# NIE Energy Supply Price Control 2010/11

# Decision Paper

**15th March 2010**

# Executive Summary

This document forms a further one year Supply price control for NIE Energy Supply (previous controls for 2000-2005, 2005-2007, 2007-2009 and the latest being a one year price control for the period 2009-2010). This one year control covers the period 1st April 2010 until 31st March 2011. The new price control is being introduced at a time of change in energy retail competition.

This price control deals with one element of the final tariff formula ($S_t$ Term) and in the main sets the total revenue NIEES can recover from customers for the duration of the control. As NIEES has minimal assets, this control follows the standard regulatory precedent regarding price controls for Supply companies without assets i.e. the Allowed Revenue will consist of operating costs and a margin related to turnover. In keeping with the UK regulatory precedent, working capital costs are derived from the business's margin. NIEES have again highlighted to the Utility Regulator (UR) the enhanced working capital pressures due to SEM weekly payment arrangements as an issue that should require some recognition in terms of the quantum of the Margin. This decision to keep the margin at the current level is consistent with the consultation paper which explained that the UR recognised the step change in working capital commitment brought about by the creation of SEM in setting the 09/10 price control. This is explained in more detail in the section on margin.

The last one year price control was applicable to all customers except for non-domestic customers with an annual consumption greater than 150MWh, as it was proposed that these customers would become de-regulated and be removed from the price control. Previous to this all customers over 1MW were deemed outside of the regulated sector and part of the competitive market. This traunch of deregulation took place as part of the 2009/10 price control.

NIEES have proposed a further traunch of deregulation as part of this price control. NIEES proposed an arrangement that would include c3,000 additional sites and the deregulation would apply to those groups of sites which would consume in total >150MWh per annum as a group i.e. a group of small sites purchasing electricity as a single entity or as a single customer. Whilst further deregulation impacts upon the price control parameters with regard to allowable operating costs and net margin it may form part of a separate consultation exercise if it is deemed appropriate to investigate further de-regulation in the timeframe of this one year price control. The UR consider that a full analysis of deregulation and it affects up until now would be required and market participants views sought before any further deregulation could take place. The UR decisions regarding this price control will assume no further de-regulation and will set baseline allowable revenues which can be adjusted to take account of any further de-regulation in the event it is implemented. The quantum of these adjustments will be discussed as part of any separate consultation.

This paper outlines the UR decisions with regard to the supply business entitlement. The decisions have been made on the basis of information and data submitted (including the updated latest best estimate for 2009/10 and a forecast

for 2010/11 provided by NIEES) and meetings with NIEES, and also with regard to the responses to the public consultation of which there were five. Listed below are the main features of this control.

| | |
|---|---|
| Form and Scope: | will remain as they are currently (except in the case that the additional deregulation takes place – this is currently undecided and may form the subject of a separate consultation) |
| Duration: | April 2010 until March 2011; |
| Margin: | Will remain as a fixed margin (rather than a percentage of actual turnover) at the same level, being £10.491m (09/10 prices); |
| Operating Cost: | £17.592 (09/10 prices) |
| Total Revenue: | £28.083 million (09/10 prices) |
| Et Term | A modification to the Et term to accommodate the pass-through of actual costs of domestic competition (as reasonably agreed in advance with the UR and verifiable); and |

Proportion of Gross Profit apportioned to fixed costs remains the same as the previous price control at 67%.

# NIEES Price Control to Date

The original NIEES price control ran from April 2000 to March 2005. Thereafter a series of shorter controls were put in place covering the periods 2005-07, 2007-09, and a further one year control covering the period 2009–10. This one year price control covers the period 1 April 2010 to 31 March 2011.

References in this document to NIEES, NIE Supply or the Supply business, should be taken to refer to NIE Energy Supply.

# Changing Environment

A primary reason for the series of shorter term controls in the past number of years is to retain the flexibility to change the form or scope of the regulation of NIEES in light of any developments that have been identified in the competitive market, especially the domestic sector. Furthermore the UR will be shortly publishing a roadmap which will outline the way forward regarding issues such as the treatment of NIEES over and under recoveries. This work may impact the UR decisions on the form of a longer term NIEES price control. Hence, it is pragmatic to set a one year control that can be amended in 2011 after decisions regarding the roadmap have been taken.

It is anticipated that the longer term price control will be set in the next review and will take effect from April 2011.

# The Price Control and Tariffs

The allowed unit price of electricity (M) is made up of a number of components:

$$M_t=G_t+U_t+S_t+K_t+(J_t-D_t)+E_t$$

In year $_t$,

$G_t$ refers to the cost of the electricity which NIEES purchases and so long as NIEES complies with its Economic Purchasing Obligation, this will be passed directly through to customers.

$U_t$ covers the costs of using the electricity network; these costs are regulated through the NIE Transmission and Distribution (T&D) price control.

$K_t$ is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).

$J_t$ encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the $D_t$ term representing any savings on the buy-out NIEES achieves.

$E_t$ is associated with costs arising from implementation of the Single Electricity Market (SEM) and European Directive concerning the internal market for electricity including retail market opening, along with uncontrollable costs which are passed through to customers on a 100% basis. These latter costs include licence fees, NI2007 establishment costs and past pensions deficit. This will be amended to allow for the pass through of the costs of domestic competition. These costs will need to be agreed with the authority in advance.

It is the case therefore that apart form St NIE Energy Supply's costs are straight pass-through costs which are subject to other price controls or regulations and thus, this price control review deals principally with the $S_t$ term of the tariff formula which is in effect NIEES' own operating costs and margin allowed by the regulator. This amount must be sufficient to finance an efficient business and would normally comprise:

| Operating costs |
|---|
| Capital expenditure |
| Depreciation |
| Return on assets/ Profit margin |

The St allowed revenue is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%).

NIEES currently has minimal assets and therefore a return on assets for investors is not a consideration within the allowed revenue. There are no plans for the current price control duration to formulate a Regulatory Asset Base (RAB) based on capital expenditure (however, this will change after NIEES completes Stage 3 of the Enduring Solution Project) and thus the St allowed revenue will consist only of operating costs plus a margin (forecast depreciation amounts are residual due to the transfer of Keypad metering to the Transmission and Distribution business).

# Approach

The Utility Regulator instigated the price control discussions with a meeting with NIEES on 18th September 2009. A further series of meetings took place on the 30th September (this meeting included CCNI), 19th October, 3rd November, 9th November and 11th December 2009.

In the interim period between 19th September and 11th December information requests were made to NIEES. NIEES also submitted a paper on 16th October detailing their proposals. Information requested included the actual operating cost figures for 2008/09 and various other submissions relating to specific operating cost lines. The data provided was examined and analysis carried out to determine the variance between allowed operating expenditure and actual outturn. Based on the data provided and analysis carried out the Utility Regulator formulated a number of proposals, which were discussed with NIEES. On the basis of these proposals NIEES provided further analysis and detail of forecast cost pressures for 2010/11.Following receipt of this information the UR published a consultation paper on 21st January 2010.

In the consultation paper the UR stated that they had requested an LBE from NIEES for 2009/10 and that receipt of this LBE would impact upon the proposals for Operating Expenditure.

The UR held two further meetings with NIEES during the consultation period and a meeting on 1st March 2010, after the consultation period had closed.

# Proposals
## Form and Scope

The consultation paper proposed that the current form and scope of the price control should continue including the K factor which allows for NIEES under and over recoveries in any given tariff year to be folded into subsequent tariff years.

However, NIEES proposed further deregulation. This would include approximately 3,000[1] additional sites which would consume in total a similar volume of units to the customer grouping which was deregulated on 1 April 2009. The previous category which was deregulated included non-domestic customers with annual consumption greater than 150 MWh. The new criteria covering both the first phase of deregulation and the new proposed phase would be:

a. Individual sites consuming > 150 MWhs per annum; or
b. Group entities where their collective sites would consume in aggregate more than 150 MWhs per annum.

The consultation stated that the current form of the price control should remain the same for the period (including the K Factor) as well as the scope with the possible exception for the proposed new traunch of deregulated customers.

A number of respondents commented on the potential further deregulation.

Firmus stated in their response that they did not agree with further deregulation due to the lack of competition in the residential sector. They felt that it could hamper further competition. In addition to this, they also stated that there should be further clarification regarding the customer group this would impact in terms of customer number and type.

ESB stated that the price control and the consideration for further deregulation should be treated as two separate issues. They also expressed the opinion that this proposed further deregulation was too soon after the previous traunch. ESB have a strong view that in the absence of a 'Roadmap' approach to further deregulation they would not be in favour of this partial deregulation. They also highlighted that the Roadmap should include the impact of the previous deregulation. ESB expressed the opinion that consideration should be given to a similar approach as that in the ROI with the CER Roadmap. This approach included SEM committee involvement in terms of the proposals for future deregulation.

### Utility Regulator Decision

The potential for further deregulation will form part of a separate consultation. The timing of this consultation has yet to be decided.

## Duration

[1] NIEES sites only. Does not include sites that are already with other suppliers.

The Utility Regulator recognises that there is an essential requirement for a longer term price control to be put in place. This review should commence in early 2010 and put in place a multi-year control (exact duration to be confirmed) beginning in April 2011. This review would examine, in detail, both the operating expenditure and margin of NIEES. It should also take account of best practice and benchmark against relevant industry standards.

However, due to the finalisation of the workstreams such as K factor, tariff structure and the development of Roadmap, which will have an impact on the NIEES price control, this proposal is for a one year price control running from 1 April 2010 until March 2011.

NIEES, in their response, refer to this control as a one year extension to the previous 2009/10 control. It should be reiterated that this is not an extension but in fact a further one year control.

The Consumer Council Northern Ireland (CCNI) agreed with the UR view that there is a requirement for a longer term review. However, given the current circumstances a one year control is the most appropriate course at this time.

### Utility Regulator Decision

Due to the ongoing workstreams outlined above the UR takes the view that a duration of one year is prudent under these circumstances. This is with the assumption that a review into a longer term control will start early this year with the aim of setting a price control (duration to be determined).

## Operating Costs

The consultation paper proposed to allow an operating expenditure at the level of the 08/09 actual out turn costs. This proposal was made in the absence of the latest best estimate for 09/10. There were significant recurring efficiencies made and as such these were reflected in the new proposal for the 2010/11 Supply price control.

Thus, the UR proposed to use the last set of actual outturn figures for accuracy. This would have resulted in a reduction in allowed operating expenditure to the 2008/09 actual figures, being £17.858m.

However, the consultation paper stipulated that any other actual, or latest best estimate information pertaining to the current year which were received in the consultation period would be taken into account as part of this price control process.

NIEES subsequently provided the latest best estimate (LBE) for 09/10 and the forecast of expected costs for 10/11. Based on this, the UR view is that the previous proposal is now no longer relevant. The decision will be based on the most recent up to date information.

In their response to the consultation NIEES identified new cost pressures they could expect in 2010/11 regarding competition (switching or churn costs including changing customer details, communicating with them, issuing additional bills etc.), current service pension cost and bad debt. They stated that the NIEES gross margin, as a percentage of turnover, is much less than that of comparable electricity and gas suppliers in GB and Ireland. NIEES stated that NIAUR dismissed the additional costs they identified and felt that the proposals gave inadequate weight to the likelihood of operating cost rises, the existence of significant risks of economic loss and the need to provide appropriate shares of the benefits of cost savings between customers and shareholders.

In terms of the incentive to achieve efficiencies NIEES stated that the series of short term price controls mean that very little of the saving is passed through to the company and as a result gives little incentive to the company to cut costs. They felt that certain efficiencies, which had been achieved only recently, should not be passed on in this price control.

NIEES expressed the opinion that the operating cost allowance should remain unchanged (from the 2009/10 allowance)

The CCNI agreed with the UR proposal that the operating expenditure should be reduced from the £19.25 million set at the last price control.

## Utility Regulator Decision

The UR acknowledges the argument that NIEES have laid out in relation to a series of short price controls. In theory we agree that one year price controls may stifle the incentive to make cost savings. However, it is noted that efficiencies have still been made in the last two controls and the business does have a incentive to make these, albeit somewhat diluted, in that the savings are retained by the company.

When analysing the potential efficiencies, NIAUR did not make an assumption in terms of productivity growth. The efficiencies were with specific regard to the six months of efficiency realised in the financial year 08/09 in relation to the in-sourcing exercise. It was assumed that in 09/10 there would be a full 12 month realisation of this efficiency. The proposal for operating expenditure in the consultation took account only of the 6 months efficiency actually realised in the financial year 08/09 rather than taking account of a full 12 months (i.e. full year effect) we would have expected for 09/10. It was assumed that as there would be a full year effect of the outsourcing efficiency this should cover any additional cost pressures (those submitted by NIEES).

As stated above NIEES has, since the publication of the consultation, submitted the most up to date information in terms of their costs. The table below shows the latest best estimate for 2009/10 and the forecast for 2010/11.

**Table 1.1**
Table showing the comparison between the LBE for 09/10 and the forecast for 10/11

| | 2009/10 Estimate (09/10 Prices) £m | 2010/2011 Forecast (09/10 Prices) £m |
|---|---|---|
| Salaries | 4,224 | 4,534 |
| Materials and Bought in Services | 5,403 | 5,733 |
| Bad Debts | 2,984 | 2,812 |
| Outsourced Service Delivery | 3,297 | 2,929 |
| Corporate Charges | 1,093 | 1,039 |
| Costs of Domestic Competition | 0 | 2,491 |
| Depreciation | 12 | 61 |
| **Regulated Operating Costs** | **17,013** | **19,599** |

*Source: NIEES*

In the interim between receipt of the latest cost estimates and the decision paper, we have undergone an iterative process with NIEES to understand the rationale behind these cost forecasts.

Any increases in forecast cost lines from 09/10 levels have been explained and agreed as reasonable. The two increases are related to salaries and materials and bought in services. The UR has agreed the need for extra staff to deal with increased levels of bad debt. Furthermore, there is an increased current service pension cost related to the poor performance of financial markets. The extra staff will be utilised in the future on call handling related to competitive activity in the domestic sector. The materials and bought in service increase is due in large part to an increase in agency costs related to keypad payment transactions. The number of transactions is set to increase due to an increased number of keypad installations as a consequence of greater debt management activity.

Having examined each category of costs we are minded to allow all of the forecast costs except for the cost of competition (amounting to £17,108).

With regard to the forecast cost of competition, this figure was derived from a report by NERA[2] which cites a competition cost of £16 per customer based on a competition rate of 45%. This makes the assumption that there will be a cost across all customers and not only those customers switching. NIEES used this as a basis for their assumption of the costs of competition to the business, resulting in a £3.20 charge per customer for competition across the entire customer base (£16/45 x100 x 9% = £3.20).

NERA, in their paper, provide a definition of the cost of competition. However, the paper gives no detailed analysis of where the £16 per customer has been derived from in terms of quantitative analysis:

[2] NERA report can be found at http://www.energy-retail.org.uk/media/press/documents/NERAAnalysisofEnergySuppliersMargins07.12.09.pdf

*"Suppliers incur costs to compete for customers, i.e., when they approach customers by telephone or in person, arrange a new contract, register a new customer, and transfer details from the previous supplier. When they lose the customer to another supplier, they also incur costs to terminate the contract and to transfer the customer to the new supplier".*

With regard to the costs of competition the UR will consider these as a pass-through cost if they are required. The UR will consider reasonable costs of competition throughout the term of the price control. These will, however, need to be agreed in advance with the UR. In addition to this, NIEES will need to produce evidence that the costs are necessarily incurred. Our view on the current NIEES estimate for the cost of competition is that it is arbitrary and relates to a per customer figure set in a very different market. It is also the case that the timing and activity levels of any emergent competition in the domestic sector in Northern Ireland are as yet unknown. It is possible, for instance, that entry by a supplier could be delayed until the price control was almost over or that the level of market activity could be very slight. At this stage the UR has no empirical evidence to go on as we have as yet never seen domestic competition. It seems prudent therefore for the next year at least to treat any extra costs of competition on an ad hoc and pass through basis.

The additional cost pressures identified by NIEES in December[3] have mostly been included in the forecasts for 2010/11. Included in the salaries forecast is an assumption that seven additional staff will be employed. It is our view that, whilst these staff have been identified for debt management and additional call handling, we expect that in line with the NIEES December submission[4] they will be redeployed for activities relating to increased competition. NIEES stated:

*"These staff will be used primarily to handle additional billing inquiries (ie contact centre), and increased debt activity (ie debt management agents). We would envisage some of this recession related debt work easing over time, however, these people would then be deployed in handling additional calls and debt activity that would be a product of competition in the domestic sector".*

In deciding the operating cost allowance the UR had to consider one final issue regarding efficiency. NIEES had achieved an efficiency midway through 2009/10 and the UR needed to consider if this should be retained by the business for 2010/11. NIEES prepared a submission detailing the efficiencies made in 09/10 (which are included in the 10/11 forecast). The expected efficiency amounts to £484,097 (full year affect). After discussion with NIEES and internally, it was recognised that if the allowed Operating Expenditure was set at £17.108m this would take back all efficiencies made in the year 09/10. This would result in NIIEES only being allowed to retain the efficiencies for a 6 month period. It was agreed internally that this was not in line with regulatory best practice to encourage efficiency by allowing the regulated business to retain them for a reasonable period.

[3] NIEES submission of 15th December 2009
[4] NIEES submission of 15th December 2009

Therefore, based on this the UR's decision is to allow an Operating Expenditure of £17.592m (being total proposed operating costs of £19,599m less Competition Costs of £2,491 plus the 09/10 efficiency of £0.484 million). This is with the view to allowing direct costs of competition, as they occur (and as are deemed reasonable and justifiable) through a pass through term i.e. the Et. The UR feels that this is the most transparent and fair way of authorising expenditure on competition costs.

# Margin

The consultation paper set out the issues highlighted by NIEES during the iterative process carried out before publication of the consultation paper. NIEES highlighted to the UR the enhanced working capital pressures due to SEM arrangements as an issue that should require some recognition in terms of the quantum of the Margin. However, this issue of extra working capital commitment due to the step change in payment timings brought about by the formation of SEM was dealt with by the UR when setting the 09/10 control. The analysis carried out of the "swing" in financing costs from £1M income in 07/08 to £3.1M cost in 08/09 resulted in a change in the regulated margin from c.1.5% of turnover to c.1.7% of turnover (these percentages are not exact because under the present form of control the UR sets a margin figure based on NIEES forecast turnover. The margin figure remains as set regardless of whether actual turnover is higher or lower than forecast). As stated however, this increase in net margin of c.0.2% of turnover from the previous price control has taken account of the step change in working capital commitment due to the creation of SEM. The margin of c.1.7% of turnover compares to 1.3% for ESB Customer Supply (a supplier operating in the SEM) and 1.5% for Phoenix Supply (which also has a penalised 'K' factor regime more restrictive that NIEES).

With this in mind, the UR proposed that the current margin figure should remain constant for the 10/11 price control i.e. £10.49M (09/10 prices) in recognition of the fact the figure was set only 10 months ago and this price control is for one year only. The UR also put forward a proposal for the 10/11 control for the margin to be calculated as 1.7% of actual turnover. This method would ensure that the net margin of the business fluctuates with overall turnover and allows a higher margin amount in times of higher turnover. This greater amount can be used to offset the larger working capital commitment associated with a larger turnover. In like manner the margin amount falls as turnover falls.

In their response, NIEES stated that they do not agree with the method by which NIAUR set the price control. They challenged both the cost forecast and the margin proposed by NIAUR. They also stated that they were of the opinion that NIAUR should set the price control using one of following methods:

- The level that would be charged by competitive entrants, which would both encourage competition as well as leave sufficient headroom for it to be profitable
- The level that recovers a revenue that is comparable to that recovered by similar organisations (e.g. ESB CS allowed revenues) in other jurisdiction, which

introduces "comparative competition" and incentivises efficiency by enabling an efficient company to keep part of the savings produced.

NIEES highlighted, that in their opinion, there were a number of risks which meant that a margin of 1.7% or £10.49M is no longer adequate given the size and asymmetry of the risks and working capital costs. NIEES identified risks in terms of generation costs, resulting in an expected cost or loss to NIEES. In addition to this, they expressed the opinion that they were exposed to competition risks meaning that under-recoveries are increasingly unlikely to be totally recovered in later years while the operation of the price control means that over-recoveries must be returned. They sited the experience of ESB in the ROI and stated that the "potential sums dwarf NIEES margin. Such a one-sided risk warrants a much larger figure". In summary, NIEES proposed that the net margin should be set at 2% of turnover. If we assume turnover for 2010/11 as circa £600M this equates to a figure of circa £12 million.

NIEES also reiterated their concerns in relation to working capital and the fact the timing of payments has changed increasing the working capital pressures.

NIEES stated that with the proposed margin there was little 'headroom' for competition. NIEES also compared their gross margin of 5.3% to that of ESB which is 8.5% and GB, where Ofgem found gross margins were as high as 18.4%. However, they did indicate that they would prefer a fixed margin as opposed to one that was calculated as 1.7% of turnover, so as to provide less uncertainty.

Phoenix Supply Limited noted that the proposal for the margin to be set at 1.7% of actual turnover wasn't high enough. They stated that the margin should be upwards of 5% post tax in line with other suppliers in GB. Firmus also stated that they felt a margin of 1.7% was too low and would prevent new entrants into the market. They also added that the combination of the 'K' factor safety net of the incumbent also prevented new market entry.

In their response, the CCNI supported the margin being kept the same as the previous price control. They also supported the proposed methodology of setting the margin as 1.7% of actual turnover for future controls, stating that this would avoid the risk of over or indeed under estimating the required margin.

## Utility Regulator Decision

The UR does not agree with the 'headroom' argument and we fully expect that new entry into the market is imminent. However, we believe that ***full*** competitive entry is not an issue at present due to the constraints on the switching system in Northern Ireland. For the duration of this one year control it is deemed that only 9% switching of customers is possible at this stage (based on the maximum switching capability of 6,000 per month). This is a one year price control and these elements will all be considered in greater detail as part of the longer term review – due to start over the next few months.

As previously stated the change in SEM payment timing was an issue at the last price control and was taken account of then – the base was reset. This price control (with the allowances to recognise the additional working capital pressures) was accepted by both the UR and NIEES and as such we feel that there is no requirement to recognise this as a separate issue in the setting of this price control.

In terms of the gross margin versus net margin argument, the UR takes the standard regulatory approach and sets a net margin that is appropriate. Given the market NIEES operates in and the other local benchmarks NIAUR believe that the 1.7% margin is adequate. We would specifically highlight that ESB has a net margin of 1.3% and that Phoenix operates with a margin of 1.5%. Based on these benchmarks it would appear that this margin is adequate.

In relation to our overall policy for headroom, the UR is not minded to increase this in advance of more evidence that it is actually required to stimulate competition. We feel this would not be a prudent use of customer money. We would also point to the experience of the ROI where an increase to headroom wasn't required for entry into the market.

Based on the analysis above, the UR has decided to keep the margin as proposed in the consultation. This will result in a fixed allowed margin for the price control of £10.491 million. This equates to c.1.7% margin on an assumed turnover of circa £600M as opposed to the NIEES proposal of £12M or a 2% margin. However, it is likely that in the longer term price control from 2011 onwards it will move to a floating margin i.e. calculated as a percentage of actual turnover. This methodology is consistent with UK regulatory precedent and the Phoenix Supply price control set by the UR. It also removes the uncertainty around setting a net margin based on a forecast rather than actual turnover.

# Allowed Revenue ($S_t$)

## Total Allowed Revenue

The allowed revenue figure is the total of operating costs and the allowed margin:

| | **2010/11** | **2010/11** |
|---|---|---|
| | **NIEES Proposal** | **UR Decision** |
| | **£m** | **£m** |
| Total Operating Costs | 19.599 | 17.592 |
| Net Margin | 12.000 | 10.491 |
| **Total $S_t$** | **£31.599m** | **£28.083m** |

## Fixed: Variable Ratio

The ratio of fixed to customer variable proportions of the Allowed St Revenue is proposed by NIEES to remain at 67:33 unchanged from the current price control.

No respondents commented on this.

### Utility Regulator Decision

The UR is content to accept this proposal and continue with the current fixed:variable ratio 67:33.

# Next Steps

A response by NIEES to this Decision Paper is due no later than Friday 2nd April 2010. A licence modification process to implement the new price control for the period 1 April 2010 – 31 March 2011 will follow.

NIEES should send their response to Nicola Sweeney at nicola.sweeney@niaur.gov.uk