual Reports - 2017-18 can be found here.