SP TRANSMISSION PLC

REGULATORY FINANCIAL PERFORMANCE REPORT

2018/19

Contents

Executive Summary

We are pleased to submit this narrative which has been prepared, in accordance with Ofgem guidelines, in support of SP Transmission plc's (SPT) Regulatory Financial Performance Report (RFPR) tables submitted to Ofgem on 31st July 2019.

2018/19 has been another important year for SPT building on the success of 2017/18. RIIO T1 Totex investment, on a cumulative basis, on new infrastructure and asset renewal has exceeded £1.3Bn$_{09/10\ prices}$. Delivery of key projects has resulted from meticulous long term planning as we continue to provide what we stated we would do at the outset of RIIO-T1. We currently forecast that by the end of RIIO-T1 period we will have spent £58m$_{09/10\ prices}$ less than allowance, through efficient project delivery and changes to forecast allowance and expenditure for generation connections.

In 2018/19, the net profit earned by SPT was £156.9m. The 2018/19 Regulated Accounts presented a "Net cash outflow from investing in property, plant and equipment" for 2019: £266.3m; 2018 £245.2m. In addition financial support is provided to the company by £1.35bn of intercompany loans.

ScottishPower's strategy, adopted by SPT, is to conduct business in a manner benefiting customers through balancing cost and risk while delivering shareholder value and protecting ScottishPower's performance and reputation by prudently managing the risks inherent in the business. To maintain this strategic direction, ScottishPower develops and implements risk management policies and procedures, and promotes a robust control environment at all levels, all of which in turn are adopted by SP Energy Networks, including SPT.

We believe stakeholders are displaying a fundamental knowledge gap in relation to the cost of debt (CoD) allowance for Network Owners. There is a lack of understanding that companies' annual CoD allowance does not cover the actual annual cash outflows for interest and shareholders are required to fund interest payments in excess of allowance. We believe this should be addressed through actions including prominently explaining the cost of debt is provided on a real basis however the interest rate on the majority of company debt is on a nominal basis. We have therefore provided our version of financial performance and Ofgem's view in table R7.

The consistency and comparability of the RFPR needs to be enhanced through continued development of the RIGs guidance. There are areas like taxation, forecast debt costs and enduring value adjustments where different approaches may be adopted. We believe enduring value adjustments should be completed by all companies.

In the Ofgem annual report for 2017/18 Ofgem said that consistency was applied in some areas but no specifics were mentioned. It would be beneficial for stakeholders for this to be quantified.

Overview on Regulatory Performance

R1 RORE

Return on Regulated Equity (RoRE) has previously been published as an operational performance metric on a notional gearing basis. The RFPR now extends RoRE to include enduring value adjustments, potentially impacting Totex performance and includes performance on debt and tax. We have removed debt performance from our submission as it requires further consideration for comparability and consistency throughout the industry as mentioned above.

Furthermore, RoRE is now presented on both a notional and actual gearing basis with cumulative-to-date and full ET1 period positions. There is a 0.5% difference between the notional and actual gearing basis for SPT as summarised below.

The RoRE presented excludes Transmission Investment in Renewable Generation (TIRG) as it is a legacy funding arrangement unrelated to RIIO-T1.

RIIO-ET1 RoRE	SPT	
	Notional Gearing	Actual Gearing
Allowed Equity Return	7.0%	7.4%
Totex outperformance	0.5%	0.5%
IQI Reward	1.0%	1.0%
Output Incentives and Innovation	0.4%	0.4%
Penalties and fines	0.0%	0.0%
RoRE - operational performance	**8.9%**	**9.4%**
Tax performance	-0.1%	-0.1%
RoRE - including tax	**8.8%**	**9.3%**

In terms of proposing a preferred metric to RORE at this point, we strongly advocate the Return on Capital Employed (ROCE) as the most appropriate performance metric for the purpose of reporting company returns. The ROCE metric is defined as the earnings before interest and tax (EBIT) divided by total assets less current liabilities. EBIT is used as it measures the return available to meet both equity and debt holders before the impact of taxation. It best reflects operational performance since it is unaffected by corporate and tax structures. It is a commonly used and understood measure of profitability across many industries. For example, the CMA used return on capital employed (ROCE) as a principal profitability measure in the GB energy market investigation (*Source: CMA (2016): Energy Market Investigation, Final Report, Appendix 9.9, Approach to profitability and financial analysis, para 23-25*).

R2 Revenue

Allowed Revenue

Our revenues are set in accordance with Ofgem guidance. They comprise an element which is fixed, an element which is linked to specific variables (such as the amount of connected generation) and an element to capture the incentives and adjustments from previous years.

We recover our revenues through charges to the system operator, National Grid, who in turn, levy charges on users of the transmission system across GB.

Base revenue in R2 – Revenue table is the revenue agreed with Ofgem at final determinations to cover the cost (*R4 – Totex*) of delivering agreed outputs; including financing (*R7 – Financing),* taxation (*R10 – Tax*) and historical pension liabilities (*R12 – Pensions*).

This table summarises the component parts of the allowed revenue cap;

- impact of maintenance and investing in the network (see *R4 – Totex/MOD*)
- incentive revenue adjustments (see *R5 – Output Incentives*)

- innovation related awards (see *R6 – Innovation*)
- uncertainty mechanisms; indexation and pass-through items

Under RIIO, base revenues are revised annually in the annual iteration process (AIP). This adjustment is the *MOD* term found in row 11 and is published by Ofgem in November of each year.

Given the timeline, the use of forecasts and other economic factors which can affect demand we may under or over collect (row 28) what the revenue cap outturns (row 26). Consequently we true-up, by increasing or decreasing, future allowed revenue under the correction factor term (row 25) as detailed in our licence.

The table has no requirement for forecast information.

Reconciliation to the Accounts

In addition to regulated revenue, SPT receive income for non-regulated activities. This is represented by row 64 in the table. It is not covered by the price control but the licence includes rules about how the charges must be calculated.

The table reconciles to the turnover in the Profit and Loss account in the Regulatory Accounts.

R3 Rec to Totex

R3 is directly populated from 2018/19 Regulatory Reporting Pack (RRP) to Ofgem, obtained from SPT Costs and Outputs Pack within the tabs 1.4 Reconciliation to Regulatory Accounts and 2.2/2.4 Totex Forecast. Table 1.4 provides both the Regulatory Accounts values and the required adjustments for each year of the RIIO T1 period to date while table 2.2/2.4 provides the Total Totex values and Price Control Totex values that have been incurred for each of the years of the RIIO T1 period to date. The differences between these two values equate to the adjustments listed out in bottom section of the R3 table. The Adjustments listed are governed by the latest Regulatory Instructions and Guidance document (RIG'S) which contain the principles on what expenditure is valid (Total Totex Versus Regulatory Accounts Values) as well as the latest iteration of the Transmission License which governs the treatment of qualifying expenditure i.e. Price Control Totex.

The "Total Expenditure Per Accounts" is taken directly from the relevant statements and notes located in the relevant Regulatory Accounts of the year in question.

The sources for these values are as follows:

- Tangible Fixed Asset Additions – This comprises of the movement in the year of the balance sheet entry of "Property, plant and equipment" (PPE) (Current year less previous year) as well as adjustments for Deprecation charged (Depreciation, Amortisation charges, Allowances and Provisions (DAAP) note) in the year and any disposals made in the year (PPE note Current years disposals less previous years disposals)
- Customer Contributions Additions – This comprises of the Contributions received in the year and is the "Transfer of Assets from Customers" receivable in the year from the deferred income note

- Capitalised Interest – This comprises of the interest value that has been capitalised in a given year normally against our largest projects. This value can be located within the Trial balance for the Income statement for the current year and is present within the total "Financial expenses" line of the Income Statement
- Operational Costs Incurred – This comprise of the following entries from the Income Statement; "Net Personnel expenses" , "Net external expenses", "Taxes other than Income Tax" & "Depreciation and amortisation charge, allowances and provisions" . However the following items are removed as they do not feature in the RRP as per the RIG's; The annual Deprecation charged is removed leaving only the movements in Allowances and provisions on the balance sheet (DAAP Note) and for the years prior to 18/19, the amortisation of customer contributions is removed as this has been included within the Other Operating Income (OOI) figure which is embedded as part of the "Net external expenses" value above. Post 18/19 this value is no longer recorded within Other Operating Income in the accounts.

The first set of reconciling items (Between Totex & Regulatory Accounts) are as follows:

- Adjustment for ongoing pension costs for IAS 19 present value accrual - Adjustment built into the RIG's. Calculated by taking the ledger pensions value and comparing this to the annual accounts.
- OOI - This adjustment arises due to the fact that not all Income is reported within the RRP in accordance to the RIG's. This adjustment is arrived at by taking the OOI values in the regulatory accounts and deducting any item that is reported within the RRP.
- Capital Contributions for the Network Innovation Competition (NIC). This adjustment arises as we receive contributions in relation to NIC projects which are included in our regulatory accounts but per the RIG's are not reported within the RRP.
- TIRG related expenditure not included in Price Control Totex; this adjustment arises as TIRG related expenditure is not regarded as Price Control Totex due to the fact that it is funded via a bespoke mechanism as mentioned on page 3. Due to this it is not reported within table 2.4 of the RRP and therefore is a reconciling item.
- SPPS Depreciation of Non System Assets as per the RIGS but not reported in the RRP.
- Non System Capex - some Capex costs for Non System Assets are borne by SPPS as a service provider and recharged to the licensee as a depreciation cost above. As per the RIG's the cash cost incurred by SPPS on behalf of SPT in the year is reported in the RRP and the future deprecation costs charged to the licensee are not reported in the RRP. These costs normally relate to Non Operational Property or Computer systems which are shared between SPD and SPT and therefore these cannot be applied to more than one legal entity. The service provider model used by SPEN allows for these costs to be borne by SPPS and then allocated to SPT/SPD based on usage of the assets in question. These costs are required for the delivery of operational activities and therefore are required as part of SPT's licence obligations.
- Pension Deficit repair payments - there are two Pension schemes that currently service SPT, Scottish Power Pensions Scheme ("SPPS") and the SP Manweb Pension Scheme ("Manweb") both of which are held within Scottish power holding company PLC ("SPUK"). As These schemes contain both Regulatory and Non regulatory elements as well as both Distribution and Transmission elements it would be inappropriate to allocate these schemes within the

SPT licence. The deficit costs are not directly billed to SPT because of this reason, instead we continue to report the relevant element to Ofgem via the RIG's Annex K Pensions and Tri annual Pension Deficit Allocation Methodology (PDAM) reporting requirements.

The second set of reconciling items (between Totex & Price Control Totex) are as follows:

- Non Controllable Opex – The following items are excluded from Price Control Totex as they are treated as Pass Through items in the regulatory settlement therefore are deemed to be out of the control of TO's , Rates/Established Pension Deficit/Excluded, Consented and De Minimis Services/Pension Scheme Levy/Bad Debts. All items are located on table 3.1.
- Innovation Expenditure relating to NIC/Network Innovation Allowance (NIA) – Innovation expenditure is remunerated separately to ordinary price control Totex (Business as usual) as per the RIG's. Therefore these values are removed from the Totex values that are compared with the T1 Allowances.
- Opex Related Party Margin – Related Party Margin is disallowable as per the RIG's if the company in question's turnover has no or minority of business (25%) with external parties. As both SPPS and SPUK do not meet this hurdle all margin between these companies does not form part of price control Totex and therefore no remuneration is received on these values.
- Capex Related Party Margin - Related Party Margin is disallowable as per the RIG's if the company in question's turnover has no or minority of business (25%) with external parties. As both SPPS and IEC do not meet this hurdle all margin between these companies does not form part of price control Totex and therefore no remuneration is received on these values. (Pre 18/19 Only)

R4 Totex

Our current forecast total expenditure (Totex) over the eight years of RIIO-T1 is just over £1.74bn (2009/10 prices). This is approximately 3% below allowance (£57.9m), delivered to date through efficient project delivery and changes to forecast allowance and expenditure for generation connections.

Our total spend in 2018/19 was £142.9m, £67.0m below our original plans, taking our cumulative investment in the RIIO-T1 price control period to over £1.3bn (87%). Overall for the RIIO-T1 period, the position relative to allowance will vary, reflecting changes in project delivery profiles since the RIIO-T1 Business Plan was submitted and also the evolving view of generation connections. This can be seen in the profile of spend against the allowances for each of the six years of RIIO T1 to date.

Our current forecast illustrates that we expect average investment over the last two years to be well above 2018/19 actual. The remaining years of T1 are characterised by renewable generation works, expenditure on large 275kV switchgear replacement schemes and developments associated with RIIO-T2 programme. Investment in the latter half of RIIO-T1 is lower, on average, by c£70mpa (c30%) than investment in the first half of RIIO-T1. This relates to timing of a small number of large load-related (LR) projects (wider works) that are now delivered.

The 2018/19 RFPR – encompasses three Enduring Value Adjustments (EVA) that are already included in the base numbers for Totex allowance (row 13) to represent SPT's best view forecast position for RIIO-T1. These EVAs represent:

- Current and future claims under the generation connections incentive mechanism (LSpC6F) for Shared-Use Infrastructure. This is the only mechanism currently in use by SPT,
- Known changes to future output delivery claims under the generation connections incentive mechanism (LSpC6F) for Sole and Shared-Use Infrastructure,
- Known adjustments that result from the Mid-Period Review (MPR) parallel work-streams decisions in relation to wider works – Voltage Control (Kilmarnock South project).

SPT may reasonably expect to make further EVAs; one against MPR for Western HVDC (profile of allowance) and the other to reflect RIIO-T1 close-out for Network Output Measures (NOMs) incentive mechanism (LSpC2M). Transmission Network Owners are currently working with Ofgem to complete their restatement of outputs following agreement of a common methodology. Upon completion of this work, SPT will be able to evaluate the relevant EVA impact and include in a future RFPR.

At this time, SPT are aware of a prospective further close-out adjustment in relation to Totex that would result from a 'true-up' of excluded services (ie connection works explicitly funded by specific customers). This has been incorporated in the file in accordance with Ofgem's treatment as per Transmission Annual Performance Report.

SPT, for 2018/19, has utilised a single Enduring Value Adjustment (EVA) applied across six work-streams to reflect timing differences in delivery of projects or activity compared to original plan. The adjustment re-profiles allowance by project and/or category to match actual/ forecast expenditure across the eight years of RIIO-T1.

The aforementioned EVA has been applied in a single uniform approach, however, SPT recognise that the adjustment to the timing of allowances in relation to Western HVDC (offshore) is subject to a separate and specific agreement with Ofgem under the MPR. In this regard, the approach applied may be considered as illustrative for this report. Nonetheless, its application reveals that efficiency has been delivered through the early years of the price control; mainly in relation to wider works and asset replacement schemes.

It important to note that savings across all aspects of our load and non-load investment programmes are derived in a similar manner. The current estimated savings are calculated predominantly from schemes that are complete (or nearing completion), which is reflected in the adjusted profile within Totex table R4. Whilst, this is mainly from actual costs to date we are working hard to deliver cost efficiency in current schemes as reflected in our forecast future costs. Future cost estimates are prepared for each project, taking account of award values and possible future variations. SPT are committed to delivering the outputs agreed for RIIO-T1 at the best possible price we can realise for the consumer.

Whilst our approach to driving efficiency centres around dis-aggregated competitive tendering philosophy it is much wider than that. Our comprehensive planning approach enables us better coordinate works and take advantage of market position, coupled with engineering expertise and knowledge (eg specify tighter parameters for contract specifications, enabling better comparisons of bidders to drive tendered costs down) that has benefits regardless of tendering approach.

SPT's approach, in essence, follows three streams:

- Integrated and Coordinated Planning. The full RIIO-T1 plan (load/non-load) is held in a single repository and is subject to regular multifunctional review. This ensures our whole business have the same priorities and allows for business wide contingency planning.
- Contract Dis-aggregation. SPT act as its own EPC contractor, rather than outsourcing as is common in the industry. Taking on this role involves carrying out our own detailed engineering designs and procuring a wide range of equipment as well as acting as Principal Contractor.
- Market Development. To support dis-aggregation considerable effort has been expended developing our supply chain e.g. sourcing wider range of smaller (tier 2) contractors as well as monitoring to ensure effective competition in our supply chain. In OHLs we increased the number of competent bidders from two to ten.

These under-pin the level of efficiency from discrete projects stated in our RRP and annual performance report.

There has been significant efficiency realised from wider works schemes (strengthening the network to increase the capability to transport more power through our network). Whilst our approach to development and delivery has been consistent the results are most clearly seen in wider works and overhead line asset replacement. The deployment of innovative solutions e.g. Series Compensation re-design coupled with reduced supply chain costs e.g. MSCDNs, Hunterston East GIS has delivered value for money projects for consumers. The majority of original schemes are complete. Outturn costs may be subject to contract claims, otherwise expect performance to remain as realised. The last wider works scheme - reflects MPR decision (substitution for Kilmarnock South (deferral of Hunterston Power Station closure to 2023/24)) - is the network voltage control project, which is currently under construction. It has delivered over 85% capacity against a total output 420MVAr inductive compensation; with final unit (60MVAr) anticipated during 2019/20.

In addition to our strong performance on wider works our non-load related programme has continued with delivery of a broad range of outputs. This is evident from the extent to which we are ahead of plan – on a cumulative basis; we have delivered 66% of our total non-load outputs, well ahead of our T1 plan of 60% for the first six years. This has included further units delivered on 275kV overhead lines, 275kV and 132kV switchgear, 275kV shunt reactors and 132kV transformers.

A number of modernisation projects were undertaken to address substation assets that were at or approaching the end of their life. These include:

- The replacement of transformers/reactors at Erskine and Johnstone during 2018/19. A unit at Shrubhill was decommissioned; a new dual LV-wound unit will be commissioned Summer 2019.
- Major engineering works associated with the replacement of end-of-life switchgear continued at 132 kV (Chapelcross) and 275 kV substations (Currie, Kaimes, Strathaven and Wishaw).

In accordance with the company's asset strategy, asset replacement and refurbishment work was undertaken to improve the asset health of a number of 400 kV, 275 kV and 132 kV overhead line routes. This included:

- Continuation of work on two 275 kV routes – Kaimes to Cockenzie and Dalmally to Windyhill. These routes are being modernised as part of a wider programme that ensures outage availability is coordinated in an optimal manner with other projects, with full project completion expected during 2019.
- Commencement of construction works to fully refurbish V-route (which runs between Galashiels, Hawick and Harker) 132 kV overhead line, which is scheduled for completion by the end of RIIO-T1.

In addition to the progress we have made with our non-load related programme, the culmination of detailed long term planning continues to result in delivery of key load related projects during the reporting year across wider works and generation connections.

A total of two windfarms were connected in 2018/19 with an output of 139MW as part of this portfolio, requiring a significant level of activity in the area during the year. In support of these connections we have strengthened the network capacity by 299MVA through commissioning of two schemes during the year. This has increased the cumulative output to just over 2000MVA; almost double SPT's RIIO-T1 output target (1073MVA) and facilitated an increase in allowance under the volume driver mechanism.

The construction of the new network infrastructure in South West Scotland has been a significant achievement, requiring 970 hectares of commercial forestry to be felled, 1.1 million tonnes of stone for tower foundations and road construction including the opening and operation of three local quarries, 86km of access roads and 3.8 million man hours of effort to build the 80km of new network. As the schemes that have delivered this output move into their post-commissioning project closure phase we have evaluated volumes of civil works from 'as constructed' contract records. The output from this has been incorporated in 2018/19 RRP, amending associated allowances upwards.

Recent years have been affected by the impact of policy changes and uncertainty affecting our customers in the Renewables sector. Following government announcements on changes to subsidy arrangements for renewable generation, we undertook an extensive exercise to gain a better understanding of likely levels of generation that will ultimately connect to our network. We regularly review this uncertain area of our plan; our forecast reflects our best view forecast based on available information at the time.

The aforementioned additional capacity will support the connection of renewable generation for the benefit of customers and assist in the achievement of UK and Scottish government climate change targets. Whilst we always adopt the most cost effective solutions to deliver these reinforcements, which are a tangible output for customers, a number of the technical solutions we are deploying cannot be properly recognised as a result of Ofgem's MPR decision. SPT will continue to design the most cost-efficient and economic solutions to meet customer needs. Unfortunately, such efforts in this area cannot be fairly recompensed and, as a result, SPT is forecasting to over-spend against allowance whilst delivering an increase in network capacity of 3,482MVA. Overall, SPT are currently forecast to incur expenditure of c£78m in excess of allowance on behalf of generation connections customers across the RIIOT1 price control period.

Following pressure in the reporting year from Ofgem to hand back funds to consumers, SPT successfully contested that this is being delivered via the generation connections mechanism following their Mid-Period Review decision. In addition, SPT agreed to provide a further £20m$_{nominal}$ through the introduction of a Green Economy Fund to enable uptake of low carbon technology and this remains incorporated within our overall forecast for 2018/19.

R5 Output Incentives

In 2018/19, we earned a £3.4m$_{09/10\ prices}$ reward for going above and beyond delivering a safe, secure and reliable service to our customers and meeting our stakeholders' needs.

We have earned £26.5m$_{09/10\ prices}$ to date with a further £5.0m$_{09/10\ prices}$ forecast resulting in total forecast incentive reward of £31.5m$_{09/10\ prices}$ in RIIO-T1 which we estimate to pay c£5.9m$_{09/10\ prices}$ of tax on.

a) Network Reliability Incentive

Our network is critical to delivering reliable supplies to customers and has delivered excellent levels of reliability this year, continuing a trend of strong performance. While transmission faults are rare, when they do occur they can have large impacts. Our network was responsible for only 39.1MWh of unserved energy this year. This represents the annual electricity consumption of a single house and Overall Reliability of Supply of 99.999805%. This is considerably below the benchmark level of 225MWh which was derived from the 10 year average prior to the RIIO-T1 review period, resulting in a reward of £1.8m$_{09/10\ prices}$ in 2018/19. We expect to earn a small reward to the end of the RIIO period.

b) Stakeholder Satisfaction Output

I. Stakeholder Satisfaction Survey

Each year a stakeholder survey is performed by an independent company which provides feedback and scoring from the broad range of stakeholders we interact with. For the second year in a row we have seen a substantial increase in the satisfaction of our stakeholders recorded in this survey achieving an overall satisfaction rating of 8.3 (with an Ofgem break-even level of 7.4). To ensure we are driving on the matters that stakeholders value we measure the indicators which underpin these. To this end, we have achieved a reward of £1.5m$_{09/10\ prices}$

II. Stakeholder Engagement

Ofgem's independent panel assessment of our 2018/19 regulatory submission and subsequent Q&A session will be determined later in the year.

From previous performance we are striving to achieve an award for the remainder of the RIIO period.

c) SF6 Emissions

We continue to outperform the historic SF6 leakage rate of 3% and over RIIO-T1 aim to reduce this rate even further.

In 2018/19, an overall increase in SF6 emissions from 10,488 to 15,863 tCO2e was mainly caused by one specific site on our network. Overall, our SF6 emissions are within forecast, at 15,863 tCO2e against a forecast of 17,960 tCO2e. We were awarded £0.1m$_{09/10\ \text{prices}}$ in 2018/19.

d) Environmental Discretionary Reward

We achieved leadership status in 2015/16 and 2016/17, earning £6.6m$_{09/10\ \text{prices}}$ to date. We have made a prudent forecast going forward. This in no way implies any less commitment to delivering the benefits of this activity for customers.

e) Performance re offers of timely connection

104 connection offers were made in year; all offers were issued within the licenced timescale.

R6 Innovation

We continue to hold a leadership position in innovation and remain the only TO with projects under all three of the RIIO-T1 innovation funding mechanisms. We have continued to develop our Transmission innovation programme whilst delivering key outputs. The construction work on the Innovation Rollout Mechanism schemes have been substantively completed realising cost savings against the approved funding level.

Network Innovation Allowance (NIA)

The Network Innovation Allowance provides limited funding to RIIO network licensees to use for two purposes:

- To fund smaller technical, commercial, or operational projects directly related to the licensees network that have the potential to deliver financial benefits to the licensee and its customers; and/or
- To fund the preparation of submissions to the Network Innovation Competition (NIC) which meet the criteria set out in the NIC Governance Document.

Allowable Expenditure

Allowable NIA Expenditure is the total expenditure that can be recovered from the NIA. It includes Eligible NIA Expenditure (90% of the total expenditure incurred) and, in relation to NIC Projects which passed the NIC Initial Screening Process (ISP) in or before Relevant Year 2017/2018 only, Eligible Bid Preparation Costs.

SPT have so far received £5.6m for Allowable NIA Expenditure in the ET1 price period. We continue to make active use of the Network Innovation Allowance (NIA) to support smaller innovation projects. This year we have been working on fifteen projects funded through this mechanism. Experience has demonstrated that this is an effective pipeline for future larger innovation projects, and for eventual business as usual deployment on our network.

Examples of NIA projects include:

Our Reducing Energy Losses from Transmission Substations project; We have carried out extensive environmental monitoring and modelling of five of our transmission substations. The results of this project will allow us to characterise substations and define potential interventions to reduce the energy losses from these substations. This project will be completed this year, with lessons for all areas of the business.

Our System Integrity and Restorative Actions (SIARA); project aims to extend the principles of the digital substation to include protection requirements between transmission substations.

Unrecoverable Expenditure

Unrecoverable NIA Expenditure is any NIA Project Expenditure arising from a failure to conform to technical requirements or arising from an increase in payments associated with a reduction in standards of performance and as such can't be recovered from NIA expenditure. No Unrecoverable Expenditure has been incurred to date, nor is forecast for the remainder of RIIO-T1.

Network Innovation Competition

The Electricity NIC is an annual opportunity for electricity network companies to compete for funding for the development and demonstration of new technologies, operating and commercial arrangements. Funding will be provided for the best innovation projects which help all network operators understand what they need to do to provide environmental benefits, reduce costs, and maintain security as Great Britain (GB) moves to a low carbon economy. Up to £70m per annum is available through the Electricity NIC. Network companies make a compulsory contribution of 10% of the total project funding approved at the start of the project. This is the maximum value of the Successful Delivery Reward (SDR) for each project. Companies can apply to receive this once their project is complete if they can demonstrate how they have met certain criteria.

We have commenced the PHEONIX project (£15.6m) whilst progressing to programme and budget on our VISOR (£6.5m) and FITNESS (£8.3m) initiatives.

Following successful completion of our NIC project, VISOR was eligible to apply for a Successful Delivery Reward (SDR), which received 100% successful delivery funding (£0.7m), representing the high standard of our innovation project delivery at national level. This reward returns our initial contribution from 2014/15 in 2018/19.

R7 Financing and R7a Financing Input R8 Net Debt and R8a Net Debt Input

Actual finance cost and debt figures are taken from regulatory accounts information for each licensee. This information can be found on our website at:

https://www.spenergynetworks.co.uk/pages/accounts_information.aspx

Forecast finance costs and debt figures are derived from business long term plan projections of cash requirements, and assume that all new debt/refinancing will be via an intercompany on demand loan at a variable rate plus margin.

We have a licence derogation in place as agreed with Gas and Electricity Markets Authority (GEMA). SP Distribution Plc and SP Transmission Plc provide guarantees to Scottish Power UK plc with respect to their external debt holders outstanding as at October 2001.

The overriding rationale of the debt guarantee provided by SP Distribution and SP Transmission to the then Scottish Power UK plc external debt holders, at the time of business separation in October 2001, was to ensure that the existing debt holders, effectively had access to the same asset base, and cash flows that they would have had pre that imposed asset separation and that they had originally lent to. The companies providing the guarantees, ultimately, being responsible for the repayment of both the interest and principal of that guaranteed debt. If the guarantees were ever called the companies would assume that external debt obligation and therefore be required to generate sufficient cash flows to satisfy the external debt holders requirements.

R9 RAV

The regulatory asset value (RAV) is a key building block of the price control review. RAV represents the value upon which the companies earn a return in accordance with the regulatory cost of capital and receive a depreciation allowance. Additions to the RAV are calculated as a set percentage (90%) of Totex.

The latest Price Control Financial Model (PCFM) was published in November 2018 following the Annual Iteration Process (AIP). The AIP PCFM is designed to update future revenues as a result of past performance and the latest available debt index allowance. It does not forecast future total expenditure performance. Consequently, future RAV values and allowances (including debt and tax) are not necessarily representative of a network company's position through the remainder of RIIO-T1.

This table addresses that issue above and updates RAV for the Totex, allowances and enduring value adjustments reported in *R4 – Totex*. This allows revised allowances for which debt (*R7 – Financing)* and tax (*R10 – Tax*) performance is based upon.

SPT report a compound annual growth rate of 7.1%, a 73% increase from opening ET1 RAV of £1.094bn$_{\text{09/10 prices}}$ to an ET1 closing RAV of £1.894bn$_{\text{09/10 prices.}}$

R10 Tax

We receive a tax allowance calculated through the Price Control Financial Model (PCFM), based on a fixed split percentage of tax pool additions and forecast nominal financing costs ('*net interest paid'*).

In order to compare like-for-like performance against the allowance, we have revised the tax calculation updating for actual capital allowances and financing costs. SPT has an accounting period to December, therefore our taxable profits, capital allowances and liabilities are on a calendar year basis. In order to convert our accounting period reported values to compare with a regulatory year allowance, we have assumed a 25%/75% split of capital allowances to date.

Most of our assets are Special Rate Pool items and will attract a rate of 6% from 1st April 2019 (previously 8%).

Our 2018 CT600 is not yet due for submission to HMRC, consequently the 2017/18 value in [*R10 – Tax, H12*] is a forecast to compare against the allowance. The additional *other adjustments* will be trued up in due course.

In respect of previous years and up to 2016/17, SPT contributed a further £53.3m in tax to HMRC for activities where we receive no tax allowance, for example incentives, innovation and non-regulated activities.

R11 Dividends

A dividend is proposed annually and is based on distributable reserves at a level no greater than the notional gearing levels for SPT (55%). This proposed dividend goes through a rigorous diligence process to ensure it is not in breach of any licence conditions (Licence condition B7) and in order to state that SPT would not be in breach of these obligations in the future. Once satisfied the dividend is approved by the Board of Directors prior to payment.

R12 Pensions

Figures in R12 Pensions reflect the total of established and incremental payments across both the ScottishPower Pension Scheme (SPPS) and the Manweb Group of the ESPS (Manweb) for each licensee. Similarly, the latest pension scheme valuation results at 31/3/16 are based on the total of the SPPS and Manweb scheme figures.

PDAM licensee provided information from the PDAM tables (tables P1.1/2.1) submitted in 2014 are used to calculate established and incremental deficit payments for regulatory years ending March 2014-2017. PDAM tables submitted in 2017 are used to calculate established and incremental deficit payments for the regulatory year ending March 2019.

Results of the 31/3/16 valuation have been input in nominal terms (i.e. assumed price base 15/16) and are taken from the relevant PDAM tables submitted in 2017.

R13 Other Activities

SPT has not been subject to any investigations, fines or penalties as shown on Ofgem's website: https://www.ofgem.gov.uk/investigations

Quality of Service Guaranteed Standards

SPT has no quality of service guarantees.

Data Assurance statement

Data assurance was conducted in accordance with SPEN's "Regulatory Submissions Procedure" developed and implemented to ensure compliance with Ofgem's DAG. The details of the accountabilities we have in place are contained in the SPEN NetDAR Submission, 28 February 2019, Section 1.4 Organisational Data Assurance Process.

Based on DAG methodology, a risk assessment was carried out on the submission and the result is as below:

<table>
<tr><th>Submission</th><th>Total Risk Score</th><th>Impact Score</th><th>Probability Score</th><th>Impact and Probability Breakdown</th></tr>
<tr><td>RFPR</td><td>High</td><td>‘3’</td><td>‘3’</td><td>Impact:
• Financial category was allocated ‘3’
• Comparative Efficiency was allocated ‘3’
• All other categories were allocated ‘1’.
Probability:
Reporting Assessment:
• All categories were allocated ‘4’
Control Framework Assessment:
• Control activities ‘0’
• Experience of personnel ‘1’
• Historical Errors ‘2’</td></tr>
</table>

The minimum DAG was applied per table and based on the Total Risk Score and amount of data in the submission, we selected an Internal Data Audit and Director Sign-off as additional assurance. Also, due to parts of the submission being published, CEO Sign-off was deemed relevant.

The Internal Data Audit was performed by our Licence and Assurance Team and our Finance Department who are independent from table preparation. Assurance was performed on a sample basis on the following tables in the submission. No findings were noted.

Table No.	Table Name
R3	Reconciliation to Totex
R6	Innovation
R7	Financing
R8	Net Debt
R10	Tax

In summary, the following assurances were completed:

- Method Statement
- Second Person Review
- Senior Manager Sign off
- Internal Data Audit
- Director Sign off
- CEO Sign-off

Appendices to include

Reconciliation between regulatory year end and statutory year end

Given that price controls are set on a March year end we have reconciled to the March Year End publicised Regulatory Accounts. Our Statutory Accounts are prepared on a calendar year basis. Our Regulatory Accounts can be found on our website using the following link:

https://www.spenergynetworks.co.uk/pages/accounts_information.aspx

Enduring value adjustments

The enduring value adjustments we have made and the methodology of these adjustments are embedded within this document. We believe it is more helpful to explain these in the context of the specific projects where they are applied. Therefore we have not explained them in this section separately.

Basis of estimations and allocations

We do not consider our Regulatory Financial Performance Report to contain any estimates and allocations nor does it include apportionments.

Other relevant information

We do not consider any further information to be relevant in addition to the tables and this commentary.

We have provided our opinion above on a weighted average RoRE and consideration of other methods to be a more appropriate basis of evaluating performance.