

GUIDELINES FOR RISK LIMITS AND REALISING THE APPLICATION OF THE RISK POLICY FOR IBERDROLA'S NETWORK BUSINESSES IN SCOTTISH POWER

The Board of Directors of SCOTTISH POWER, LTD. (the “**Company**”) is responsible for (i) disseminating, implementing and ensuring compliance with the policies, strategies and general guidelines of the Iberdrola group in the United Kingdom, (ii) adopting the Risk policies, (iii) specifying, where appropriate, the companies which are included in the scope of the policies, (iv) approving the appropriate guidelines for risk limits, and (v) promoting the application of the Risk policies specific to the different businesses of the Iberdrola group while complying with the characteristics and peculiarities of each country.

Within the framework of the *General risk control and management policy* and associated risk policies, as approved by the Board of Directors of IBERDROLA, S.A., (“**Iberdrola**”) acting in its own interest and that of the companies belonging to the group whose principal entity is, in a legal sense, the Company (the “**Group**”), this *Risk policy for Iberdrola's network business in Scottish Power* is approved, based on the foundations as outlined in this policy.

On the basis of the foregoing, the Board of Directors of the Company approve the current guidelines for risk limits and realising the application of the risk policy for the networks business in Scottish Power (henceforth the “**Risk policy for Iberdrola's network businesses in Scottish Power**”).

Simultaneously, the Board of Directors of Scottish Power Energy Networks Holdings, Ltd. (“**Scottish Power Energy Networks**”) will approve, where appropriate, the corresponding specific risk limits applicable to its respective subsidiary.

In exceptional circumstances, following proposals from the relevant business or corporate department, and with the supervision of the Group Risk Committee and the Iberdrola Operating Committee, the Board of Directors of Scottish Power Energy Networks can approve exceptional exclusions to the established policy limits.

1. Purpose

The purpose of this document is to establish the guidelines for the framework for the control and management of the risks, within the general guidelines determined in the *General risk control and management policy* approved by the Board of Directors of Iberdrola which, in turn, is further developed and supplemented by the *Corporate policies* and the specific risk policies that may be established in connection with certain businesses and/or companies of the Group.

2. Scope

Within the limits specified in the laws and regulations applicable to regulated activities, the *Risk policy for Iberdrola's network businesses in Scottish Power* applies to all network

regulated activities carried out by Scottish Power Ltd. (“**Scottish Power**”) and its subsidiaries in the United Kingdom, including investments in and operation of electricity distribution and transmission assets in the areas allocated to Scottish Power Group, under the applicable regulatory framework, through the following licensees:

- a) SP Distribution PLC (SPD)
- b) SP Manweb PLC (SPM)
- c) SP Transmission PLC (SPT)

and the integrated services company, SP Power Systems Limited (SPPS).

SPD and fellow subsidiary companies SPM and SPT, are the "asset-owner companies" and their main activities are, 1) Transmission of electricity (SPT) and 2) Distribution of electricity (SPD & SPM), including planning, development and the operation and maintenance of networks.

	RAV	End of price control
SPT	GBP 2,879,000,000	01/04/2021
SPM	GBP 2,395,000,000	01/04/2023
SPD	GBP 2,136,000,000	01/04/2023

The *Risk policy for Iberdrola’s network businesses in Scottish Power* contemplates all risks faced by Scottish Power, including regulatory, business, market, credit, operational, and reputational risks.

3. Risk factors - definitions

The general definitions of risk factors included in the Group’s General Risk Control and Management Policy shall apply to this Policy, along with the following specific risk definitions:

- ✓ **Regulatory and Political Risks:** the risks associated with possible regulatory changes that may have an impact on the business or on the operation of the market in the short or the long term.
 - Changes resulting from the United Kingdom leaving the European Union single market and the possible effects it may have on the development of the energy policy that will settle in the coming years.

UK electricity transmission and distribution utility businesses remuneration framework apply a “*price control*” model, based on a recognized cost for WACC, Asset Depreciation and Operating Costs plus a performance-based incentive, which benefits (or losses), achieved through efficient management, are partially retained by the company during the established regulatory period.

RIO framework is an outputs-based regulatory framework. This approach provides powerful incentives for companies to innovate and seek the least costly way to provide

network services. The outputs present the companies with either a risk or an opportunity in many areas of SP's operational business.

- Current distribution price control model (RIIO ED1), including SPD and SPM, is set from April 2015 to April 2023
- Current transmission price control model (RIIO T1), including SPT, is set from April 2013 to April 2021.
- “*RAV (Regulated Asset Value)*” can be defined as a financial measure representing regulatory historic recognized investments.
- “*OFGEM*” is the electricity regulator in UK and is responsible for monitoring compliance with the conditions of licenses.

- ✓ **Business Risks:** uncertainty regarding the performance of key variables inherent in the business, such as weather conditions and others.

Variations in demand, in the longer term, do not impact the P&L or investment activity in Energy Networks.

- ✓ **Market Risk:** the risk stemming from changes in market conditions.

Energy price risk is not significant given that the Networks business does not sell energy.

WACC remuneration is indexed for each year of the price control period using data for the cost of debt to the previous 31 October and the Retail Price Index.

In the case of Transmission, the cost of debt is obtained by ten-year moving average of the Iboxx+10 Sterling non-financial corporate bond index, deflated by the “breakeven” inflation projection derived from index linked gilts. In the distribution companies, the same index is used to obtain the cost of debt in distribution, but the average is extended every year by one year.

All incomes, costs and regulated asset values are linked to the Retail Price Index (RPI) which is one of the standard UK measures of inflation.

Some employees of the Regulated business are members of the Scottish Power and Manweb company pension's schemes, including the defined benefit schemes. The Energy Networks component of these schemes (including any deficits if applicable) is currently funded through the price control.

- ✓ **Credit Risk:** the risk that counterparty fails to perform its contractual obligations, thus causing an economic or financial loss to the Group. The main counterparties are:

- a) In the case of distribution, electricity supply companies who pay SPD and SPM Distribution Use of Systems charges. In the case of transmission the Transmission Network Use of Systems charges are paid to SP Transmission by National Grid Electricity Transmission (NGET) which is the Transmission System Operator in the UK.

Any credit losses experienced by Energy Networks are considered recoverable through future price reviews.

b) Contractors and manufacturers providing materials and services to SP Energy Networks.

- ✓ **Operational, Technological, Environmental, Social and Legal Risks:** likelihood of direct or indirect losses derived from inadequate internal procedures, technical failures, fraudulent activity, human error, or as a consequence of certain external events or legal risks including bribery and corruption.

In addition to the exclusive assets of SPT, SPD and SPM this includes the Scottish Power share of the HVDC Western Link project owned and operated in partnership with National Grid. As most of the cable is undersea, the Operational, Technological and Environmental risks are augmented. Consequently, this can increase the impacts of legal and regulatory risks.

- ✓ Quality of service in electricity distribution business means reliability of supply (determined by the number and duration of power supply interruptions) and quality of the product (in terms of characteristics of the load and the technical parameters established by the supply contract). Minimum quality of service is established by the current regulation, for both points of supply as well as geographic regions covered by the distribution company.

Such losses can occur through increased costs and compensation to customers with the price review period incentives aimed at improving service quality along with reducing technical and commercial power losses.

- ✓ **Reputational Risks:** potential negative impact on the value of the Company as a result of behaviour by the company under the expectations created among various stakeholders, customers, media, analysts, public administration, employees and society general.

4. **Basic principles**

Scottish Power is committed to maximized added value, through cost and investment efficiency, maintaining a high level of service reliability and a safe work environment for its employees, contractors, customers and other stakeholders and protecting the environment.

All actions aimed at controlling and mitigating risks shall be aligned with the principles laid down in the *General risk control and management policy* and, in addition, shall comply with the following basic action principles specifically applicable to the scope of the *Risk policy for Iberdrola's network businesses in Scottish Power*:

- ✓ **Adopt** any investment or expense decision with unified criteria, based on a prioritization of market growth, reliability of supply, and Scottish Power optimal rate of return.
- ✓ **Ensure** continuity and sustainability in the provision of services and the contribution of value to all stakeholders, even in the case of possible extraordinary events.

- ✓ **Maintain** a leading quality of service position in the United Kingdom, reducing the network vulnerability risk to extraordinary events, with sustainable economic criteria.
- ✓ **Keep** Scottish Power's good reputation among all stakeholders, including employees, customers, suppliers and regulators.
- ✓ **Encourage** a culture of continual improvement in its activities of Scottish Power, providing enhanced economic performance, improved employee productivity and experience, better quality of products and services for customers and an enhanced relationship with the communities, as well as a lesser environmental impact.
- ✓ **Acknowledge** Scottish Power's responsibility for the impact on the environment and on the communities in which it operates.

Scottish Power is committed to the highest standards of ethical conduct and integrity in its business activities in the UK and overseas, and has zero tolerance of any criminal activity or fraud.

5. Guidelines

Scottish Power shall implement the mechanisms required to ensure compliance with the *General risk control and management policy*, and with the standards, guidelines and limits generally established in such policy and in the various *Corporate policies*, as well as with the following specific guidelines and limits:

5.1. Common to all activities

- ✓ All regulated utilities will manage their interest and exchange rate risks, according with their regulatory frameworks. Any shareholders interest or exchange rate risk will be reported and transferred to the Finance and Resources Division to be integrated with the rest of the Group's positions within the principles of the Group's financial risk policy.
- ✓ In all new contracts, the acceptance of clauses which demand the provision of additional guarantees in the event of a credit rating downgrade of the Group should be avoided wherever possible and in case they are strictly necessary they will be previously communicated to the Finance and Resources Division and properly approved.
- ✓ Establish environmental risk management processes and controls for all business activities to ensure, at a minimum, compliance with all statutory, regulatory and environmental obligations in accordance with the principles established in the environmental policy of the Iberdrola Group and report any significant incident.
- ✓ Maintain appropriate systems and procedures to ensure the confidentiality, integrity and availability of information as well as security and access control at all facilities.
- ✓ Continuity plans shall be designed to minimize the impact of natural disasters or other external events.
- ✓ Ensure the appropriate qualifications and training of persons and the planning and implementation of occupational health and safety measures in accordance with the

principles established in the Group's occupational risk prevention policy, including its contractor companies.

- ✓ UK Risk Management will monitor the compliance with all guidelines and limits and inform the Corporate Risk Management Group on any exceeds or significant deviation, which in turn will provide timely information to the Group Risk Committee.

5.2. **Incomes of system charges and credit risk**

- ✓ Use of system revenues against target shall be monitored

Use of systems revenue against target (Gross Margin): £1,174.6m

SPD: £402.7m

SPM: £376.7m

SPT: £395.2m

Earnings Before Interest : £563.7m

- ✓ Transactions shall be made with solvent counterparties and/or with adequate guarantees and with the guidelines and limits of the *Credit risk policy* will be met.
- ✓ Credit risk arising from overdue payment for use of system charges for Transmission and Distribution must be appropriately mitigated in line with UK regulations.
- ✓ *Corporate Risk Management must be informed, on a monthly basis, of overdue debt, debt due over 90 days and any balance and movement in provisions.*

5.3. **Investments**

Investments in and operation of distribution and transmission networks shall be aimed at ensuring the utmost efficiency, minimal unavailability and cost optimization, based on appropriate investment standards that fully take into account the standards and commitments of the regulator, guaranteeing established occupational safety and health levels and respect for the environment.

- ✓ All investments will be developed according to the criteria, guidelines and limits established by the *Investment policy*.
- ✓ All investments shall be made taking into account the physical effects in the assets derived from climate change, particularly considering the increased frequency and severity of adverse weather events.
- ✓ In order to ensure compliance with the investment plan agreed with the regulator (Ofgem) within the framework of the multi-annual rate review, an adequate annual budget shall be approved and the evolution thereof shall be adequately monitored.

- Delivery against Ofgem allowances:

- *Capex: £559.8m*

- *SPD: £187.3m*

SPM: £179.1m

SPT: 193.4m

- % Distribution Totex delivered against allowance: 79.7%
- % Transmission Capex delivered against RIIO- T1 allowance: 87.7%

More generally, any failure to deliver output commitments would result in claw back of the associated revenues plus a minimum of 2.5% in additional penalties. In some cases, the shareholders may be expected to finance the original investment to reinstate SP to the level which was agreed in the next price control period. Such investment would only attract revenues of 55% of the original value.

- ✓ Regulatory risks shall be identified and reviewed and, where appropriate, the availability of the necessary permits and licenses shall be ensured.
- ✓ Efforts shall be made to adequately mitigate the risk of price changes in the cost of the investments agreed with the Regulator.
- ✓ In order to mitigate the risk associated with the volatility of raw material prices, transactions may be made to hedge the market risk associated with the purchase of materials for projects.
- ✓ *Insurances shall be taken in accordance with the standards, guidelines and limits established in the Insurance Policy Group. In particular, an appropriate level of deductibles shall be contracted to optimize total cost of premium payments plus maximum probable annual deductible costs.*

According with Corporate insurance policy guidelines, all events over £100,000 will be properly recorded and communicated to the corporate insurance team.

- ✓ *Divergence Risk*
 - *Monitoring any increases in divergence between RAV and statutory NBV*
 - *Indicator: 130% by 2023 and there is no significant (>3%) deterioration in the current years result from the previous year's projection (NBV + PPA / Regulatory RAV)*

5.4. Operation and maintenance

- ✓ A comprehensive maintenance program shall be established, effectively combining corrective and preventive maintenance.
- ✓ Asset maintenance and investments shall be carried out using the company's own or subcontracted resources, and any subcontracting shall be done in accordance with the credit risk management guidelines that may be established and following procedures and standards defined by Procurement.
- ✓ There will be a continuous monitoring of all regulated parameters that can affect profitability, including possible incentives and/or penalties.
- ✓ Real opex against Ofgem recognized opex will be monitored and will consist of costs arising from activities relating to maintaining the networks including telecontrol, preventative maintenance, corrective maintenance, tree cutting and indirect opex from SPPS:

- ✓ Customers shall be informed of planned power outages in the network and of any failures that may affect supply.

- *Broader Customer Satisfaction: SPD: 8.94*

- *Broader Customer Satisfaction: SPM: 8.94*

This is an Overall Customer Satisfaction Score based on Interruptions (Planned/Unplanned), Connections (Quotes/Completed) and General Enquiries. Score is out of 10)

5.6. Pension Schemes

Scottish Power “Defined Benefit” pension schemes risk shall be periodically monitored.

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The *Risk policy for Iberdrola’s networks businesses in Scottish Power* was approved by the Scottish Power Limited Board of Directors on May 12th 2020.