



**The Consumer Council**

***Consultation: Investigation into Northern Ireland Electricity's capitalisation practice: Draft determination***

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## **Introduction**

The Consumer Council welcomes the opportunity to respond to this consultation.

The Consumer Council is an independent consumer organisation, working to bring about change to benefit Northern Ireland (NI) consumers. Our aim is to make the consumer voice heard and make it count.

We have a statutory remit to *promote and safeguard the interests of* consumers in NI and we have specific functions in relation to energy, water, transport and food (the Consumer Council and the Food Standards Agency (FSA) have a memorandum of understanding and the Council's strategic focus on food is primarily in relation to food prices and customer experience). These include considering consumer complaints and enquiries, carrying out research and educating and informing consumers.

The Consumer Council is also a designated body for the purposes of supercomplaints, which means that we can refer any consumer affairs goods and services issue to the Office of Fair Trading, where we feel that the market may be harming consumers' best interests.

In taking forward our broad statutory remit we are informed by and representative of consumers in NI. We work to bring about change to benefit consumers by making their voice heard and making it count. To represent consumers in the best way we can, we listen to them and produce robust evidence to put their priorities at the heart of all we do.

## **Summary**

The whole issue of NIE's capitalisation practice is a serious concern to consumers. We welcome the fact that the Regulator has managed to uncover a hitherto undisclosed and unauthorised change by NIE to its regulatory accounting and furthermore proposes to return to consumers' money that this has caused them to unwittingly overpay.

The evidence presented in the 'Investigation into Northern Ireland Electricity's capitalisation practice', ('the consultation'), in our view constitutes an allegation that NIE failed to inform the Regulator of a change that it made unilaterally to its accounting practice and as a result, inflated its profits at the expense of consumers. We are aware that NIE have publicly denied any wrongdoing in their auditing and intend rebutting this allegation.

Until we see the evidence that NIE provide to rebut the allegation we can only comment on the information we have in the consultation. On the available information, consumers will be quite rightly shocked that NIE did not inform the Regulator that it had changed its auditing practice. Perhaps less shocking but of equal concern is that over a

period of seven years the Regulators office failed to detect this practice by NIE.

Now that the Regulator has uncovered this practice of NIE, the Consumer Council wants to see the following take place:

- Every penny that consumers have overpaid must be accounted for and returned to them;
- Any culpability on the part of NIE be assessed and appropriate sanctions imposed against them;
- An assurance given by the Regulator that no similar practices have been or are presently taking place within regulated utilities in Northern Ireland; and,
- Steps taken by the Regulator to ensure that similar practice does not happen again.

### **Quantifying the loss**

It has been at times difficult to compare information in the consultation with corresponding information in the earlier 'Northern Ireland Electricity Transmission and Distribution Price Controls 2012-2017 Draft Determination' (the 'Draft Determination'), on the same issue.

In the Draft Determination, a figure of £118.5m as the total outperformance against controllable, opex allowance is stated. This figure was calculated using the five year period of 2005/06 to 2009/10. However, in the consultation at Figure 1, what appears to be the corresponding figure over the same period amounts to £90.1m.

Point 8.1 in the consultation asks the reader to consider a seven year period covering RP3 and RP4, whereas in the 'Draft Determination', we are asked to consider a five year period.

Furthermore, the Draft Determination states that the £118.5m may include an amount that is due to 'genuine improvements in operational efficiency'. However, there is no indication whether in arriving at the final figure of £35.32m in the consultation a test of these possible efficiencies has been carried out.'

Thus we have a rather confusing picture and we would ask the Regulator to confirm that the exact amount they have arrived at of £35.32m overpaid is a settled one. Consumers need to be certain that the extent of the problem has been correctly quantified and that the refund they get will be final.

The Regulator states that it will be adjusting NIE's RAB and revenues by £35.32m which represents two per cent off the network charge for two years and 1 per cent off the network charge for the following 38 years. Currently network charges account for around 23 per cent of

the average domestic electric bill. Based on the average domestic electricity bill of £505 per year<sup>1</sup> the adjustment will save consumers £2.32 per year for the first two year and £1.16 per year for the following 36 years or a total of £46.46 over the 40 year period.

The material loss to the consumer is therefore relatively small. However, the undermining of trust between NIE and consumers is significant. NIE must have been aware of its responsibility to inform the Regulator when it changed its capitalisation practice and to produce accounts on a 'consistent basis'<sup>2</sup>. If it did not, then it would have been unaware of important legal and regulatory requirements.

### **Culpability and sanctions**

The Regulator must investigate the culpability of NIE in withholding information from the Regulator and thereby inflating its profits at the expense of consumers. The evidence that has appeared so far already casts NIE in a negative light. If the allegation is correct, this matter will undoubtedly and rightly have a reputational damage on NIE and its parent company ESB. Despite having a vital role at the centre of NI's energy infrastructure NIE has no competitor for consumers to switch to. Thus, reputational damage will have a limited impact on the company's business and will not be sufficient to act as a deterrent to prevent such activity recurring in the regulated NI utilities in the future.

The Regulator has powers to impose financial penalties under Article 45 of the Energy (Northern Ireland) Order 2003, and having considered the culpability of NIE and considered regulatory precedent, must publicly state whether a fine or an alternative sanction should be imposed. If no sanction is deemed appropriate, the Regulator must explain why, as giving consumers back their money is not a penalty to the company. A deterrent is required if regulation is to protect consumers going forward.

### **Regulatory scrutiny**

This issue also puts the Regulator's office in the spotlight. The Regulator acts as a proxy for competition and must ensure that unnecessary costs and unreasonable profit is driven out of the final price through its scrutiny processes, just as competition drives out these costs by the need to offer the lowest price.

We recognise that the Regulator's office has worked diligently to uncover this issue and is seeking to return consumers their money. This is the right thing to do and what we expect of the Regulator's office. However, consumers also expect the Regulator to have in

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<sup>1</sup> Based on the Power NI average domestic bill from 1<sup>st</sup> October 2012 at 3300 kwh.

<sup>2</sup> NIE Licence, Condition 2, 3(b)

place a framework that ensures that this type of practice does not occur in the first place and where it does exist is able to detect and deal with it as quickly as possible. The issue of capitalisation appears to expose a weakness in the past practices of the Regulators office. A number of statements within the Regulators documentation support this view. For example:

- The statement in the consultation at 4.2 that, ‘given the time required for this necessary process, we did not have visibility of NIE T&D’s actual outperformance for the last two years of the RP3 period at the time we came to set allowances for RP4’;
- The statement at 4.3 that ‘Once RP3 was complete we had the information we needed to calculate actual outperformance during the period’, appears to contradict with the statement in the Draft Determination at 6.16 that: ‘The total outperformance against the controllable opex allowance in the five years between 2005/06 and 2009/10 was £118.5 million. We accept that some of this may be due to genuine improvements in operational efficiency. It is not clear however how much is due to efficiency and how much may be due to the change in capitalisation practice’. It appears that despite having the information required in April 2007, by April 2012 the Regulator was still unable to decide on the level of efficiencies that NIE had actually achieved;
- Table 2 in the consultation shows outperformance in RP3 at 40 per cent and in RP4 at 42 per cent. It describes this as ‘significant’ and requiring more detailed evaluation. The statement at 4.3 in the consultation and repeated in the bullet point above indicates that the RP3 outperformance was known to the Regulator once RP3 was complete. However, the statement in the consultation at 4.7 that ‘After publishing our RP5 determination, in which we raised concerns about NIE T&D’s capitalisation practice, the company provided additional information with regards to its claimed outperformance over RP3 and RP4’ raises the possibility that it was only then that the full extent of the outperformance figures were known. The Regulator should have flagged up the issue of the significantly high efficiency savings immediately they were known and this should have been before the RP5 draft determination was published;
- The CEPA Report into the ‘Confirmation of capitalisation practice materiality’ states at 1.2 that ‘When the CEPA Consortium was appointed by the Utility Regulator to support the review of the RP5 price control, NIE’s operating expenditure had not been subjected to an external efficiency review for 10 years’<sup>3</sup>.

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<sup>3</sup> Cambridge Economic Policy Associates Ltd Report into RP5, August 2012

- Point 5.8 of the 'consultation' states: 'The consultant auditor's investigation revealed difficulties when trying to understand the company's reporting systems. We intend to discuss this area further with NIE T&D to allow effective reporting for RP5 and future price controls'.

Consumers need to feel confident that the Regulatory process is robust and up to the job of protecting their interests. We need assurances that:

- There are no other similar practises occurring in NI utilities now;
- This type of practice will not be able to occur again;
- That when such practices are uncovered they are resolved and consumers refunded in the shortest possible time.

The Regulator must address this issue if confidence in the Regulators' office is to be maintained by consumers.

### **Asset Management**

In section 9 of the consultation, it states that some efficiencies that NIE claimed for were as a result of stopping or reducing activity. The concern here is that this may not represent best asset management practice as increased maintenance or replacement costs may occur in the future. Whilst the Regulator does not propose penalising NIE for this it does intend 'exploring reporting arrangements and asset management practices further with NIE'. This highlights our concern previously stated in our response to the RP5 consultation that:

*'It would appear that previous Price Controls have failed to provide a regulatory framework in which NIE was required, or felt it necessary to systematically assess the quality and performance of its network and make decisions that aspired to the most efficient outcome.'*

We reiterate our view that NIE should now be instructed by the Regulator to introduce PAS55 or other accredited industry standard methodologies.

### **Conclusion**

All stakeholders who support the best interests of consumers and the energy industry in Northern Ireland should be concerned at the findings of the Regulators report. We support the Regulator's proposal to return all the money to consumers. However, the Regulator must go further and take action to reassure consumers that the regulatory process is sufficiently robust to identify and prevent any reoccurrences of such practice and so protect consumers' interests.



The Consumer Council

# ***Making the consumer voice heard and making it count***

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